

Flow-on effects from the East Asian financial crisis on Pacific island economies

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The East Asian economic crisis continues to unfold; growth forecasts in Asia and the rest of the world continue to be downgraded as the slowdown spreads from East Asia into Russia and Latin America. The immediate effects of this slowdown on Pacific island economies has been minimal due to limited capital market integration, but the long-term effects could be significant due to current account exposure of these economies to East Asia and the rest of the world. There are several policy lessons for the Pacific island economies from recent experiences, including proper sequencing of reforms and the need for good governance for economic prosperity.

The 'Asian crisis', though much publicised, is not as yet fully understood. Much like the 'Asian miracle', its impact has been on the confidence of international investors in the growth prospects of Asia. While the current crisis has dissipated confidence in the miracle of Asia, the earlier belief in the growth miracle led to exuberance in the success of Asia. Whilst the Asian miracle led to rapid and often under-cautious investment in Asia, the crisis is leading to overly cautious engagement in the troubled regions. The investment boom in Asia followed by a

capital exodus, the latter over an extremely short period of time and translating into extreme hardship to the affected economies, has the hallmarks of overshooting reactions of the market. The damage done in the adversely affected economies has been the result of the rapidity of financial reactions, it is therefore not surprising that repeated calls have been made to control the market from these over-reactions.¹

The current economic crisis in Asia is not a new phenomenon, similar crises occurred in Chile in 1982, Argentina in 1982 and 1995, Venezuela in 1994, Mexico during 1994–95, and in Finland, Norway, and Sweden in the early 1990s (Miller 1998). The symptoms of balance of payments and banking problems are not new either, all of the previous crises experienced shortages of foreign reserves and liquidity problems in the banking sector. Recent research suggests that causation between currency and banking crisis are two-directional—the two feed-off one-another. Policy dilemmas in the choice between high interest rates to defend the falling currency and the need to allow ample liquidity in the troubled financial institutions is not new to Asia, similar dilemmas arose in the Chilean

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banking and currency crisis of the 1980s (Kaminsky and Reinhart 1998). All of the countries recovered from their crises, several including Chile and Mexico made a strong and rapid comeback after the crisis. The one difference in respect of the recent crisis is the extent of the international spillovers, but this is perhaps more the result of the extent of globalisation of factor and product markets than anything else; at the heart of the 1997 crisis in Asia has been the volatile international capital and weaknesses in the financial sector.

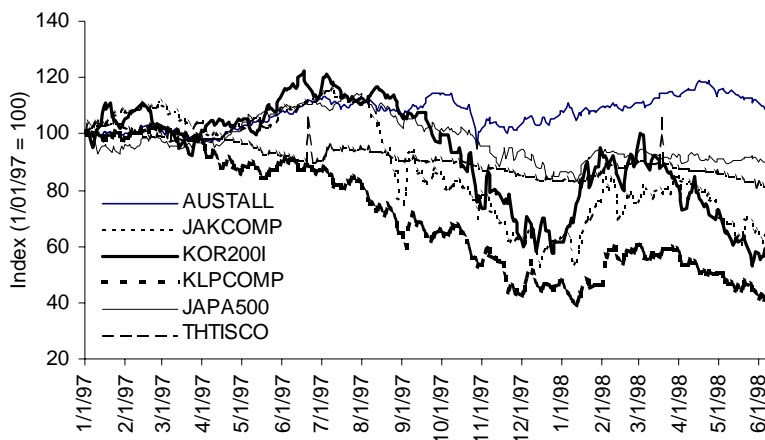
This paper provides a selective review of the extent and possible causes of the crisis, but this is not the principal focus of this analysis. Here, attention is paid to the likely impacts of the slowdown in East Asia on economic performance in Fiji and Papua New Guinea. The findings here have relevance for the South Pacific island economies in general.

What went wrong?

East Asia up until mid-1997 was exemplified as a development success; incomes in the respective economies had grown rapidly over the last two decades, poverty had declined, and the region was attracting an increasing quantity of global capital. During this period of rapid economic growth, there was an exuberance about the East Asian success, consequently the risks of failures were largely ignored (Garnaut and McLeod 1998). When investors reassessed their risks to investment in the region, things changed rapidly. From mid 1997, East Asia changed from an economic miracle to one in desperate need of one.

