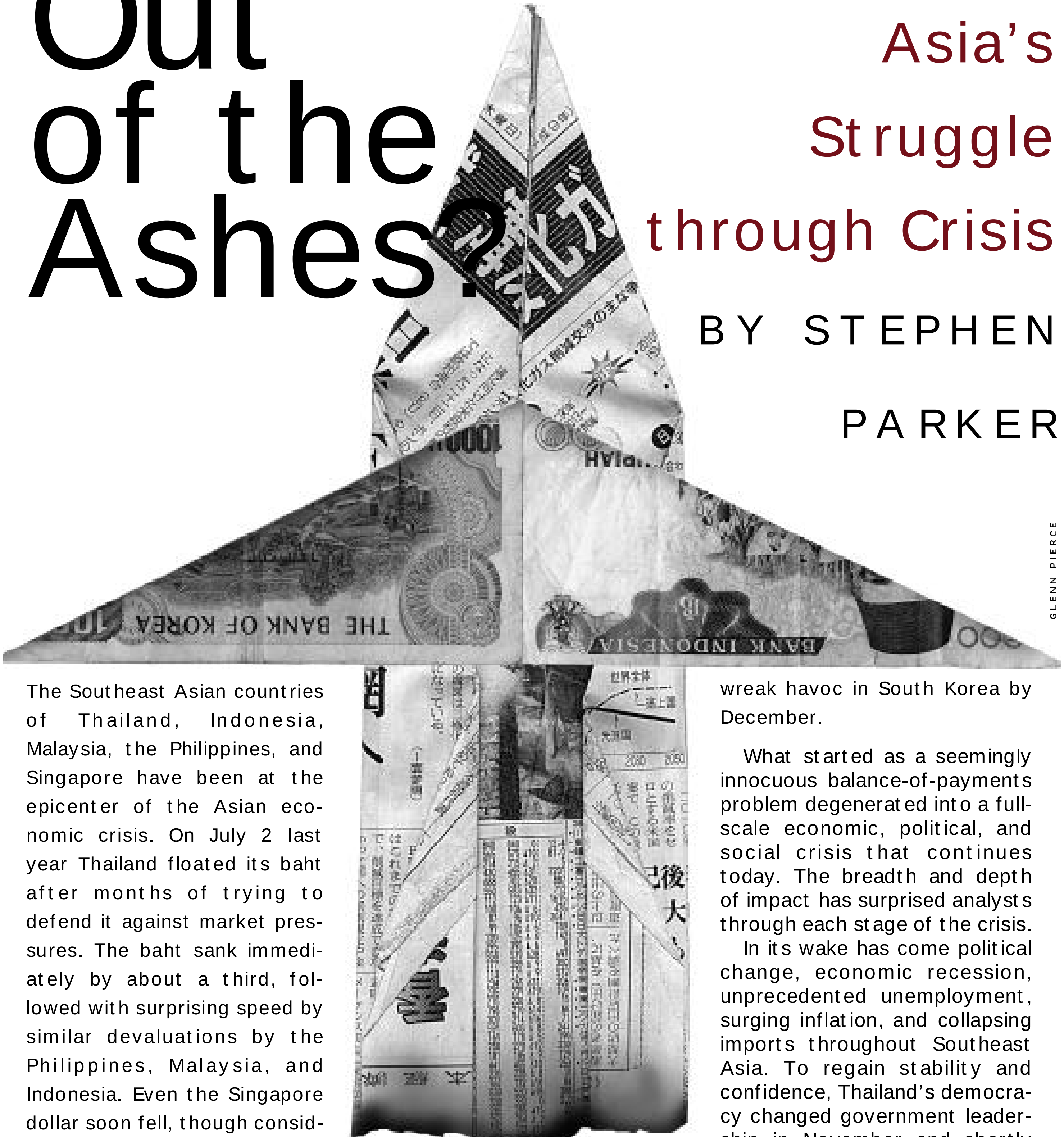
Out of the Ashes?

Southeast Asia's Struggle through Crisis

BY STEPHEN PARKER



GLENN PIERCE

The Southeast Asian countries of Thailand, Indonesia, Malaysia, the Philippines, and Singapore have been at the epicenter of the Asian economic crisis. On July 2 last year Thailand floated its baht after months of trying to defend it against market pressures. The baht sank immediately by about a third, followed with surprising speed by similar devaluations by the Philippines, Malaysia, and Indonesia. Even the Singapore dollar soon fell, though considerably less than the other currencies, and pressure on currency values spread to Northeast Asia, eventually to wreak havoc in South Korea by December.

What started as a seemingly innocuous balance-of-payments problem degenerated into a full-scale economic, political, and social crisis that continues today. The breadth and depth of impact has surprised analysts through each stage of the crisis.

