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The Asian Financial Crisis 25 Years On

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Twenty-five years ago on 2 July 1997, the Thai authorities decided to float their currency, the Thai Bhat, after having practically run out of international reserves in its defence since late 1996. That move triggered the Asian Financial Crisis (AFC), a veritable storm over East Asian economies—from Indonesia to Malaysia, Korea, Philippines and Hong Kong.

In the wake of the AFC, oil prices collapsed and as a result the Russian Federation defaulted on its domestic debt. Brazil was also hit by renewed debt problems requiring a record $42 billion bailout for the country. One of the largest hedge funds in the world—Long-Term Capital Management, with two future Nobel Laureates on its board—had to be saved to prevent a Wall Street meltdown. Global GDP (gross domestic product) growth for 1998 turned out only half of what it had been projected to be before the crisis.

What had started as a minor financial problem in a medium-sized emerging market soon turned into a region-wide economic crisis, and in some countries, a political and a humanitarian crisis, which pushed back millions into poverty, and left many more millions out of a job. The crisis came as a surprise to most, as the affected Asian countries had been celebrated by many as beacons of development, including by the World Bank, which a few years before in 1993 had published a book in praise of the "East Asian Miracle".

WHY DID THE AFC HAPPEN?

Though there had been some clouds on the horizon (a lack of productivity increases as first signalled by Alwyn Young's "The Tyranny of Numbers", the Yen's depreciation after 1995 and growing international competition from China), few would have predicted in 1996 that within a year the Asian economy would be facing sharply depreciated currencies, deep recession, failing banking systems, unemployment, sharp increases in poverty and the need to call in the IMF (International Monetary Fund) to the rescue.

Even after currencies had started to slide, in September 1997, there was no sense of the depth of the crisis that was to come. The World Bank wrote in its annual Global Economic Prospects that "[w]hile it is clear that growth in more severely affected countries will slow in the next one to two years, the outbreak of a Mexico-style crisis appears unlikely". IMF Managing Director Michel Camdessus had concluded the IMF-World Bank Annual Meetings in Hong Kong in the same month with a strong endorsement of capital account openness:

> "*First, you have expressed your conviction that global opening and integration offer the only path to greater global prosperity. Many have cautioned against allowing market turbulence to divert us from the critical task of fostering closer financial integration. Indeed, many of you have pointed to the role that the free movement of capital can play in accelerating investment and growth. Notwithstanding the problems of recent months, this region testifies to the benefits that can spring from the productive use of capital inflows over the longer term. These recent events should not cloud that reality*".

However, reality bites, sometimes. Even today, the causes of the AFC are still being debated Though each affected country had its own particular cause of the crisis, what seems clear today is that a combination of relatively open capital accounts, high external (private) borrowing, a weak domestic financial system and oversight combined with fixed or at least tightly managed exchange rates set the countries up for disaster. The crisis happened in a global environment that experienced a rapid increase in capital flows and the emergence of an "electronic herd" of speculative capital that sought to exploit policy weaknesses around the globe. Indeed, the AFC came only a few years after the Tequila crisis hit Mexico, and the embarrassing 1992 exit of the British Pound from the European Monetary System. These two crises carried elements of the AFC, as capital flows and unsustainable exchange rate policies played a role in those crises as well.

The AFC was triggered by a sudden stop in capital flows to the countries, which put pressures on the exchange rates and resulting in swollen sharp increase in foreign debt to GDP. In Thailand, non-bank financial institutions had led borrowing from abroad, whereas in Indonesia and Korea it had been private and public enterprises. With the depreciation of the currencies, the burden of foreign debt swelled, and as a result, many companies were de facto insolvent, and were not able to repay their domestic bank loans. Moreover, in defence of their currencies, the monetary authorities in crisis-affected countries hike their short term rates to fend off speculators, which also aggravated the economic downturn.

The lack of transparency increased the uncertainty for market participants (and international organisations ready to help). In Thailand, much of the Bank of Thailand's intervention to defend the currency had been done through the forward market; thus, official reserves as reported gave a far rosier picture than reality, but once reality hit, it hit hard. In Korea, international liquidity dried up in the wake of the Indonesian and Thai crises, in particular because Japanese banks that had provided the finance thus far could not or would not roll over their exposure because of the losses incurred elsewhere in Asia. Moreover, Korea's foreign debt was discovered to be far larger than originally thought because the debts of overseas branches of the *chaebols* had not been counted as such.

