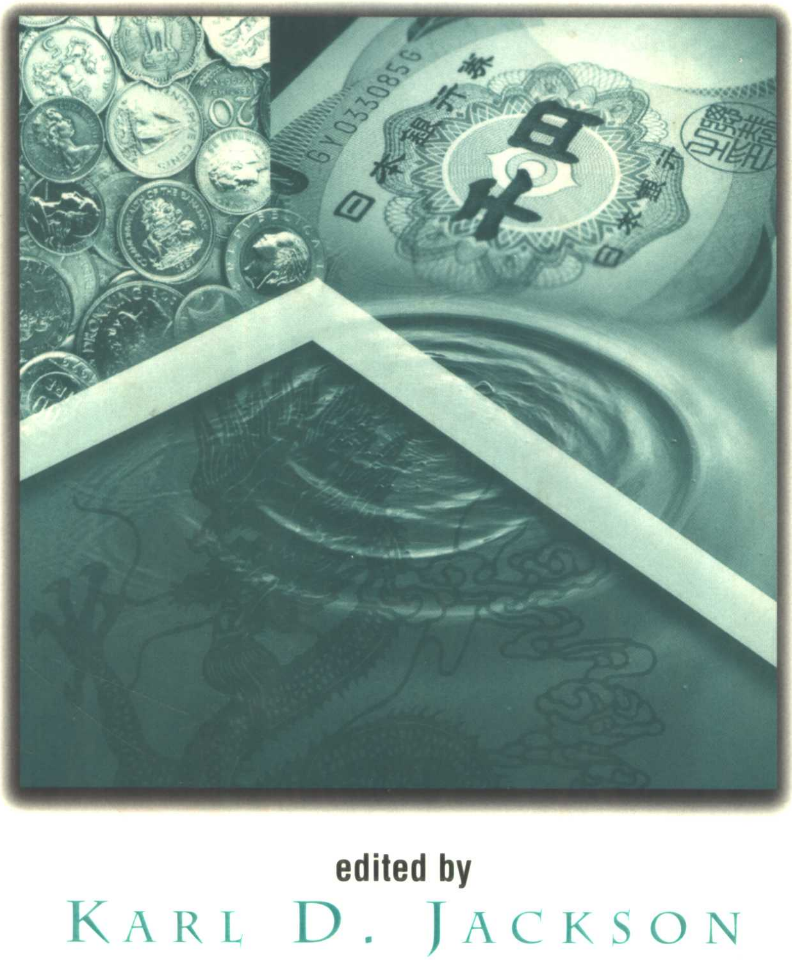
ASIAN CONTAGION

The Causes and Consequences of a Financial Crisis



edited by

KARL D. JACKSON

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Westview Press
A Member of the Perseus Books Group

Published in 1999 in the United States of America by Westview Press, 5500 Central Avenue, Boulder, Colorado 80301-2877, and in the United Kingdom by Westview Press, 12 Hid's Copse Road, Cumnor Hill, Oxford OX2 9JJ

A CIP catalog record for this book is available from the Library of Congress.
ISBN 0-8133-9033-8 (hc) — ISBN 0-8133-90354 (pb)

The paper used in this publication meets the requirements of the American National Standard for Permanence of Paper for Printed Library Materials Z39.48-1984.

10 9 8 7 6 5 4 3 2 1

This book is dedicated to

P. C. F. Hu
Lifelong Friend

Preface

For me, this book is the tale of two rivers: New River in Fort Lauderdale, Florida, in the 1950s and the Chao Phraya in Bangkok in the mid-1990s. On January 8, 1994, I had spent the day exploring the ruins of Ayuthaya, the former capital city of Thailand fifty miles north of modern Bangkok. I was returning to bustling Bangkok by air conditioned boat along the Chao Phraya on that sunny Saturday, when I first sensed the advent of what would become known as the Asian financial collapse of 1997–1998.

I had grown up in Fort Lauderdale in the mid-1950s. At that time, white stone bridges were still connected to vacant residential plots that had become mangrove swamps again after the collapse of the real estate boom of the 1920s. The white bridges along the canals of "the Venice of America" were monuments to the real estate developers who had gone bust because they had planned luxurious residential developments for a marketplace that would not catch up with their dreams for another thirty years.