In its wake has come political change, economic recession, unprecedented unemployment, surging inflation, and collapsing imports throughout Southeast Asia. To regain stability and confidence, Thailand's democracy changed government leadership in November and shortly after rewrote the constitution to increase government accountability and transparency. Although the Thai baht has

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strengthened in recent months, the realization of the extent of the economic downturn becomes more sobering with each government report, the latest predicting a recession with output falling about 6 percent for 1998.

As of this writing, Indonesia stands on the brink of systematic collapse, with the resignation of President Suharto after 32 years of leadership of the New Order Regime and the prospect of declines in output of 20–30 percent. The nation is caught in a vicious cycle—with political transition requiring time but with economic collapse adding instability.

The economic fallout on Malaysia, the Philippines, and Singapore has been less severe, largely because of their more limited foreign debt exposure. For these countries, economic growth is expected to decline by at least half, to 0–4 percent. Nevertheless, Malaysian Prime Minister Mahathir has agreed to dismantle the long-time core of his political strategy, the New Economic Policy, that provided preferences for Malay nationals relative to ethnic-Chinese nationals. The Philippines, in many ways the least affected country in Southeast Asia, faces concerns about populist President-elect Estrada's commitment to continue the successful economic reforms of the Ramos administration. Even Singapore, the most economically developed Southeast Asian country, with respected market and commercial law institutions, is struggling with lower growth and heavy financial exposure to the Indonesian debacle.

Out of this turmoil, however, one catches glimpses of a rejuvenated Southeast Asia with strengthened political and economic institutions. Although the current unraveling in Indonesia (and a weak Japanese economy) casts a pall of concern over the region, many economic forecasts expect the Southeast Asian economies to bottom out over the next six to nine months and to resume moderate economic growth in 1999. After a damaging period of reticence by governments early in the currency crisis, Thailand, Indonesia, Malaysia, and the Philippines are all now implementing a wide range of economic, regulatory, and legal policy reforms. Rather than reversing course and turning inward by increasing protection and fomenting nationalism, all have reconfirmed their commitment to outward-looking development strategies.

The complex, systematic nature of the crisis has revealed strengths and weaknesses—both economic and political— in Southeast Asia's development process. Each country, of course, is different in many ways, but each faces the challenge of adapting its distinctive domestic political and economic systems to the homogenizing forces of globalization. The rapid spread of the crisis from its core in Southeast Asia to the rest of East Asia and then to world markets emphasizes the worldwide integration of financial markets. It also reflects the inability of international and regional mechanisms to monitor and contain the contagion effects of mistakes by governments and the private sector.

What were the main causes of this crisis? What lessons does it offer? What are the implications for U.S. interests? A closer look at the evolution of the crisis yields some interesting insights.

ANATOMY OF THE CRISIS IN SOUTHEAST ASIA

Almost universally, Southeast Asians and the international community trumpeted the region's strong economic fundamentals and stable political systems leading up to, and even into, the initial stages of the crisis. After all, the Southeast Asian economies had grown in mass by close to 8 percent for decades, lifting tens of millions out of poverty and creating vibrant middle and upper classes. Southeast Asian governments and businesses had gained confidence and influence in regional and international affairs. In fact, however, the economic fundamentals were not as strong as projected in mid-1997, and they are not as weak now as they are presumed.

The region as a whole had been fighting a tendency to overheat since 1993–95. Characteristics of bubble economies were becoming increasingly apparent—prices on assets such as real estate and stock had skyrocketed; imports were growing rapidly while export growth lagged, resulting in substantial current account deficits. These deficits were financed by large inflows of foreign capital, which in turn exerted pressure to keep currency values high. Nominal currency values in the region had remained relatively stable for years, while real rates had appreciated significantly against the U.S. dollar (and even more so against the Japanese yen), lending a sense of security to investors that led many to resist spending the additional amounts needed to hedge their investments as a precaution against currency devaluation. Rapid growth and wealth generation created political environments where vested interests became increasingly virile, while East Asia's vaunted capacity to grow and to improve income distribution came into increasing question. Inflation, on the other hand, had generally declined in 1995 and 1996, reflecting conservative monetary and fiscal policies and the strong currency values.

SIGNS OF TROUBLE

Four understated weaknesses in the Southeast Asian economies stand out. First, although poorly researched even now, these economies (as did East Asia as a whole) appear to have been losing global competitiveness for at least the past several years. Their dramatic decades-long growth had depended on export growth typically in the 20–40 percent range. Most telling was the collapse in export growth between the summer of 1995 and the summer of 1996 in China, Korea, and Japan, as well as Thailand, Singapore, and the rest of Southeast Asia. Although exports rebounded a bit in 1997, they had not regained their earlier strength.

