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EMERGING ISSUES AND DEVELOPMENTS AT THE REGIONAL LEVEL: REGIONAL ECONOMIC COOPERATION

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EMERGING ISSUES AND DEVELOPMENTS RELEVANT TO THE SUBPROGRAMME: THE FINANCIAL CRISIS IN THE REGION AND ITS POLICY IMPLICATIONS

Note by the secretariat

SUMMARY

Since mid-1997, a number of the best performing economies of the region have faced an acute financial crisis. The crisis originated in the sudden deterioration in the balance of payments of some countries as export growth slowed sharply in the face of a continuing rapid rise in imports. As a result of the progressive integration of financial markets, instability in one economy has been transmitted to others so that a number of economies have been affected at the same time. Even economies relatively unaffected by the financial turbulence have been downgraded in terms of international creditworthiness.

The impact of the crisis on the affected economies has been far-reaching. External capital flows, both credit and investment, have either stopped or slowed sharply. Economic growth has slowed as a consequence and unemployment has started rising. The overall crisis is likely to worsen in 1998 and could spread within and beyond the region.

The present note attempts to set out in some detail the origin of the problem and its implications for policy within the context of regional economic cooperation.

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Introduction

1. Since mid-1997, a number of the best performing economies of the region have faced an acute financial crisis. Despite commitments by the International Monetary Fund (IMF), the World Bank, the Asian Development Bank (ADB) and bilateral sources to provide large-scale financial assistance, the crisis deepened throughout 1997 and early 1998. Exchange rates and stock markets continued to decline, apparently owing to a lack of investor confidence in the economies and the financial systems of the concerned countries.

2. These developments have serious implications for the affected economies as well as the entire Asian and Pacific region. Progressive integration of financial markets in recent years has permitted instability in one country to be transmitted to another, so that a number of economies have been affected at the same time. If the crisis persists, it may even spread to economies relatively unaffected thus far. Such economies are bound to suffer as their trade and investment relationships with the affected countries are impaired, and their creditworthiness is downgraded as a symptom of the lack of confidence in the region as a whole. Thus the crisis may impact adversely on economic growth in the region, which had been quite strong up to 1996 and the earlier part of 1997.

3. The present note attempts to set out the genesis of the financial crisis, its impact thus far, the policy approaches adopted by countries, and the scope for additional action within the context of regional economic cooperation.

I. THE EMERGENCE AND EFFECTS OF THE CRISIS

4. Since the mid-1980s, East and South-East Asia have been the world's fastest growing subregions and they have become increasingly integrated with the world economies in terms of trade and financial flows. This is evident from the rise in trade intensities (measured by share of trade in gross domestic product), and foreign financial inflows which have formed a higher proportion of domestic expenditure. Rapid economic growth has been based on high rates of investment and rapid expansion of exports and imports. During the 1990s, however, in several economies of East and South-East Asia, there emerged large current account deficits which were financed by inflows of foreign capital.

5. In 1996 and early 1997, a sharp worsening in the current account deficits occurred as export growth slowed. This was caused, in part at least, by the relative appreciation of the exchange rates of several of the currencies in 1995-1996, resulting from their link to the United States dollar which had strengthened. As export growth slowed in the face of broadly unchanged import growth, current account deficits widened sharply. Interest rates had to be raised to support the exchange rate. Attracted by a differential in domestic and international interest rates, considerable foreign funds flowed in to meet the current account deficits as well as to reap better returns on lendings and investment. A major part of these inflows were of a short-term nature.

6. Several economies of East and South-East Asia invested the short-term inflows in activities and projects, or on-lent them via the financial system, without sufficient regard for susceptibility to adverse changes in the market environment. In 1996 and the first half of 1997, as export growth slowed, the economies began to experience serious shortfalls in expected cash flow, either because of a reduction in foreign demand in tradable goods, or because of the build up of excess domestic supply, for example, in real estate. As a result, many borrowers could not service their loans from the financial institutions and the problem of non-performing assets in the banking system worsened.

7. Three complications served to compound the problem. First, as the downturn in foreign demand and excess domestic supply became evident, the underlying prices and asset values, for instance the prices of export items, property and share prices, declined sharply. The latter two had been supported with borrowed funds and had also been pledged as security for obtaining credit. As the borrowers defaulted, banks could not resort to foreclosures in order to rebuild liquidity. Second, as problems worsened, many of the borrowing or intermediating entities suffered a series of downgrades by rating agencies, making roll-overs of inter-bank credit lines or access to new facilities virtually impossible. Third, the resulting depletion of liquidity in the financial system began to have an adverse impact on the ability of even unrelated enterprises to function normally. The result was attrition of foreign exchange reserves as investors and borrowers scrambled to acquire foreign currency, leading to sharp depreciation in exchange rates and a fall in stock market prices.