There was an exodus of capital, first from Thailand, then Korea, Hong Kong, Malaysia, Indonesia, and Philippines. A significant quantity of this capital went to the United States, McKibbin (1998)

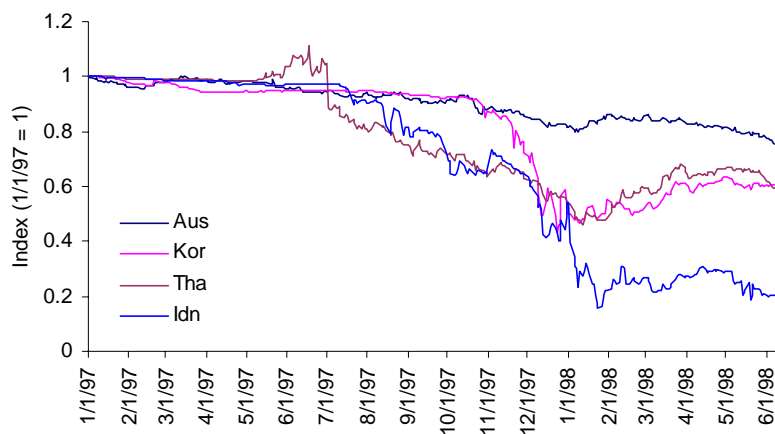
Figure 1 **Stockmarkets crash!**



Source: Datastream.

Note

Figure 2 Exchange rates dive!



Source: Datastream.

attributes the growth in the US stockmarket and the low interest rates prevailing there as being a direct consequence of capital flight from East Asia to the United States. There were several symptoms of the crisis, some of these included rapid falls in the stockmarket, sharp deteriorations in the value of the domestic currencies, and a

rapid rise in short-term interest rates with accompanying shortages of liquidity (Figures 1 to 3). Confidence in the ability of East Asia to continue to generate wealth for investors dissipated rapidly leading to an unwillingness of lenders to rollover short-term debt; liquidity dried up quickly as a consequence and a rapid contraction in

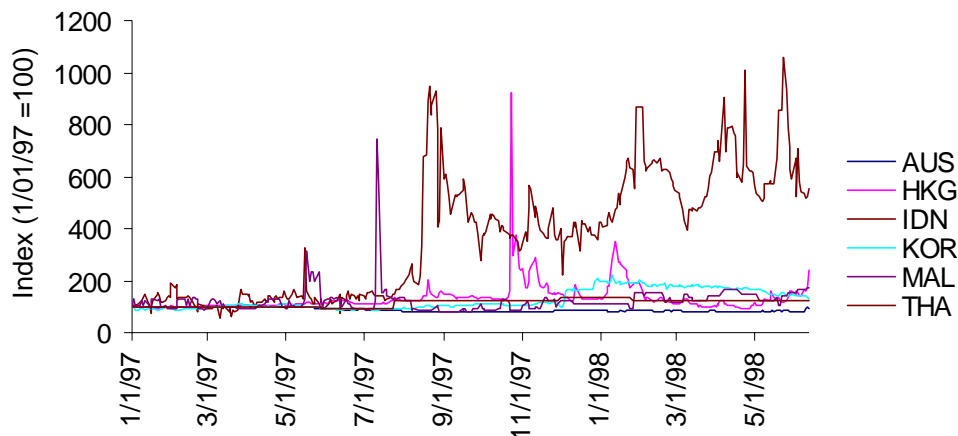
Table 1 Real GDP growth revisions

	1996	1997 (estimate)	1998 (June 97 forecast)	1998 (April 98 forecast)
Indonesia	7.8	4.6	7.6	-6.3
Thailand	6.4	0.0	5.9	-4.1
South Korea	7.1	5.5	6.1	-1.6
Malaysia	8.6	7.8	8.0	1.1
Singapore	6.9	7.8	7.3	2.7
China	9.7	8.8	10.4	7.8
Philippines	5.7	5.1	6.3	2.2
Hong Kong	5.0	5.2	5.5	3.0
Taiwan	5.7	6.8	6.5	5.9

Source: Goldstein, M. and Hawkins, J., 1998. 'The origin of the Asian financial turmoil, Research Discussion Paper, Reserve Bank of Australia, Sydney:16.