Two things impressed me during that afternoon boat trip between Ayuthaya and Bangkok in 1994. The first was the degree to which the urban sprawl of Bangkok had expanded far beyond the city I had known when I lived in Thailand during the late 1970s. In "the Venice of the Orient," canals had been paved over to accommodate ever-expanding vehicular traffic in the capital city of the world's most rapidly growing economy. Bangkok was growing rapidly upward, as well as outward, in an exploding urban sprawl. Second, during the leisurely trip down the river, I spied several new, luxurious—and thoroughly empty—thirty-story apartment buildings that had been built on the assumption that large numbers of wealthy buyers would rapidly be produced by the ever-increasing Thai prosperity. Thus, my first inkling of the coming collapse of Asian assets came from mingling the images of empty Bangkok buildings in the 1990s with memories of equally bold real estate developers of South Florida who had so woefully misjudged the marketplace of the 1920s.

On a subsequent trip to Bangkok, inkling became hypothesis. In the company of business colleague Rod Porter, I returned to Bangkok in September 1994. Representing a New York foreign exchange firm, we were attempting to interest Thai institutional investors and wealthy individuals in the firm's foreign exchange risk management services. The businessmen with whom we spoke were polite but non-committal. After all, the value of the baht would "never" change; hence, there was little risk to be reduced. My colleague's morning jog that Sunday morning passed numerous construction sites. Later, he hypothesized with me that there was no way the Bangkok market could absorb all of the modern offices and luxury condominiums being opened or under construction. To test our hypothesis, after returning to the United States we obtained basic data on current office space, the amount of new space coming on-line, and the vacancy and absorption rates. From these data we concluded that even at 8.5% per annum growth rates, Bangkok was on the verge of a real estate crisis that would have a substantial negative impact on the banking system. In a January 1995 letter, conveyed indirectly and informally to the highest levels of the Bank of Thailand, we predicted a crisis similar to the American Savings & Loan debacle of the late 1980s. We warned of a negative impact on the banks similar to the aftermath of the collapse of the bubble economy in Tokyo.

During 1995–1996, an informal collaborative group formed to devise plans for achieving a "soft landing" for Thailand. Pornpimol Kanchanalak, Tom Kendall, Tadashi Maeda, John Merante, Rod Porter, John R. Taylor, and a number of exceptionally astute Thai friends contributed their time, pro bono, to this effort. With each plan (dutifully passed along to Thai authorities), we learned more about the depth and breadth of the crisis. It became clear that the glutted real estate market accounted for only a third of the non-performing loans threatening the banking system. Non-performing loans also had appeared throughout the modern manufacturing sector.

A further trip led me into a series of interviews with bankers and several Thai financial analysts. Most of the individuals admitted there was a non-performing loan problem, but they claimed it was not serious and that only one bank, the Bangkok Bank of Commerce, was in deep trouble. Only one person suggested the problem was large, involving the property companies, the finance companies, and ultimately the banks. The officials with whom I shared my findings did not take offense but gently indicated the problems would be handled "the Thai way," behind the scenes, through compromises among builders, bankers, and regulators, thereby precluding both slow growth and financial panic.

Repeated trips to Bangkok clarified the political fact of life that for each proposal there was always another special interest group standing in the way of rational policy choices. Sophisticated technocrats, with advanced degrees from the most prestigious universities in the United States and Western Europe, remained solidly embedded in their own business culture. They proved unable to begin unraveling "the Thai way," by which personal relationships supplied the only real collateral for business loans. Long before the baht crashed, business began to sour. Poor business decisions became non-performing loans and, in the absence of a binding foreclosure law, the financial sector could not clear its books.

Thailand had also become a democracy, and the political will required for tough decisions could only be assembled, it seemed, once the failure of the entire system had become evident to the whole world. Action could not be taken until the threat was obvious to all, and by that point a "soft landing" was no longer a real option. Particularly in 1995 and 1996, the interests of property owners did not coincide with the interests of the finance companies, which in turn differed in important ways from those of the banks. Rather than reigning in a runaway boom, those responsible for regulating the system instead sought to be responsive by keeping the boom going.