8. The most striking feature of the financial crisis in the region has been the loss of international investor confidence in a number of economies in East and South-East Asia. For economies that had become dependent upon substantial inflows of foreign capital to sustain economic activity, rebuilding this confidence has become the most urgent priority. Rebuilding confidence is needed not only to regain creditworthiness, but also to prevent the collapse of exposed banking and other corporate entities in the short term.

9. Investor confidence, while ostensibly influenced by a deterioration in the current account or through the build up of short-term debts, is quite often unrelated to them in any precise way. A tendency to overreact when an economy appears to run into problems, the so-called herd mentality, generates pressure on foreign exchange reserves and exchange rates of extreme severity. That is what seems to be happening in the region. The measures to contain them, even by raising interest rates to very high levels, has proved ineffective. The result has been steep depreciation in exchange rates.

10. The herd mentality, by intensifying pressure on capital repatriation, can, through regional contagion and spillovers, greatly worsen the problem of the shortage of liquidity. It can cause a contagion effect, impacting several countries at the same time, irrespective of differences in fundamentals. The result is a crisis that is deeper and perhaps more long lasting than might have been the case otherwise. It affects not only the private borrowers but also the government, which becomes

preoccupied with the need to avoid a default on its international obligations in order to maintain the country's reputation and future creditworthiness. There is an upward movement in the cost of funds and a diminution in the level of economic activity, which significantly prolongs the pain of adjustment.

11. As the crisis spread in the region, higher interest rates, falling equity and property prices, rising corporate debts and falling profitability seriously affected investments and the prospects for growth. Many forecasters expect South-East Asia to grow by no more than 4 per cent in 1998. Growth had already slowed to an average 4.6 per cent in 1997, down from more than 7 per cent in 1996. Slower overall growth in the region is likely to have implications even beyond the region, as imports to the region may be curtailed sharply. That, in turn, may affect a considerable proportion of the exports of countries such as the United States of America. Almost a fifth exports of goods and services of the United States are destined to Asian countries; for Japan it is 42 per cent, although for the European Union (EU) it is only 7 per cent. Exports to Asian countries constitute 2 per cent of the GDP of the United States and the EU. For Japan it is 4.4 per cent. Almost three quarters of Japan's export growth since 1990 has been generated by the increase in sales in Asian markets. Thus Japan's economy will be affected the most, but other developed and developing economies of the region will also be affected.

12. The financial crisis has served to focus attention on two crucial areas: one, the exchange rate regime and two, the financial sector. Since the 1970s there has been a gradual but significant shift towards more flexible exchange rate arrangements in virtually all economies. In certain cases, countries have opted for arrangements that allow frequent adjustments, such as exchange rate bands, managed floats or even freely floating rates. In other cases, countries have opted for exchange rate stability by anchoring their currencies to the United States dollar.

13. The crisis has revealed particularly serious weaknesses in the financial sectors of many of the affected economies. This has involved not only the operations of the financial entities but also of the regulatory and supervisory regimes governing them. On the one hand, the intermediating entities appear to have been unaware of, or unable to, gauge correctly the underlying risk of many of the investment and lending decisions they have taken; on the other hand, they have not had the capital strength to absorb the losses that occurred. Supervisory and regulatory bodies, too, appear to have been lax in carrying out their functions effectively, whether in the matter of banking regulation or in stock market supervision, but particularly in allowing a lack of transparency to flourish.

14. One of the consequences of such laxity is that independent agencies do not have access to full and accurate information on the short-term indebtedness of countries until well after a crisis has broken out. Lack of such information has meant that market operators have been influenced by rumours. An absence of transparency has made it difficult to assess the true extent of non-performing loans of financial institutions, or the financial health of large corporate entities operating with a number of subsidiaries and affiliates involving a complex array of cross-shareholdings and parent company

guarantees. The result is that problems are kept hidden for considerable periods and corrective measures delayed, often until it is too late.

II. POLICY ISSUES

15. The policy approach adopted by the affected economies has been to rebuild international investor confidence by seeking support from IMF and other multilateral and bilateral sources, and to address critical structural weaknesses, for example, in the financial sector. As a means to this end, action has been taken to narrow current account deficits and reduce public spending. At the same time, insolvent financial institutions are being closed down and restrictions on foreign capital inflows considerably reduced.

16. It is to be noted, however, that investor confidence has been very slow in recovering. Several reasons have been advanced for this: the scale of the problems prevalent in the affected economies has been underestimated; the size of the rescue packages announced has been regarded as insufficient; or the ability or commitment of the authorities in individual countries to implement the reforms considered to be essential has been judged to be uncertain. With the prevalence of such doubts, the crisis has lasted far longer than might have been expected. Those very economies that had been successful in attracting international capital in the early 1990s now have to re-establish their long-term creditworthiness.

