

The Economic Crisis of 1997-98

Major event: serious, unanticipated, introduced a new hierarchy of devt performance, raised many major analytical and policy issues, major social impacts.

Diverse outcomes; see O/H. Indo and Thai more serious; Sing, Phils (for once!), VN lightly affected.

Want to look at:

- what happened/outcomes;
- why it happened, the causes; the most important;
- socio-economic consequences;
- responses, post-crisis trajectories.

1) What happened?

Highly uneven impacts.

Indo: 13% decline, 21% from trend; Thai: 10%, 18%; Mal: 7.5%, 15%.

Others mild; why?

Divergent recovery trajectories. Generally 'V', but to slower growth.

No loss of macroeconomic control, except Indo briefly.

Investment collapse; by 10% of GDP and more. Why?

Major shift in macro balances: fiscal, from balanced/surplus to deficit; current account, from deficit to surplus. Why?

Regime collapse in Indo; elsewhere, political impacts minor.

2) Why did it happen?

Complex! Opinions still divided. Need to consider:

(a) theories of crises, (and how differ from growth explanations?),
(b) weave in politics and economics, domestic and international factors, (c) caution re one size fits all.

Need to distinguish between:

(a) prelude/vulnerability indicators,
(b) the 'trigger',
(c) initial responses and spread of the crisis, and
(d) longer term adjustment and management issues.

What do 'crisis theories' say? At least 6 explanations; some mutually reinforcing:

1) International financial markets inherently unstable; prone to boom and bust. Kindleberger, etc.

2) Specific 1990s events: suddenly huge flows to emerging markets from the OECD, from about \$9 B to \$240 B. Push factors (low returns at home) and pull factors (higher interest rates in SE Asia).

3) Domestic, (a) macro:

'LA-style' fixed ERs, loose fiscal, leads to inflation, REER appreciation, then crisis.

Fiscal may look OK, but conceals much off-budget, contingent liabilities, etc.

Mundell-Fleming: 'impossible trilogy', open K account, fixed ER, independent MP; OK only if K account not fully integrated.

4) Domestic, (b) financial: 'over-guaranteed, under-regulated'; looks OK with growth, but can't handle sudden shock.

5) KKN: growing corruption infects institutions, leads to debt-driven growth, rising inefficiency, affects export competitiveness, etc.

6) IFIs, especially IMF, not prepared, equipped to handle, mis-diagnosed symptoms.

Prelude to the crisis:

Strong growth; unlike former USSR, Phil in 1980s.

Superficially, CADs, financial system appeared OK; high S & I.

Ratings agencies, WB, IMF, etc uniformly positive.

A view that growth might slow down as input growth declined (Krugman, etc); but this not a crisis scenario.

Though some problems beginning to surface, especially in Thai, with beginnings of capital outflow, SM decline (Warr).

Discuss range of pre-crisis vulnerability indicators; see O/H.

Sequence of events:

July 2, 1997: Baht collapse; fed quickly into banking system. Why? Unhedged borrowings, high interest rates cause debt distress.

Speculative attacks on other currencies in SE Asia, especially Indo, Malay; ie, 'contagion', risk perceptions, triggering capital flight.

Beginnings of general currency and SM collapses.

Initially, domestic and international authorities caught off guard:

Domestic - ambivalent, complacent, unprepared.

IMF - also unprepared, push for fiscal surplus, too much conditionality.

Continuing and reinforcing downward spiral in late 1997. ER collapse leads to financial crisis (unhedged borrowings), and general econ downturn.

This a general story, but important to consider country specifics and variations. See readings.

Indonesia

The worst affected, 'twin crises'.

Background: strong growth,TFPG positive and increasing, improving social indicators. Political unrest, but no discernible impact on SM, ER.

Prelims: See Hill, p.120, 5 sets of indicators; most but not all looked OK; initially 'not Thailand'.

Pre-crisis vulnerability?

1) Debt and capital mobility? Debt/GDP stable, though quite high. ST debt rising, though poorly measured. Issue of how to define mobile K.

2) Poor macro?

Looked OK; deficits contained; inflation below 10%, ER not badly misaligned.

But some problems: recall Mundell-Fleming, trying to set MP targets, run a tightly fixed ER, with open K account. OK, but only as long as K flows mainly public and long term FDI.

Also, fixed ER, combined with substantial r/i differences meant large borrowings abroad but without hedging.

3) Poor financial regulation? Weak data. NPLs looked OK, but not well measured; bank borrowings modest; less bubble (than Thai) in asset markets (real estate, SM). Rising credit/GDP but seemed manageable. Key was what would happen to debts after ER collapse.

4) KKN/governance: Problems. But getting worse? Impossible to measure. And how come 30 years of high growth?

Enters the story more as a policy response factor.

Management of the crisis

This the key; see Hill, p.129ff.

