South –East Asian Crisis- An Important Lesson for the Global Economy

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Introduction

Crises are an intrinsic feature of the market–oriented credit and financial system. Business cycles showing periods of boom and bust will continue to occur, only the intensity shall matter. An unprecedented crisis that erupted in five Asian economies: Indonesia, Malaysia, the Phillipines, the Republic of Korea and Thailand, in mid 1997-1998 raised concern about the stability of the "Global Financial Architecture." The clear evidence emerged of a rapid and unsustainable buildup of investment in fixed assets financed by excessive borrowing. This investment-spending spree resulted in poor profitability, reflected in low and declining returns on equity and on capital employed. The severity of the crisis in the Asian region was so great that some other countries in the world – Brazil and Russia, in particular also got affected by the contagion.

The financial crisis in South East Asia differs in important ways from previous crisis in the developing world. Unlike the Latin American debt crisis of the 1980's the roots of this turmoil were in the private sector, not public sector, borrowing. Most of the afflicted countries had run budget surpluses or minimal budget deficits in recent years. At the same time, private sector borrowing increased heavily, especially from abroad and especially- short run. For instance, loans to Thai corporations from international banks doubled from 1988 to 1994. By 1997, Thai foreign debt stood at $89 billion- four-fifths of which was owned by private corporations. But most disturbingly, one-half of the debt was short-term, falling due inside a year.

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It is noteworthy that a few countries escaped the contagion by demonstrating that correct macro-economic policies do protect the financial and economic health of the economies concerned. For instance, Taiwan, Singapore, Australia and New-Zealand showed that improvements in accountability of the domestic institutions, transparency of financial operations and a better monitoring of financial system would insulate them from the repercussions of the crisis affecting even the neighbouring and closely linked economies. Two other major economic giants, China and India, also escaped it primarily on account of the cautious step they took in handling the business of Capital Account Convertibility.

Reasons

In the language of economists, the crisis is a story of market failure. Southeast Asian capital markets failed in three critical ways. **First**, too much capital rushed in. Lured by the prospect of continued double digit growth and searching for new places to invest its overflowing coffers, financial capital continued to flow in the real estate sectors of these economies even when financial instability was widespread and obvious to all. **Second**, the capital markets and the banking system could not channel these funds into productive uses. Too much money went into real estate and too little went into productive investments likely to sustain the export boom. **Third**, too much capital rushed out, too quickly. The excessive inflow of capital reversed itself and fled with little regard for the actual strength of a particular economy.

Capital Inflows:

The 1990-1996 period is known as a period for capital market financial flows to the emerging market economies. All the economic and financial crisis of the 1990's preceded by large capital inflows into the economies. Many emerging market economies were transformed from near financial autarkies to globally integrated ones.

In addition, institutional investors in the industrial economies, in an attempt to diversify their portfolios and increase the rate of return, became increasingly inclined to invest in the emerging market economies. These developments in the global capital markets substantially improved access of the emerging market Asian economies to the pool of global savings. However the flip side of the coin is that a spurt in capital inflows during 1990's has been identified by some as one of the causal factors behind the recent woes of the Asian economies. (IMF, 1998)

In the five crisis- stricken Asian economies- Indonesia, Malaysia, the Phillipines, the Republic of Korea and Thailand - the rise in capital inflows resulted in historically large external deficits, which reflected the excess of investment spending over domestic savings. These deficits were $41 billion in 1995 and $55 billion in 1996. As a proportion of the GDP of the five crises affected economies, the level of deficits were respectively 4 percent in 1995 and 4.9 percent for 1996, which is high by international standards.

As foreign investors reassessed their financial exposure to Asia in 1997, they began to withdraw and the current account deficits of the same set of five economies fell to $27 billion (or 2.6 percent of GDP) in 1997. Financial flows recorded a reversal in 1998 and the deficit turned into a surplus. (IIF, 1998)

Short – Term Capital Inflows:

There is convincing historical evidence that short-term capital movements contribute to volatility in financial markets, which in turn leads to macro-economic instability. The Asian crisis has demonstrated that lenders and borrowers both perceive an exchange rate peg as a link in the chain of implicit guarantees. Under these circumstances, the high nominal interest rates characteristics of emerging markets can and did, lead to large short-term capital inflows.