Like the Florida developers of the 1920s and the Tokyo speculators of the late 1980s, Bangkok's developers, financiers, bankers, and government leaders had all adopted a linear view of history. They assumed that the economy would expand indefinitely and that the baht would remain permanently pegged at the current rate. Therefore, they reasoned, the prosperity of the last twenty years could safely be projected far into the future, without fear of a possible cyclical downturn that would be financially lethal to those who had borrowed too extensively abroad. Thai and other Asian entrepreneurs had no lack of skill, daring, and sophistication; but they did not understand the boom could not last forever.

Regardless of location—in time or cultural space—the booms that precede financial panics are always characterized by beliefs about the uniqueness of a particular time or place and the incomparable skills of the business elite. This was equally true of Tokyo, Shanghai, Bangkok, and Kuala Lumpur, where foreigners were continually assured that special qualities precluded the application of standard business practices. Likewise, in the spectacular 1998 failure of Long Term Capital Management of Greenwich, Connecticut, neither sophisticated derivatives nor Nobel prize winners in economics were sufficiently unique substitutes for sound business judgement about the real value of underlying assets. Judgement, rather than intellect, is the rarest of commodities when markets begin to unwind in unprecedented ways. In business, as in other fields of endeavor, hubris comes before a fall.

Books always involve a group effort. Michael Carns, Executive Director of the Center for International Political Economy, encouraged this project throughout and supplied funding for the on-going policy seminar at the Paul H. Nitze School of Advanced International Studies (SAIS) where most of the chapters were originally presented. Yasusuke Tsukagoshi, of the Japan Center for International Finance, supported the research for the chapters on China, Indonesia, India, and Thailand. My colleague, Fred Brown, was involved from start to finish, and the volume would not have been possible without his good judgement and unstinting support. Lois Weiss, Program Office Coordinator for SAIS Southeast Asia studies, oversaw the entire enterprise with competence and good humor. David Timberman arranged the contract with the publisher. Martin Lasater labored long and hard as the copy editor; without his skill and efficiency the production schedule would have been lengthened considerably. Diligent and skillful research assistance was supplied by Sampriti Ganguli, Tracy Henry, Suzanne Jessop, and Jae Ku. I owe a special intellectual debt to my business colleagues, Thomas Kendall, John Merante, Rod Porter, and John R. Taylor, who taught me just enough to comprehend what was going on, but mercifully not enough to allow me to meddle too extensively in the practical affairs of finance that will determine the future of Asia. Finally, none of this would have been possible without the insights of friends and associates in

Tokyo and especially in Bangkok. They offered their time and their wisdom, and I hope the product is in some ways worthy of their effort.

Karl D. Jackson
Washington, D.C.
September 1998

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Introduction: The Roots of the Crisis

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From 1945 to 1997 the Asian economic miracle fueled the greatest expansion of wealth, for the largest number of persons, in the history of mankind. Prognosticators spoke confidently of the advent of "an Asian century." By 2020 Asians were expected to produce 40 percent of the world's GDP while the U.S. and European shares would recede to 18 percent and 14 percent, respectively. Some market researchers predicted that Asia's middle and lower middle classes would grow to more than a billion people by the turn of the century, powering the greatest explosion of consumption the world had ever seen (see Rohwer 1995).

Regional Impact of Crisis

In mid-summer 1997, a half-century of economic progress came to a crashing halt. In direct contradiction to conventional wisdom, several Asian economies previously praised for balanced budgets, high savings and investment rates, low inflation and openness to the world marketplace, went into free fall. What became a region-wide panic struck first in Thailand before spreading to Malaysia, the Philippines, Indonesia, and eventually to Korea. Stock markets and currencies plummeted, prompting central banks to mount expensive currency defenses through buying forwards, raising interest rates to unprecedented levels, or both. The magnitude and volatility of the crisis dealt a sharp blow to fragile and overextended banking systems, while devastating those manufacturing establishments dependent on cheap capital and foreign inputs for their production. During the first year of the crisis, the currencies of the five affected countries depreciated by 35-80 percent, diminishing substantially the wealth of the five miracle economies (Table 1.1).

TABLE 1.1 Impact of the Crisis: Exchange Rates and GNP

	Exchange Rates to U.S. Dollars		GNP in U.S. Billion Dollars	
Country	June 1997	July 1998	June 1997	July 1998
Thailand	24.5 baht	41	170	102
Indonesia	2,380 rupiah	14,150	205	34
Philippines	26.3 peso	42	75	47
Malaysia	2.5 ringgit	4.1	90	55
Korea	850 won	1,290	430	283

Source: Updated version from a table in R. J. Cheetham, "Asia Crisis," June 1, 1998.