In addition, much of the region's rapid export growth in the 1990s was due to declining trade and investment barriers that encouraged greater trade in intermediate inputs among multinational production networks that now flourish in Asian economies. Although this encouraged efficiencies in production, it probably overstated growth in regional export value added. Southeast Asian firms had saturated many of their traditional export sectors such as clothing, footwear, and household electronics. They were facing increasing competition from other low-wage producers, while finding it hard to expand into new, more sophisticated export sectors. At the same time, trade liberalization, strong currencies, and rising domestic demand spurred growth in imports, which combined with weaker export growth to generate the high current account deficits.

The second weakness involved another of what many considered to be a Southeast Asian strength—the rapid inflow of foreign funds. A common view was that since the private sector was more than willing to invest (loan) funds to cover the current account deficits, then these economies must be well-managed, leveraged economies. But two trends were underappreciated. First, the composition of longer-term foreign direct investment was increasingly shifting away from export sectors and more toward nontradable sectors that generally earned revenue in local currencies and that depended on domestic market conditions for success. Second, the composition of financial inflows was shifting away from more stable foreign direct investment toward portfolio investment, and an increasingly large share of the financial inflows was in the form of private debt. For example, in June 1997 foreign debt totaled $69 billion in Thailand and $59 billion in Indonesia. It was also on the rise, though at lower levels, in Malaysia and the Philippines, where it reached $29 billion and $14 billion, respectively.

With interest rates on local debt about twice those on foreign debt, local banks borrowed overseas to cover lending to local business, and corporations borrowed directly from overseas sources. And, as has always been the case in Asia, most of this private debt was relatively short-term, predominantly less than 18 months, though it was often used to finance long-term projects that would require several rollovers to complete the financing cycle. Short-term private debt thus mounted without government authorities or private markets knowing its full extent. The region, especially Indonesia and Thailand, grew increasingly vulnerable to a shock to exchange rates since more and more overseas debt was used to earn revenue in local currency, but had to be paid back in foreign currency.

Third, the efficient use of private debt depends greatly on the effectiveness of an economy's financial intermediation system, which in Southeast Asia is concentrated in bank operations. Bubble economies place considerable stress on banking systems even in developed economies, as the costly U.S. savings and loan crisis did in the 1980s and as the ongoing and even more costly Japanese banking debacle is doing today. The situation is often even worse in developing economies, where regulatory environments are less strictly enforced, vested interests sometimes use preferential access to fund risky investments, and banks are not as skilled at differentiating the risk of investments. Worse still, some Asian banks tend to lend funds based on the asset values of their customers rather than on careful analysis of the cash flow returns of a particular investment. Thus the Asian banks increased their investment while asset values were high, and then, when asset values collapsed, drew back their loans more than necessary. The general lack of transparency of business operations in Asia, relatively unnoticed during the good times (in the case of Southeast

Asia, for decades), exacerbated the downturn. Southeast Asia's banking system was not well prepared to absorb the shocks of an economic downturn or a plunge in currency value.

Fourth, governments proved less able than they had been in the past to manage the relatively moderate economic shocks at the beginning of the crisis. Many see Thailand's weak response to numerous economic warnings as early as 1995 and 1996 as the incubator of the crisis. Moody's rating agency had in fact downgraded Thai bonds as early as the summer of 1996.

In this sense, the longstanding cronyism, and often corruption, that accompanied decades of rapid growth in the region were particularly decisive. The bubble-enhanced financial interests tied up government responsiveness as they had not earlier. In 1985, for example, Indonesia had informally restructured its foreign official debt portfolio almost seamlessly following the collapse in oil prices. Technocratic reformers in Thailand and Indonesia, who had traditionally been called in to resolve economic difficulties, actually favored bringing in the IMF to counterbalance the domestic political interests of the status quo who were blocking reform.

One reason for the limited success of the first IMF agreements in Indonesia and Thailand was the IMF's presumption that the technocrats would be given political authority, as they had been in the past, to implement the relatively mild policy changes initially required and to manage the financial restructuring to deal with the still underestimated private debt exposure. When political forces did not pass the torch to the technocrats and instead blocked meaningful change, governments and the IMF lost critical credibility in both domestic and international markets. As a result, they also lost the opportunity to buy time for serious financial restructuring and for distributing the costs of successfully rescheduling the predominantly short-term private foreign debt.