Note

Figure 3 Interest rates move



Source: Datastream

domestic demand followed. At least in the short term, the stabilising forces of markets seemed to have disappeared with asset and equity price falls appearing to have lost the bottom while short-term interest rates increased by as much as a factor of ten.

Several of the economies appealed for international assistance in the form of advice and short-term capital to boost reserves. Amongst the worst affected economies of Thailand, Korea, and Indonesia, short-term interest rates increased by as much as a thousand per cent over night (see Figure 3) while the stockmarket and exchange rates fell drastically. The Jakarta composite had dropped to 40 per cent of its value within the year to January 1998 (see Figure 2) while the Indonesian rupiah had plunged to less than one-fifth of its value in the same period. In all of the above mentioned economies, the financial crisis had turned into an economic crisis, massive lay-off of workers was under-way and serious shortage of working capital was observed.

In the case of Indonesia, the crisis had worsened to becoming a political crisis leading to the resignation of the then president.

Growth forecasts of the affected economies have been revised down several times, and this revision of growth forecasts continues as the crisis unfolds. Indonesia and Thailand are the most severely affected, but the flow-on effects of the slowdown in East Asia will impact on the rest of the world depending on the extent of exposure of individual countries to the affected economies in Asia.

Why did things go wrong?

There is no single and common reason for the crisis in the various countries, here I consider three inter-related hypotheses on the source of the crisis. The extent to which the proposed reasons for the crisis are applicable to individual country cases differs between countries, but these reasons appear to be present in each of the affected economies.

Note

Crisis as an end to a boom

In the decade prior to the crisis, all of the affected East Asian economies grew rapidly; Korea and Indonesia achieved average growth rates in excess of 7 per cent per annum on a per capita basis. Such a high rate of growth translates into a doubling of income in ten years, or an eight-fold increase in the level of income in one generation (30 years). Much of this growth was the result of resource accumulation, capital was accumulated at a rapid rate from high domestic savings and rapid capital inflow, the latter driven by the exuberance of the 'Asian growth miracle'.

Unemployment as well as underemployment was high, at least in the initial phase of growth, hence abundant labour was available for producing output, but as growth continued labour shortages were becoming evident leading to increases in wages and declines in the

competitiveness of exports from the region. The devaluation of the Chinese yuan in late 1994 and entry of China into global markets for tradables did not help in this process.

Euphoria sucked in large quantities of foreign capital, some of which was short-term and foreign currency denominated, and led to a real estate boom. An interest rate correction (rise) in the United States followed by withdrawal of short-term foreign capital forced a devaluation/ depreciation of the domestic currency, and this then translated into unsustainable debt obligations of domestic corporations and banks. It can be seen that the rapid growth on the basis of capital accumulation, much of it financed via short-term capital inflow, unravels just as quickly when the tide of capital flow reverses. This is a succinct review of the most common explanation of the crisis in the affected economies of East Asia.

Table 2 **Per capita GDP levels and growth rates in East Asian economies, Fiji and Papua New Guinea**

	Level (1995 US\$)	Index (PPP) ^a (US\$ 1995 = 100)	GDP growth (1985–95)
Australia	18720	70.2	1.4
Indonesia	980	14.1	6.0
Thailand	2740	28.0	8.4
South Korea	9700	42.4	7.7
Malaysia	3890	33.4	5.7
Singapore	26730	84.4	6.2
China	620	10.8	8.3
Philippines	1050	10.6	1.5
Hong Kong	22990	85.1	4.8
Fiji	2440	21	2.0
Papua New Guinea	1160	9.0	2.3

^a this is the purchasing power parity measure of GDP.

Source: World Bank, 1998. *World Development Report 1997*, Oxford University Press, Washington: Table 1.