Capital Account Liberalization:

Financial liberalization, including capital account liberalization, is essential for any economy seeking to benefit from broad participation in the global economy. During the 1980s and 1990s, not only were restrictions on international financial transactions relaxed, but regulations constraining the operation of domestic financial markets were also relaxed or removed. Several Asian economies, including the five crisis-stricken ones, promptly 3 liberalized their financial sector. Although a direct link between financial liberalization and financial crisis may not be seen, in a substantive number of cases financial liberalization seems to have pushed the economies towards costly financial crises. Balanced and sequenced liberalization is the only way to ensure maximum protection from financial crisis, because the lifting of controls over capital flows can lead to such alarming results as an economy accumulating a huge amount of foreign debt within a few years, followed by a stampede of foreign-owned and locally owned funds exiting the country within only a few months. This in turn prepares the grounds for systemic disturbances.

Banking and Financial Sector:

A major feature of the Asian crisis is that banks were the principal international creditors and private sector entities as the principal debtors. One of the major elements underlying the Asian crisis was serious weaknesses in the banking and financial sector of the debtor Asian economies. The Asian crisis – and experiences in its aftermath – has brought to the fore the chaotic conditions generated by bank runs within the context of a domestic financial system. That is not to say that international banks and creditors were flawless and that they did not commit excesses or miscalculations. The poor banking supervision led to poor credit decisions in the banking system and thus the misallocation of resources.

Exchange Rate Regime:

The emerging market Asian economies during their liberalization phase experienced large booms in investment and consumption. Liberalizing economies are expected to experience such booms. The booms that preceded the crisis were not choked off by an appreciating exchange rate, precisely because of the exchange rate peg. One of the consequences of these booms was cost increases, which rendered the export sectors increasingly uncompetitive.

Pegged exchange rates can encourage excessive borrowing and expose countries to financial collapse when foreign exchange reserves run dry.

Corporate Governance:

It refers to the complex process of how a firm is managed and operated, who it is accountable to, and how it reacts to changing business conditions. Many firms operating within Far Eastern business environments were largely controlled by either families or groups related to the governing party of the country. The interests of stockholders and creditors were often secondary at best to the primary motivations of corporate management. Without focusing on the "bottom line" the bottom line deteriorated.

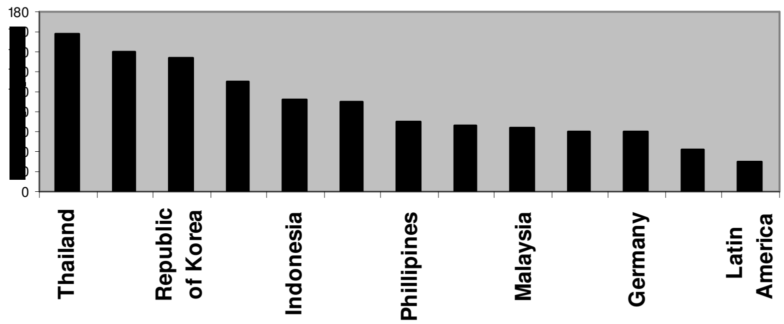
Financial Analysis:

i) Debt-equity ratio:

The debt-equity ratio—a company's debt divided by shareholder equity—indicates a company's leverage—how much borrowed money the company is using relative to its equity. Data for December 31, 1996, show that Korean and Thai companies generally had high debt-equity ratios (around 150 percent), while those in Hong Kong, the Phillipines, and Taiwan(China) had moderate ratios.

Latin American, German, and U.S. companies had modest debt-equity ratios (90 percent) in the United States.