GLOBALISM VERSUS POLITICAL TRADITION

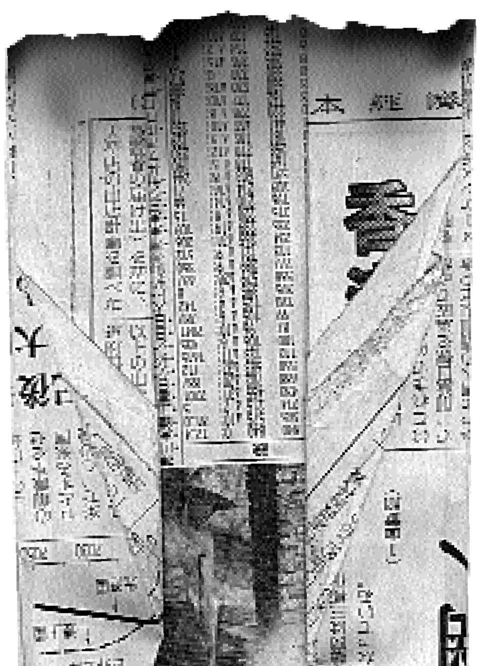
At the heart of the crisis is a fundamental tension over how governments harness the commercial windfall of globalism while managing the domestic economic, political, and social stresses caused by increased influences from abroad. As Southeast Asia moved toward modern, liberalized financial systems and open international capital markets, its domestic political and economic environment remained characterized by government preferences and by weak government regulation of banks and private foreign borrowing. The combination made the region far more vulnerable to exchange rate risk and balance-of-payments pressures.

The crisis sneaked up on the region in the guise of seemingly benign increases in private capital flows, further disguised by poorly reported statistics. In the end, however, it exposed the weaknesses, in a globalizing market environment, of domestic political systems that depend on traditional, personalized control and manipulation of powerful elite groups rather than on strong, independent institutions and legal systems.

LESSONS AND IMPLICATIONS OF THE CRISIS

The crisis in Southeast Asia proved much more serious than anyone would have imagined, both because of its systematic economic and political nature and because of the unforgiving makeup and magnitude of short-term, private foreign debt. Lessons abound.

Governments and the private sector in Southeast Asia must develop economic and political environments to regain capital, both domestic and foreign. The situation, however, is much different than it was during the capital booms of the 1980s and early 1990s, when intra-Asian capital flows were dominant. With the economic downturns in Japan, Korea, Hong Kong and Singapore, Asian sources of capital are limited. U.S. funds are thus likely to become more prominent in the region, even though they tend to have more strings attached, especially regarding demands for greater corporate and government transparency and more reliable legal systems. Market forces in this environment, therefore, are likely to reinforce IMF require-



ments to pressure for further reform.

As foreign firms move to merge and acquire Southeast Asian businesses, we already see clashes of corporate culture over managerial control and the difficulty of completing due diligence to determine the true financial circumstances of many Asian companies. These pressures, traumatic in nature for Asian economies, are likely to modernize economic and corporate governance and market institutions in Southeast Asia in ways that will strengthen their capacities in the future.

A key lesson of the crisis is that open private capital markets do indeed place considerable stress on domestic economic management and on political arrangements. Balancing monetary and exchange rate policy in small, open economies—no simple task at any time—is made particularly precarious if governments desire exchange rate stability and some independence in monetary policy. Similarly, private investors do indeed make mistakes, and governments do need to monitor and manage carefully private capital inflows. And lenders of last resort, such as the IMF, provide limited protection from government or private mistakes.

The crisis clearly calls into question what some Asians have called the "Asian Way," where economic development comes before political development, where business interactions tend to be personalized rather than supported by strong commercial law institutions, where business and the state operate in close quarters with limited independent regulatory oversight. Thailand's maturing democracy raises hopes that stronger political and economic institutions will emerge. Less politically open Singapore, in contrast, remains the bastion of solid market institutions and credibility. Indonesia's patriarchal autocracy proved incapable of balancing the need for distributing losses among domestic vested interests. The development of effective regulatory and commercial law systems is fundamentally a political decision, since independent institutions limit executive and preferential control over allocation of funds and power. There are real costs to maintaining domestic political conditions that limit the development of effective market institutions, especially for countries that rely importantly on foreign capital inflows and that are committed to global integration.

Implications for the United States are less direct. The crisis in Southeast Asia is having a relatively limited impact on U.S. commercial interests. U.S. banks were not heavily exposed to the Asian crisis economies, and U.S. trade interests with Southeast Asia are significant but not substantial. Once it became clear, with the successful negotiation in New York for the rollover of Korean debt in January, that the Asia crisis would not spill over into Japan and China, and thus would not likely pose a threat to the global economy, the U.S. stock market regained its upward momentum. In fact, the crisis-related reforms enacted by the Southeast Asian governments should open access to U.S. investment and trade, especially in financial services, once regional economies stabilize and begin to grow again.

The decision by most of Southeast Asia's governments to continue on the track of outward-looking growth deflected what could have been the most serious ramification for U.S. policy—a withdrawal by the region into inward, nationalist governments playing off an anti-American backlash. The only remaining question mark is Indonesia, where political and social instability remain a major concern for U.S. strategic and political interests. ■