17. It should perhaps be stressed that neither current account deficits nor a recourse to short-term inflows of foreign capital are problems in themselves. In the long run, a current account deficit would, of course, have to be kept within the limits of sustainability, as foreign providers of capital will not continue to provide resources indefinitely. Subject to that limit, however, economies can run current account deficits for considerable periods of time, as most developing countries have done over the years.

18. Sustaining a current account deficit is, however, determined not only by its magnitude but also by its mode of financing: the greater the recourse to short-term funds, the greater the risk of reversibility if market operators become dissatisfied with a particular aspect of policy. If there is also incongruence or mismatching in the maturity structure of the funds, i.e. if borrowed funds are locked into long-term investments or uses, recourse to short-term capital can pose very serious dangers arising from a loss of confidence. The confidence problem can be precipitated by bad investment or lending decisions. On the other hand, if borrowers remain current with interest payments, short-term funds may be rolled over and thus constitute a useful source of additional liquidity.

19. The implications of the above for the ESCAP region are as follows. First, the increased integration of national financial markets has created a much more challenging policy environment for most countries of the region. Few countries, especially those that have developed a high level of international financial market integration, have absolute autonomy in domestic policy matters, and domestic policy agendas require swift adjustment to external conditions.

20. Second, integrated financial markets mean that instability in one will almost certainly spread to another and when that happens little can be done to counter it in the short term. This transmission clearly poses serious systemic risks as any payment difficulties encountered by one institution within the intermediation chain may spread.

21. Third, integrated financial markets mean that much of the burden of intermediation falls on the financial sectors of capital-receiving countries. In some, the financial sectors appear to lack the strength, being under-capitalized, and in others, there is a lack of the appropriate technical expertise to carry out the function of evaluating and managing risks effectively. This applies both to the banking system and to portfolio flows.

22. It should be stressed that while financial market operators exercise great influence, their judgements can be prone to error. In an ideal world, misjudgments could be avoided by better information and communication, but the world economy is still characterized by asymmetrical information, inadequate channels of communication, lack of transparency and wide differences in perception. Given these drawbacks, it would be useful to investigate further how the current financial market turbulence originated in the region, the role of speculative instruments such as hedge funds, and to what extent a better framework of international surveillance and supervision could be fashioned to prevent its recurrence in the future.

23. In a globalized market-driven economy, crises of confidence can never be wholly prevented, as the experience of many developed countries over the last 20 years shows. What can, perhaps, be realistically attempted is to seek more innovative forms of cooperation so that a future crisis can be contained, or if not, its adverse impact can be significantly restricted. In the specific context of the current crisis, much of the turbulence can be traced to doubts regarding the ability of the economies to service their foreign liabilities, especially short-term debt. Doubts arose when market operators appeared to be unaware of the true extent of the indebtedness, principally because short-term debts had not hitherto been included in the official debt data.

24. It is clear that all economies need to make substantial improvements in this area by providing comprehensive and timely debt information to counter the deleterious effects of rumour and speculation. While this is not a proposal that falls within the ambit of regional economic cooperation, it would be useful if governments could discuss the modalities of its implementation, such as setting out common definitions and reporting requirements, on a collective basis.

25. In the context of regional economic cooperation in the area of exchange rate policy, the possibility of a regional fund has been mooted and subregional arrangements involving central banking cooperation in exchange rate management already exist. But tackling financial market turbulence is not a matter of defending exchange rates only. In fact, any fund set up for the defence of a specific exchange parity would have been powerless against the kind of pressure witnessed in recent months. Financial

market instability has been aggravated by perceptions of weakness in the financial sectors of countries and by the lack of reliable information regarding their operations. This has arisen from differing standards of regulation, the lack of information regarding non-performing banking assets, and the variability of standards of corporate accounting prevalent in different economies.

26. It would appear, therefore, that arrangements capable of generating and transmitting more accurate, transparent and timely information regarding the build up of significant financial risks within a particular jurisdiction would be very useful for the authorities in another jurisdiction.

27. At the same time, countries need to consider reforms that would lessen their vulnerability to some degree to possible future financial market instability. As already stated, reducing current account deficits and restraining recourse to short-term funds form the core actions in this regard. Minimizing the dangers from over-leveraging would also be useful in this context. Corporations and entrepreneurs are, and should be assumed to be, the best judges of how to raise the resources that they require. However, as seen recently, over-leveraging carries dangers, especially when undertaken via arbitrage and in an environment of domestic asset price inflation. It would be appropriate to make both lenders and borrowers aware of the risks involved.

28. One cannot be absolutely certain that the proposals made above would yield concrete results in the short term. However, given that confidence often emerges from a small innovative initiative, it is possible that determined action to move in these areas could well produce significant benefits in a relatively short span of time.

29. The Commission may wish to provide guidance on the future work that the secretariat should undertake on any of the matters raised in this note.