Chronicle of policy errors: bank closures, cause panic; Soeharto family businesses; Habibie as VP candidate; Jan backtracking; March cabinet; international community unhelpful.

Crisis began to feed on itself, through ER, finance.

Counter-cyclical fiscal policy not possible.

Additional factors: (a) regional downturn, especially Japan; (b) very serious drought, falling rice output and supplies; (c) TOT declining, oil prices historically low; (d) key econ policy makers incapacitated; (e) social & regional tensions.

“Everything went wrong at once!”

Continuing stand off with IMF.

KKN again: not so much the level, but its nature - key technocrats sidelined, family businesses; system totally dependent on Soeharto, illness scares in 12/1997; when he fell, so did regime; but not inevitable - see Table 5 comparisons with avoided 1980s crisis.

Other countries

Philippines: Why survived OK (the exception again)? (a) no boom, therefore no bust; (b) lessons learned from the 1980s (BSP reform, banks cautious, etc); (c) other factors - US ties useful, mid 1990s reform dividend. See Noland.

Thailand: The origins of the crisis; so need more than trigger as explanation. See Warr. Several key points:

Really large K inflows, so very large CAD; inevitably declining MP of K.

Aggressive opening of the K account; attempting to compete with Sing, HK. But shaky, weak supervision; beginnings of bank problems (BB/C); K already leaving the country pre-crisis.

BoT hung on to ER for too long, in face of \$40 B exodus.

Sudden X slowdown in 1996 rattled confidence.

Very rapid real wage growth, without commensurate HC base.

Though note no problems with IMF; entered package quickly.

Then rise of 'Thaksinomics', rise of populism.

Malaysia: Interesting case, initially 'IMF like', though never in program; fearful of implications for social programs.

Key pre-crisis vulnerabilities were financial: SM/GDP and credit/GDP extremely high. Part bubble, part govt pushing mega projects through the financial sector. Speculators see signs of vulnerability. See Athukorala.

In 9/1998 departed from 'orthodoxy': K controls, fixed ER, DPM in jail.

Why controls: (a) wanted to reflate, MP/FP; but for low r/i need capital

controls; (b) huge Sing trading of ringgit (R M 20 B?), loss of MP control; (c) politics - dismissal of Anwar.

Modest, careful program: only ST controls; rest very open; for one year, then progressive relaxation. Reflation program was reasonably non-political.

Transferable? Unlikely; Malaysia a special case: extremely open to trade & FDI, so check on abuses; relatively good quality institutions. Other countries did not seriously consider it (eg, Indo, Phils).

Evaluation: counter-factuals difficult. Probably led to faster reflation; but was a ST cost of higher risk premium. Better to impose controls ex ante not ex post. Set the ER conservatively.

Vietnam: here contagion different; K account not integrated, so channel is current account, and this never as volatile. But of some importance, as VN heavily trade dependent on East Asia. Also VN more agrarian, therefore less vulnerable.

Did slow down the reform momentum after 1998, for 2-3 years.

Singapore: Pure contagion; practically no vulnerability, apart from trade and investment ties. Some speculative attacks on S\$. Govt let it slide, plus fiscal stimulus; massive reserves in support.

Summing up

General elements plus country-specific factors.

General factors:

- 1) Fixed/quasi fixed ER; very high risk in presence of mobile capital. Resulting general preference for 'corner solutions', float v/s CBS; though still contentious; role for CBs in smoothing.
- 2) Build up of mobile, ST K flows - ST borrowings, portfolio I. Maybe a case for restricting/slowing down; though complex.
- 3) Financial sector opened up prematurely, without adequate supervision; unable to cope with large, volatile flows.

Implications:

- (a) force banks to be very conservative, high CARs, etc; (b) high quality, independent regulators; (c) encourage foreign bank presence - risk sharing and higher standards; (d) avoid govt guarantees.

Continuing search for 'predictors' of vulnerability. Though caution: each crisis is different, 'generals fighting the last war', etc.

A decade later (almost)

Outcomes, focus mainly on growth.

Others don't change much; note in passing that poverty follows growth; increased quite a lot, then subsided; nothing like crisis effects of former USSR (life expectancy dropped 10 years!), etc. Though perhaps increased sense of vulnerability, not evident as much cf pre-crisis, when continued growth taken as the 'natural order' of things.

Growth: some key points.

All now back above pre-crisis pci.

But growth generally lower – a central point, none have been able to get back yet to pre-crisis, consistently. Has to be mainly domestic/endogenous causes, since global economy buoyant, particularly in past 2-3 years.

Loss of output big time, especially in RI, some extent Thai. Eg, think of where would have been if had kept going at pre-crisis rates. RI a bit above 7%, implying a doubling of pci every 12 years. ie, would have been a \$2,000 pci country cf a \$1,000.

Note considerable inter-country differences. RP not much to do with crisis. Eg, RI recovery lower and slower than M.

Determining factors: proximate and deep.