INDONESIA'S SPECIAL PREDICAMENT

Indonesia was hardest hit by the crisis. While other AFC countries had started to recover by mid-1998, Indonesia was still deep in crisis. More than a financial and economic crisis, the AFC for Indonesia had become a political crisis, which swept away the 32 year-old Soeharto regime, gave way to first free elections under President Habibie and initiated a major

decentralisation of authority to local governments. Thereafter, after the dust had settled, I wrote the Indonesian case study for the Shanghai conference on development, which tried to explain the crisis from the perspective of institutional economics: "*Indonesia: Good Policies, Weak Institutions*". Here is the short version.

In the fall of 1997, the IMF basically saw Indonesia as a case of contagion from Thailand and as a balance of payment problem. This did not differ much from the authorities' views, who had already taken measures accordingly: widening the band within which the Rupiah was managed, floating the exchange rate, hiking interest rates, postponing big public projects and so on. The Rupiah had come under pressure, but had, at the time only depreciated from 2,400 to the USD to about 2,800 in September. Nevertheless, at the Annual Meetings in Hong Kong in the same month, the Indonesian authorities requested IMF assistance, "out of precaution". What the IMF added to the government's programme were measures in the banking sector and some minor structural measures to restore competitiveness of the economy and increase exports.

The first IMF-supported policy package, approved on 5 November 1997, included the closing of some 16 banks, among which one was owned by a son of Soeharto. Initial reactions were positive and the Rupiah strengthened. In contrast to Thailand where a similar measure had been accompanied by a temporary guarantee on all deposits, Indonesia only had a limited deposit insurance. The closure of the 16 banks started a drain on deposits from private banks, which fled to state banks that were seen to be implicitly guaranteed. Matters were made worse five days after the bank closures when the bank part-owned by Soeharto's son was reopened under a different name. This sent shockwaves through the economy, accelerated deposit withdrawals from private banks and increased pressures on the Rupiah as Indonesians converted a currency they no longer trusted.

The central bank had to supply liquidity for those banks to meet their obligation to depositors. In addition, it was the extension of large credit to insiders (often the owners) by the banks themselves, which became the fuel for capital flight that sent the Rupiah in a tailspin. When rumours on Soeharto's health emerged in early December, the Rupiah hit 5,000 to the dollar. After the government presented an unrealistic budget on 6 January 1998, the Rupiah plunged to 14,000 to the dollar. The first IMF rescue package had clearly failed.

There are several versions of what happened next. Mine is largely based on interviews with policymakers in Indonesia, including Professor Widjojo Nitisastro, the long-time adviser to Soeharto, and the dean of the "Berkeley Mafia". This was the group of technocrats around Soeharto that had created the Indonesian Miracle, 30 years of rapid growth that had preceded the AFC.

Crises, including the near-default of Pertamina, the state oil company in the 1970s, and the oil price plunge in the 1980s, were not new to Indonesia. "Never waste a good crisis", Professor Widjojo liked to say. The technocrats had used the crises to push through structural reforms that cut into the interests of the "technologists" who wanted rapid modernisation (and the crony capitalists that had benefitted from the Soeharto regime through special privileges). The latter group increasingly included Soeharto's children. This and much more has been laid out in detail in Adam Schwarz's outstanding "A Nation In Waiting", the second edition of which also includes the crisis era.

The thinking from the technocrats was to use the same playbook again for this crisis. This aligned with the thinking of the IMF and World Bank, who argued that in order to restore confidence in Indonesia, Soeharto must be seen to be capable of acting against the interests of

his family. This was a rich hunting ground: from cloves monopoly to highways, plastics and the national car, Soeharto's family had accumulated plenty of privileges.

A complicating factor was that Soeharto had lost trust in his economic team because of the failure of the first IMF supported programme and had taken personal charge of the negotiations for the second. The thinking among the advisers was that Soeharto would push back against the proposed measures, and thus the draft Letter of Intent (LOI)[1] was overloaded with measures in the expectation that Soeharto would redline most. He did not.

To everyone's surprise, Soeharto accepted all the proposed measures and signed the LOI in the presence of Michel Camdessus on 15 January 1998. The picture of Camdessus bending over Soeharto with arms crossed (a sign of disrespect in Indonesia) became one of the iconic pictures of the AFC.