Crisis from a jump in the perceived risk of investing in Asia

This explanation is not independent of the 'end of the boom' story, whereby foreign investors are purported to have been awakened to the riskiness of their investment in East Asia. The exuberance that fuelled capital inflow into East Asia ran-out leading to a re-evaluation of risk in the affected economies. McKibbin (1998: Table 3) using a global general equilibrium model estimates this jump in risk premia of 30 per cent in the case of a temporary shock to five per cent when the shock is permanent. A revision of such risk and the associated impacts led to similar questions being raised in other economies. The economies that fall to speculative attacks on the capital account are those most vulnerable to such attacks. In hindsight, the vulnerability of the worst affected economies appears obvious but the vicious circle of a large attack weakening an economy and making it then vulnerable to subsequent attacks is much harder to detect in advance.

Crisis from massive outflow of short-term capital

Outflow of short-term capital had a major role in the crisis, evident from the time profile on depletion of foreign reserves. One consequence of this depletion is the drying-up of liquidity and the consequent rise in short-term interest rates; another consequence is the fall in the values of the domestic currency. The last two effects are linked in that under a fixed exchange rate regime, a country loses foreign reserves through capital flight; this in turn drives interest rates up—the Hong Kong experience of late last year showed this well. A floating exchange rate regime, in contrast, brings about a fall in the value

of the currency with capital flight—the recent experiences in Indonesia and Korea exemplify this phenomena well.

The chain of events and the underlying drivers for short-term capital flow can be best observed in the chronology of events just prior to the crisis in Thailand. Note that the Thai economy was the first to experience the crisis. In the period prior to 1997, the Thai economy was growing rapidly in an environment of low inflation, a fixed exchange rate regime, and low interest rates abroad.

The capital market was deregulated with Bangkok a fresh aspirant as a financial hub in Asia. The low interest rate abroad together with a fixed peg of the baht to the US dollar encouraged foreign borrowing, often in US dollar terms, with these funds then lent on the domestic market in baht. Rapid growth in Thailand led to a rapid rise in the price of real estate, consequently much of the foreign capital was absorbed in this market. The financing of these loans was considered prudent on the basis of inflated real-estate prices and a favourable baht-US dollar peg.

Once the capital flows reversed,² the peg became unsustainable and a fall in the US dollar value of the baht was inevitable, making the loans unserviceable. The shortage of liquidity in the domestic market also adversely affected real-estate values which further exacerbated the problems of the viability of the issued loans. Liquidity shortages then seriously undermined the solvency of the banks that issued the loans. Though this is a stylised representation of the events that led to the crisis in Thailand, the latter half of the story is echoed throughout the adversely affected economies of East Asia.

International assistance was sought to alleviate the short-term liquidity problems faced by the affected economies.³ One

Note

theory put forward for the sudden and massive capital outflow was the role of US hedge funds that short-sold domestic currencies and hence are alleged to have created the crisis. Malaysia, and its president in particular, had voiced strong opposition to the role of these funds in the fall of the ringgit. Discounting the conspiracy theories, the hedge funds are arbitragers in the global capital market. Hence, their contribution is to enable the market to operate efficiently. Hedge funds, as such, have a role to play in reducing volatility in exchange rates. This is a helpful not damaging role, but this view is being strongly challenged in much of the current literature.

None of the above explain why the crisis happened when it did happen. The trigger for the crisis remains to be identified. Several of the reasons postulated including the prevalence of crony capitalism and corruption, and the presence of weak financial institutions in the affected economies do not explain the timing of the crisis, given that these issues have been long-standing concerns. This is not to discount the contribution each had in the lead-up to the crisis. Within the first hypothesis, the end of a boom can be caused by any tiny and perhaps individually unnoticeable factor—the ‘straw that broke the camel’s back’ factor. It is therefore, debatable whether identifying the trigger is either helpful or even possible. For completeness I consider a few of the explanations.

In the case of Thailand, Warr (1998) argues that a collapse in growth of exports in 1996 ‘provoked capital outflow and speculation against the baht’ (1998:8). Once the outflow of capital commences, according to Warr, this then becomes unstoppable and a devaluation of the domestic currency in this situation is unavoidable. The contagion from Thailand is blamed for the flow-on to the rest of the

economies. This explanation has some merit but it fails to discriminate the affected economies from those that came out unscathed. Australia has had large current account deficits and yet has not suffered much on the capital account despite having gone through a short period of capital flight.