Here note that key aggregate balances changed quite a lot.

Investment: still well down on pre-crisis levels. As much as 10% points below. Why? Countries haven't yet convinced LT investors – foreign and domestic – that these are desirable places. Public sector I also down. Intensified competition from abroad, especially China. And note where I is going – much more into non-tradables – malls, RE, portfolio K, cf LT investment.

Good illustration is in sectors where LT horizons & predictability required. Eg, infra squeeze; where some investing at about half pre-crisis rate. Also mining, Indonesia especially.

As part of this generalized swing from CADs to CASs. Initially, collapse of domestic demand, exports highly competitive, foreigners reluctant to transfer savings. But lasted much longer than expected.

Macro: All generally kept macro under control; RI a bit shaky. In fact, pre-crisis distinction among the 4 heightened.

Using as key indicator the inflation rate. But some major changes:

Fiscal: Clear shift. Weaker govts, swing from balanced to deficit budgets. Why? Partly growth effects, partly have to spend more on social. So 'routine' dominant', more 'pork barrel'; much less for devt.

ER/CBs: General shift to more independent CBs, floating rates. A clear achievement, deserves more emphasis. Phils, Indo examples.

Openness: No major changes; all 4 broadly open, with Mal & Thai more so and more clearly embedded, than the others. Though note subtleties:

Continuing swing from man to ag protection; why? loopholes, democracy, reform efforts focused on the former.

Growing emergence of dual policy regimes (export zones – are an admission of policy failure!).

Why stayed open during crisis: At least six factors, vary by country:

- 1) Large ER depreciation, ameliorated pressure for protection.
- 2) IMF program constraints, at least RI, Thai. WTO, AFTA a bit.
- 3) Finance ministries empowered; generally less protectionist.
- 4) RI, RP had recently come through major reforms, in 1980s and 1990s; still saw benefits of reforms.
- 5) Recovery dependent crucially on X sector; this constituency empowered, more able to resist pressures for protection.
- 6) A globalizing world, especially China and India; no going back; also at margin the two great examples of 'guided EO IP' both lost their shine – Korea the only NIE to be seriously crisis affected; Japan in the doldrums for over a decade.

Social outcomes; not much to say in ST, closely followed econ trends. Probably strengthened NEP proponents in Mal, from Indo experience. So set back difficult but necessary exit from NEP.

Note more generally early advances into low income 'welfare statism', with very mixed results. Three general areas:

Not bad at ST humanitarian relief: food supplies, schooling, public works, etc.

Labour markets getting screwed up; discuss later.

Pensions unfunded, fiscal 'time bombs'; eg, Phils defined benefit pension scheme, unfunded liability of about \$20 B.

Micro/business climate.

Significant changes here, especially in Indo & Phils. Reinforces Ammar Siamwalla's notion of 'bifurcated state'; ie, reasonably strong re macro, openness; but weak, vulnerable to capture at micro.

Eg, Indo, major political economy changes affecting presidency (strong to weaker), parliament (rubber stamp to powerful), civil society (empowered and noisy), regions (major decentralization), cabinet (no longer unified), bureaucracy (weakened), overwhelmed legal system.

As illustrations, consider the following:

1) Speed of clean-up after the crisis: a key indicator of depth of crisis, institutional strength. Here progress pretty much follows pci: Mal a clear leader, Indo & Phils (after mid 1980s) much slower.

2) Labour market intervention: Pre-crises (again Phils, pre-1986), labour market policy 'East Asian' cf 'South Asian', ie, growth, labour-intensive, mass education, didn't interfere much in prices, unions limited (in some cases heavily controlled). Results were strong growth in pty, wages, rapid structural adjustment.

But post-crisis, especially Indo & Phils, populist politics intruded. Freedom to organize. But major disincentives to hire labour. 3 effects: losing jobs to China, VN; 'informalization' of labour force, as jobs migrate to SMEs, informal sector; rising wage inequality. See Manning.

3) Centre-region relations: In Indo, Phils, Thai, especially first 2, major shift in centre-region relations, although all remain technically unitary states. Deliberate desire to weaken the centre (esp RP); fear of territorial disintegration (esp RI). Quite radical; but work in progress; complicated by vacuum at the centre, zero-sum game growth, etc.

Big topic, discuss later. Recall Bambang Brojo talk.

Over time, re-shaping political economy; competition among newly empowered regions.

Thailand decentralization also substantial, though less 'big bang'.

Though note decentralization hasn't done much to sort out complex regional problems – 3 Muslim provinces of S Thai; W Mindanao and Sulu; and Papua (though Aceh peace settlement very hopeful).

M still federal, but if anything headed in opposite direction.

4) Corruption: Key is shift from predictable to unpredictable, in Indo since 1998, Phils since 1986. 'Democratized and decentralized'. Major implications for business.

5) Foreign influences on policy; IMF in particular. Job of liberal reformers more difficult; guilt by association.