Exhibit-1
Average Corporate Leverage,1996

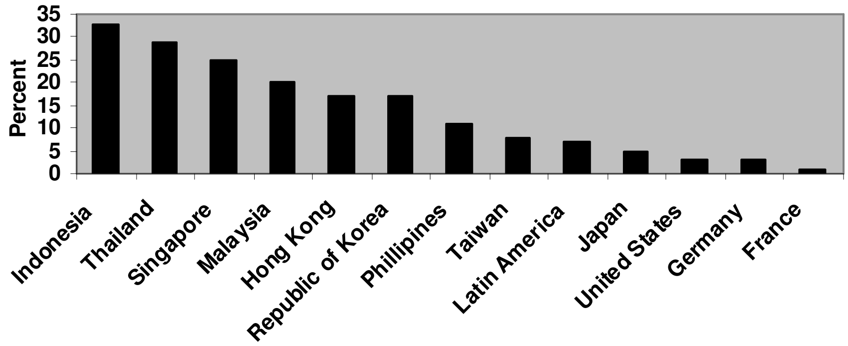


Source: World bank staff calculations based on the Financial Times Information's Extel database

ii) Growth of tangible fixed assets:

The average change in tangible fixed assets during 1992-1996 was 33 percent in Indonesia, 29 percent in Thailand, 20 percent in Malaysia. This rapid growth is in stark contrast with more moderate pattern in Hong Kong (17 percent) and in the industrial countries (1 to 5 percent). These findings evidence the untenable business growth in Asian economies. No well-managed company (with the possible exception of software companies) can prudently absorb annual growth of 30 to 40 percent. Such rapid growth would overwhelm managerial capacity and distribution and marketing channels.

Exhibit-2
Average Change in Tangible Fixed Assets,1992-96



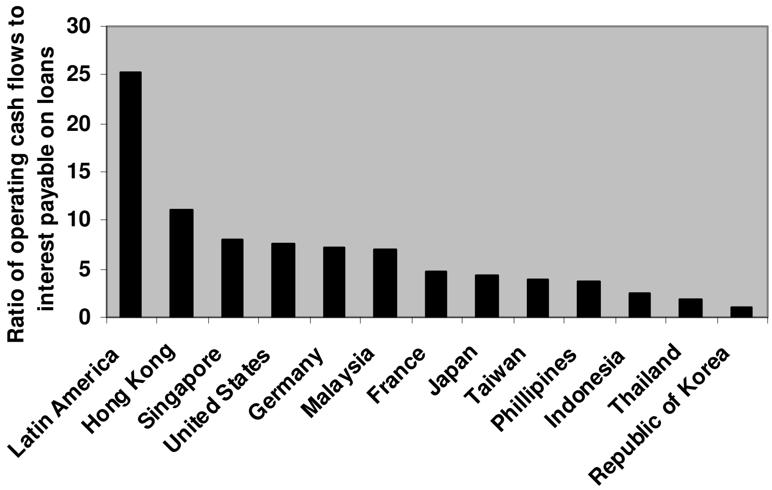
Source:World Bank staff calculations based on the Financial Times Information's Extel database

iii) Debt sustainability:

Debt sustainability can be calculated by the ratio of companies' operating cash flows (operating income before interest, taxes and depreciation) to their annual interest payments on loans or their debt service (principal plus interest payments). This ratio indicates companies' ability to cover interest payments or debt service on their outstanding loans.

The interest coverage ratio in Thailand declined from 4.6 in 1992 to 1.92 in 1996 as an increasing debt-equity ratio led to a rise in interest expense. The ratios in other vulnerable Asian countries were similar: 2.44 in Indonesia in 1996 and 1.07 in Korea in 1995. Corporations in Hong Kong, Malaysia and Taiwan (China) are more robust. Also quite robust are those in Latin America (25.36 in 1996) and in some industrial countries-the United States (7.62), Germany (7.09), France (4.75), and Japan (4.31)

Exhibit-3
Average Interest Coverage Ratio,1996



Source: World Bank staff calculations based on the Financial Times Information's Extel database

iv) Return on Capital Employed:

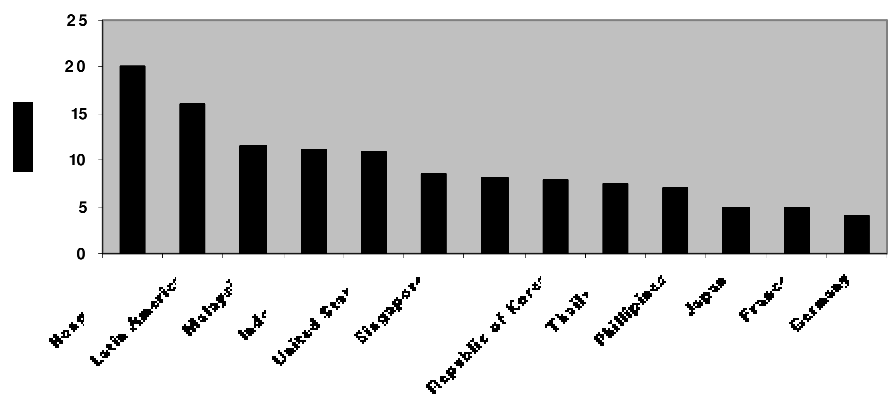
Return on capital employed or on assets (before taxes) captures the efficiency with which a company uses all its capital resources. Analysis of this ratio permits comparison of businesses regardless of differences in accounting conventions (for example, with regard to depreciation) or capital mobilization and financing strategies, because the operating profit is viewed in relation to the total funds employed.

Pomerleano (1999) computed the ROCE for several developing and developed economies for the period 1992–1996, and inferred that most Asian economies had underdeveloped capital markets because they relied heavily on bank financing. Except for Hong Kong (China), all of them had poor ROCE.

The study's results show a solid 20 percent average return on capital employed in Hong Kong in 1992–96 (?). The ratio for Indonesia, at 11 percent, is good in absolute terms (though overshadowed by domestic interest rates of 15 to 18 percent). The results for Korea, Malaysia, the Philippines, Taiwan (China), Latin America, and the industrial countries (France, Germany, Japan, and the United States) reflect large differences in average return on capital during 1992–96. While the average return in the United States was 11 percent, in Korea it was 8 percent.

Latin America's reasonable return on capital of 16 percent masks high inflation rates. The average return in some industrial countries—such as the 5 percent in France and Japan and the 4 percent in Germany—was surprisingly paltry. The study's analysis of the return on capital employed in Thailand, supplemented by the debt-equity ratio, suggests that it was no accident that the East Asian crisis first erupted in Thailand. Measures of financial risk show that Thailand was an outlier in every regard. The performance of Thai companies progressively deteriorated during 1992–96: credit ratios declined, margins were squeezed, and return on equity declined significantly, from 13 percent in 1992 to 5 percent in 1996.

Exhibit-4
Average Return On Capital Employed, Before Taxes, 1992-96



Source: World Bank staff calculations based on the Financial Times Information's Extel database

v) Economic value added:

To examine opportunity costs of capital the study applied the concept of shareholder economic value added. This indicator compares the reported profitability of a corporation—the measured return on capital employed—with the cost of capital, defined as the interest rate (figure 5). The study's results show that only for Hong Kong, Japan, Malaysia, Singapore, and the United States did the return on capital employed consistently exceed the cost of capital during 1992–96—and except for Hong Kong, not by a significant margin. But there are significant inter temporal differences for countries: declining trends in economic value added in Thailand highlight the economy's deterioration. Japan's positive economic value added is attributable largely to the country's low prevailing interest rates rather than a high return on capital employed. By contrast, the analysis suggests that the negative economic value added in Indonesia is explained by the high prevailing domestic interest rates.

Implications

What are the implications of these financial indicator levels for Asian corporations? This analysis shows that corporations suffered significant damage as a result of high debt-equity ratios in a context of rising interest rates and a worsening economic environment, coupled with exposure to unhedged foreign currency loans. A large number of Asian corporations have become insolvent.