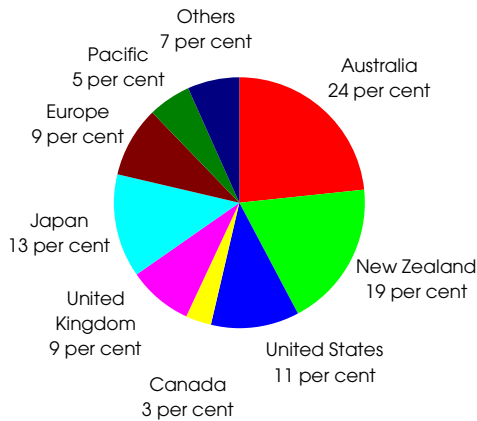
The jump in the perception of risk, according to McKibbin (1998), arose out of an interest rate hike in the United States in March 1997. This monetary squeeze in the United States then led to a sequence of problems commencing with portfolio adjustment through withdrawal of funds by foreign investors in East Asia. The problems were exacerbated by fixed exchange rate regimes and declining competitiveness of the affected economies (first hypothesis). Another, albeit non-competing, explanation of the crisis in Thailand is that it was the result of an unsustainably high current account balance. Once foreign investors realised this, they withdrew capital leading to a sudden depletion of foreign reserves forcing a devaluation then a subsequent float of the Thai baht. Contagion from Thailand then brought about a revision of the perception of risk in the rest of the crisis-hit economies. The common elements include an end to a boom, rapid flight of short-term capital, and an ensuing falls in the values of the domestic currency and stock prices.

Current account exposure of the Pacific island economies to East Asia

The Pacific island economies are unlikely to feel any immediate impact from the slowdown because of limited capital account exposure. Current problems as the drought in Fiji and Papua New Guinea and rising budget deficits and public debt

Note

Figure 4 Source of tourists for Fiji, 1996



Notes: Based on data on visitor arrivals

Source: Reserve Bank of Fiji, 1997. *Quarterly Review*, Suva, Table 38:59.

in most of the Pacific island economies are more serious concerns and more likely to have a serious effect on growth prospects. The Pacific island economies export primary produce and rely on tourists from Asia, hence an East Asian slowdown is likely to impact on the current account. Indirect effects from the slowdown in the

world on commodity prices will have long-term effects on the current account of all the Pacific island economies. While the negative impact on mineral oil prices will benefit most of the Pacific island economies, the net impact from the fall in commodity prices is likely to be negative given that all of the Pacific island economies are net primary-commodity exporters.

Table 3 Fiji: visitor arrivals, 1993–98

	Japan	Korea	Taiwan
1993	38203	2685	712
1994	39782	2800	786
1995	45300	5475	789
1996	44598	14770	736
1997	44783	12181	567
1998*	19501	959	554

Note: * for first and second quarters only.

Source: Reserve Bank of Fiji, *Quarterly Review*, Suva (various issues).

Policy options to minimise adverse effects

The Pacific island economies can draw several policy lessons from the financial and economic crisis in East Asia. Each of the Pacific island economies has as yet to fully liberalise their capital accounts; with the exception of Papua New Guinea, all of the Pacific island economies have fixed exchange rate regimes; and all of the Pacific island economies rely on foreign investment as a conduit for inflow of modern technology and capital.

Note

Table 4 Financial indicators for five Pacific island economies, 1998

	Current account (percent of GDP)	Net capital inflow (US\$ million)	Real lending rate (per cent per annum)
Fiji	1.7	-15.0	1.8
Papua New Guinea	-1.3	33.0	6.7
Solomon Islands	-10.9	28.0	4.0
Tonga	-4.2	1.5	5.5
Vanuatu	-12.7	35.2	14.5

Source: South Pacific Economic and Social Database, National Centre for Development Studies, The Australian National University, Canberra.

Fiji and Papua New Guinea are in the process of liberalising their capital accounts, while the remaining Pacific island economies are considering doing the same.

An important lesson from the recent experiences in East Asia is the need for sequencing of reforms together with the requirement of prudential supervision of the financial sector so as to reap benefits from the global capital market. Many of the Pacific island economies have the corruption, cronyism, and public sector involvement that brought the growth in East Asia to a sharp halt last year; the absence of capital account convertibility perhaps insulated the Pacific island economies from the recent problems in East Asia.