On a human scale, the Crash of 1997 shook the confidence of foreign investors and domestic entrepreneurs, while decreasing the wealth of the newly emergent middle classes and impoverishing the non-agricultural labor force. The number of people living on less than one U.S. dollar per day in the five affected countries was approximately 40 million prior to the crisis, and they were concentrated in Indonesia and the Philippines (Cheetham 1998). During the first year of the crisis the number of Asians living in absolute poverty more than doubled in countries without elaborate social safety nets, and pockets of absolute poverty reappeared in Korea and Thailand. In Indonesia, the "good news" was that the government and the international agencies were actively moving to acquire the millions of tons of rice needed to prevent starvation.

The affected middle classes had formerly been known for their automobiles, cell phones, and a materialistic lifestyle that had never been available before in Southeast Asia outside of the narrowest upper reaches of the elite. The middle classes of the affected countries worked hard, and their upwardly mobile children were acquiring educational tools in universities at home and abroad. Educational statistics are not yet available on the impact of the crisis, but the number of families incapable of paying school fees has escalated rapidly, thereby diminishing the prospect for white collar jobs for a whole generation of citizens who realistically expected them. If economic nationalism results from the Crash of 1997, it will be generated by formerly upwardly mobile people who have suddenly been denied access to the status, power, and wealth they had come to expect.

As a result of the crisis, governments throughout the area now find their political legitimacy challenged by groups and individuals who, until recently, had been willing to tolerate cronyism and familism so long as governments delivered the economic goods.[1] With remarkable speed, democratic and non-democratic governments were overturned during the first twelve months of the crisis. In Korea, former political prisoner Kim Dae Jung ousted the ruling political party, even though he had long been considered too extreme to be acceptable to important factions of the Korean elite. In Thailand, the dominance of up-country rural politicians was at least temporarily eclipsed with the promulgation of a new constitution and the installation of the government of Chuan Leekpai in November 1997. In Indonesia, a thirty-two-year regime ended abruptly when the military asked for President Suharto's resignation in the wake of student protests and urban looting directed against the Indonesian Chinese community. In the Philippines, the electorate rejected the chosen successor of President Fidel Ramos and chose the most anti-establishment candidate, Joseph Estrada, over the objections of the Catholic Church and the traditional elite power holders. As a result of the LDP's poor showing in Japan's Upper House elections on July 12, 1998, Prime Minister Ryutaro Hashimoto was forced to resign from office. Depending on the duration and severity of the crisis across Asia, other formerly secure governments may be toppled at the ballot boxes or in the streets in the political aftermath of the severe economic downturn.

Roots of the Crisis

Initially, the financial crisis was perceived almost exclusively as an exchange rate problem, being blamed alternatively on governments (for maintaining fixed exchange rates and allowing currencies to become overvalued) or on greedy foreign speculators who, in a matter of days, supposedly had undone the hard work of generations of Asians. In the early months of the crisis, commentators clung to the language of the Asian miracle by depicting the crisis as temporary, chanting the mantra of the "strong fundamentals of the Asian Tigers." At the same time, some Asian nationalists voiced conspiracy theories suggesting Asia was being put in its place by wily global capitalists using sophisticated speculative tools to deflate the value of all Asian assets in a plot to buy everything Asians had built but at fire sale prices. The frustration and resentment of Asian nationalism is captured in Mahathir's August 23, 1997, statement, "All these countries have spent forty years to build up their economies and a moron like Soros comes along" (Loh 1997).

In reality, the simultaneous crises affecting much of Asia are as multifaceted as they are tied to fundamental problems within the economic structure of each country. Excessive borrowing abroad (primarily by the private sector) is the hallmark of this crisis. In the five years prior to the crisis, the borrowings of banks and non-banks in the affected countries grew very rapidly. In particular, banks in each country rapidly increased their net foreign liabilities by large percentages during the four years prior to the crisis. By the time the crisis broke in mid-July 1997, total external indebtedness had reached large proportions, exceeding 50 percent of GDP in Thailand, Indonesia, and the Philippines (Figure 1.1).