The findings of this crisis lead to several conclusions. First, business practices in some Asian countries reflect a lack of financial discipline and, to a lesser extent, of operational discipline. The investment-spending spree contributed to the erosion of profit margins and to poor financial performance, reflected in declining and low returns on equity and on capital employed. By contrast, corporations in Hong Kong, Malaysia, and Taiwan (China) pursued prudent financial practices.

Second, the large differences in economic value added among the study countries lead to the conclusion that Asian corporations have not adopted global standards on creating shareholder value. In an era of increasing capital mobility, when capital can rapidly arbitrage differences in rates of return, disparities in underlying returns on equity and on capital employed probably are not sustainable in the long run. To ensure availability of equity capital and improved equity market performance, corporations need to demonstrate to investors that they can sustain solid performance in economic value added.

Third, the poor operating and financial performance in the crisis countries relative to that in other countries suggests a need for systemic corporate restructuring. A restructuring process needs to reflect a readiness to address insolvent corporations through court-supervised reorganization or bankruptcy, promotion of voluntary restructuring of distressed and illiquid— but operationally viable—corporations through debt-equity swaps, and assurance of the liquidity needed during the workout process through provision for debtor-in-possession financing. A restructuring process must also recognize that some corporations might not be salvageable.

Indeed, Asia's high-debt, high-risk model of economic development is a direct result of the savings intermediation process in the region's economies. Asia's high corporate leverage contrasts with that in countries with slower growth and more balanced financial systems, including well-developed equity and bond markets.

Most of the study countries with poor return on capital employed have underdeveloped capital markets. Asia's bond markets, for example, are less than 20 percent of regional GDP, small in comparison with developed bond markets such as that in the United States, which is more than 100 percent of GDP. Comparative statistics on financial sector development suggest that, in general, Asian economies have exhibited overdependence on the banking sector and under reliance on capital markets. The key ingredients for successful capital markets—transparency, corporate accountability and governance, and proper risk pricing through the transmission of market signals—have been lacking.

Finally, it is interesting to note that established, long-term relationships between companies and banks turned debt into quasi-equity (the proverbial Asian "evergreens"). But such relationships allowed lax credit approval processes, often without reference to projects' viability and possibly based on political connections.

The study's findings suggest that the lack of financial and institutional discipline—coupled with the financial sector liberalization in some countries and the imposition of market discipline (including the lifting of interest rate controls) in an environment without an adequate prudential framework—is a plausible explanation of the mix of currency, corporate, and banking crises confronting the region.

Indian Scenario

First, on the fiscal front, India remains far from ideal conditions. The average growth rate of almost 8% during 2003-04 to 2005-06 has led to increased tax revenues and some reduction in the deficit but not nearly enough. Moreover, we can scarcely be sure that the deficit will not return to the higher level if the GDP growth rate and therefore tax revenue growth revert to the previous trend as happened after 1996-97.

With interest payments on the debt amounting to more than 6% of the GDP, gross fiscal deficit of 8% and debt-to-GDP ratio of more than 90%, convertibility is bound to leave India vulnerable to a crisis. One hazard is that the government itself would be tempted to turn to lower-interest short-term external debt to finance its deficits and debt. Third, the financial sector is still insufficiently developed in India. Banks are predominantly in the public sector and credit markets relatively shallow. Insurance has barely been opened to the private sector with the foreign investment in it capped at 26%.

The debt and equity markets are thin and dominated by public sector FIs and FIIs. Because the Indian debt and equity markets are tiny in relation to the worldwide stakes of the FIIs, any time the latter begin to exit the Indian market, the financial markets go into turmoil. Because few FIIs have the incentive to carefully gather detailed information on the future profitability of various firms, such exits are characterised by herd behaviour.

Further, India is still far from fully integrated on the trade front. For this reason, ensuring a competitive exchange rate is a high priority. A move to the capital-account convertibility is bound to bring more capital inflows initially and force an appreciation of the rupee.