One country that succeeded in opening its capital account in an orderly manner has been Mauritius and its lessons have applicability in the Pacific island economies. Mauritius liberalised its current account by first changing quantitative controls into tariff equivalents, followed by reduction of these tariffs.

On fiscal consolidation, a long-term view of balancing the budget permits use of Keynesian stabilisation policy in the short term only. A target of balancing the budget leading to fiscal consolidation is

necessary for restoring investor confidence thereby attracting foreign investment in the domestic economy. Of particular concern in several of the Pacific island economies is the lack of property rights to land and the effect this has on attracting long-term investment. Lack of security of access to land is one reason for the existence of 'footloose' capital in the Pacific island economies. The prevalence of corruption, particularly in relation to access to natural resources with communal ownership, is a symptom of the inadequacy of transparent property-ownership regulations.

On the monetary front, financial market deepening together with transparency in commerce has to be introduced. The Bank of Mauritius has commenced publishing monthly treasury bill auctions and all foreign exchange transactions. Release of these information facilitates transparency and hence helps in the maintenance of investor confidence. The Mauritius central bank has strengthened prudential supervision of the commercial banks by raising the risk-weighted capital adequacy ratios to 10 per cent, this being effective from 1 July 1992. Furthermore, the minimum paid-up capital requirements for all banks has been raised.

Conclusion

The current economic crisis in East Asia is not a new phenomenon, similar crises have occurred in several other countries including Chile, Argentina, Venezuela, and Mexico. The symptoms of a balance of payments and banking problems are not new either, all of the previous crises experienced shortages of foreign reserves and liquidity problems in the banking sector. Policy dilemmas in the choice between high interest rates to defend a falling currency, and the need to allow ample liquidity in the troubled financial institutions are not new to East Asia, similar dilemmas arose in the Chilean banking and currency crisis of the 1980s. All the countries recovered from their crises, with several including Chile and Mexico making a strong and rapid comeback after the crisis. The one difference in respect of the recent crisis in East Asia is the extent of international spillover, but this is perhaps more the result of the extent of globalisation of factor and product markets. At the heart of the 1997 crisis in East Asia has been volatile international capital flows and weaknesses in the financial sector. These new phenomena present several fresh challenges for policymakers and some of these challenges have been identified in this paper.

The crisis in East Asia is still unfolding as the industrial countries now begin to feel the effects of the slowdown. One strong suggestion is that the impact of the East Asian crisis will filter through to Pacific island economies both in the short as well as the medium term. Domestic demand management with financial sector reform could minimise the adverse effects of the East Asian slowdown on domestic activity.

There is increasing relevance of globalisation in the economic performance of economies. In particular, the global capital market is a source of investable funds but access to such funds requires robust domestic financial markets. A globally integrated financial market has little tolerance for mismanagement in the financial sector. Should developing countries wish to take advantage of global capital and use foreign direct investment as a channel for technology flow, then a mature financial market is crucial for success.

A crisis is not all doom and gloom—crises are as much sources of fresh opportunities. Political reforms in Indonesia, the worst affected economy, financial sector reform in all of market-based Asia, and gains in competitiveness from exchange rate falls in the affected economies all suggest a resurgence of Asian exports should the global trading environment remain favourable. The falling Fijian dollar and the PNG kina against the US dollar masks the fact that the trade-weighted index has recovered to the position it had at the beginning of last year. Competitiveness has been regained despite the volatile exchange rates of our trading partners. In so far as Papua New Guinea provides inputs for the exports from East Asia, the benefits to the domestic energy and mineral export sectors are going to be direct. A growth recovery in East Asia will lead to a recovery in demand for final good exports such as those of food and tourist services. Such an outcome is not a matter of hope, but one of time; one hopes this happens sooner rather than later.

Note

Notes

- ¹ See McFarlane, *Australian Financial Review*, 3 July 1998:3 and Krugman, *Australian Financial Review*, 24 August, 1998:15.
- ² The reason for the reversal could be many including the realisation of the unsustainability of the exchange rate peg and the ensuing speculative attack.
- ³ The longer-term problems of the banking sector are still being addressed.

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