Soeharto probably had no intention to implement the January 1998 LOI, and it soon went off-track. Nevertheless, Soeharto was re-elected as president, and appointed a cabinet that included his children and cronies. He also called in an expert to advise the government to move to a currency board, at 5,000 Rupiah per dollar, which was totally unrealistic at a time when the Rupiah had less than half that value, and Indonesia had little international reserves left to back such an arrangement. It never happened, but the currency board episode brought more confusion and delays, and the end of the Soeharto government.

At the end of April, Soeharto wanted to use rashly implemented fuel price increases (an increase far more than required by the LOI) to rid himself of the IMF programme. Instead, it sparked street protests and riots in May, which killed some 1,000 people, and by 21 May 1998, Soeharto had to step down to make room for President Habibie.

At that stage, the Rupiah had hit 17,000 per dollar, a far cry from the 2,400 per dollar less than a year before. The collapse of the currency had exploded Indonesia's foreign debt (as it had done in other countries). In fact, debt to GDP in AFC countries was much higher than those in Mexico or Brazil in the 1980s when they had to reschedule their debt, and technically, Indonesia qualified for the HIPC (Heavily Indebted Poor Countries) initiative, which it wisely chose not to pursue.

The size of the rescue packages needed to stem the crisis was unprecedented: $40 billion for Indonesia, $57 billion for Korea, even beating the $50 billion pledged for Mexico in 1995 — which included a $20 billion commitment from the US treasury, sorely absent in the Asian Rescues. Indeed, there were serious questions as to whether the IMF resources would be enough in the era of the "electronic herd" of hedge funds and speculators that could move billions with a flip of a computer switch (and massive borrowing in currencies under attack).

Despite the financial needs, the IMF and US treasury reacted sharply to the proposal of one source of additional resources: an Asian Monetary Fund (AMF), proposed by Japan at the 1997 IMF-World Bank annual meetings. The fear in Washington was that an AMF would undermine the conditionality that the IMF and US Treasury believed to be essential for restoring economic and financial health to crisis-affected countries.

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[1] An LOI is a formal expression of the government's programme that the IMF supports, though the drafting was, at the time, done by IMF staff.

AFTER THE STORM

Much has changed since then. After the storm of 1997-98, things calmed down in crisis affected countries, with Indonesia the last to resume growth. Remarkably, growth resume to all crisis-affected countries at a pace close to that before the crisis. This is in sharp contrast to other countries that suffered BOP (balance of payments) or debt crises, such as Mexico and Brazil, which lost a decade or more of growth.

Many of the reforms triggered by the AFC made economic growth more sustainable and more resilient, with stronger banks, more reserves and much stronger supervision. As a result, neither the Global Financial Crisis (GFC) had made a dent to their regained success (so much so that the GFC is also known as the "Transatlantic Financial Crisis"), nor the COVID crisis has endangered the finances of the former AFC countries. Arguably, in Korea, the AFC pushed the reforms needed to avoid a middle-income trap, and in Indonesia, it triggered an era of "Reformasi" that made Indonesia the vibrant democracy it is today.

The crisis also led to a major rethinking of international finance, of the role of the IMF, including more flexible exchange rates, capital controls and "private sector participation" in official BOP support—the latter two were highly controversial during the crisis. The IMF, through a newly created Evaluation Office, did its own critical review of its experience. As a result, the IMF is a very different organisation today, better resourced, with more lending facilities that require less conditionality than at the time of the AFC.

Regional initiatives for reserve pooling, such as the Chiang Mai Initiative and its successor, the Chiang Mai Initiative Multilateralisation (CMIM), also have their origin in the AFC. The European Stability Mechanism, called into being at the height of the Euro-crisis is another example of such arrangements. Both work in close coordination with the IMF.

Years after the AFC, an Indonesian policymaker said, "The IMF and World Bank painted the AFC as a governance crisis [of crony capitalism and entanglement of financial and corporate sector]. Such a crisis cannot be resolved quickly, so capital kept running away. As a result the crisis was deeper and lasted longer". While this statement bears much truth, one can argue that in Indonesia it truly was a governance crisis that would have hit at some point in time. Former Indonesia Finance Minister Boediono got it right in his lessons from the crisis when he summed it up thus: "*Beware of disharmony between politics and economics*".

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