If the appreciation ends up being large and persistent, it could put trade integration into jeopardy. Furthermore, even if the appreciation is only temporary, convertibility could hurt export growth by making the real exchange rate more volatile.

Finally, the embrace of full capital-account convertibility can place the ongoing reforms in other areas at grave risk. In the Indian political environment, building a consensus for even most straightforward reforms such as privatisation and trade liberalisation is an uphill task. Therefore, if capital account convertibility were to culminate in a crisis or even create greater volatility in growth, the cause of reforms would be set back.

Therefore, we believe that India should be extremely cautious in liberalising capital outflows any further.

While it should leave no stone unturned to promote inward FDI, which, because of its very nature, is less susceptible to sudden withdrawals and also tends to promote productive use of capital and economic growth, it should be wary of short-term capital flows that have the potential to destabilise financial markets

The `slow and steady' stance that the RBI has taken towards capital account convertibility is to be appreciated.

It must be emphasised that only over time will the Indian economy be mature enough to be comfortable with full capital account convertibility — financial markets will deepen, macroeconomic and regulatory institutions grow more robust and the government will learn from past mistakes.

Lessons:

- Cautious management of capital inflows is a critical lesson of the Asian crisis. Emerging market economies should not allow a large build up of external debts, no matter how successful they are at exporting. In the early stages sterilization of capital inflows can be adopted but it can't continue for long periods because of its fiscal cost.

- Monetary authorities need to introduce flexible exchange rates in periods of large capital inflows to strengthen the exchange rate regime, although introducing it well before a crisis situation develops is a far superior strategy.

- Capital controls had favourable effects in several economies as they seemed to moderate the volumes of inflows and lengthen their maturities. Their application should be an exception rather than a rule. When the need arises they should be applied selectively, for a predetermined period and in a transparent manner.

- Financial and currency crisis is not likely to affect an economy which i) has a high level of forex reserves, ii) does not have close trade ties with the crisis-stricken economy, iii) has a strong banking and financial sector. Therefore, building up and carefully managing forex reserves have emerged as a high-priority policy objective.

- Although the neo-classical economic argument is that a liberal financial system is efficient, a negative feature associated with it is that it encourages economic agents to take imprudent risks, thereby raising the potential for systemic disturbances. These dangers, however, can easily be brought under control through a combination of sound macroeconomic and prudential policies. Indeed, crisis can also occur when capital accounts are restricted, but the record of the last two decades points to the possibility that the liberalization of capital accounts may heighten an economy's susceptibility to a financial crisis. Eichengreen and Musa (1998) believe that the road could be bumpy even if the process of liberalizing capital account is carried out in a carefully calibrated manner. However, learning to deal with these bumps is one of the most important steps in reforming the financial system (such as under-capitalised banks, high levels of non-performing loans and the like) are addressed before restrictions on capital account transactions are removed.

- Non-viable banks and financial institution must be weeded out of the system. The remaining ones should be restructured and put on a sound managerial and financial footing. Also, given the fact that, short-term capital inflows can cause destabilization, there is a strong case for liberalizing longer- term flows, particularly FDI, well ahead of short-term capital inflows.

- The perception by investors, both domestic and foreign, that the government implicitly guarantees the liabilities of financial intermediaries leads to poor quality risk assessment, overinvestment and crony capitalism. Creating such a misperception is a costly mistake to make. The fixed exchange rate regime failed to cope with financial globalization and the resulting rapid capital flows. It also tended to render export sectors increasingly uncompetitive. The post-crisis consensus among economists is that only the extremes of exchange rate arrangements are likely to succeed. An economy must either rigidly tie its currency to another by adopting a currency board, or it must allow its currency to float.

Thus the implications are to be analysed and lessons to be learnt so that we do not repeat the mistakes and the vulnerability of the future crisis are reduced.

"Without the strength to endure the crisis, one will not see the opportunity within. It is within the process of endurance that opportunity reveals itself."

(Chin-NingChu)

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