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# Foreword: The Asian Financial Contagion— A Global Epidemic

JOHN B. ATTANASIO\*

This conference was my very first proposal as Dean of the SMU Law School. It was based on the prominence that the law school enjoys among faculty and alumni in Asia, and the tremendous expertise they have in law and finance. The trailblazer was the great Dean Robert Storey. These traditions are carried forward today by an exceptional, global faculty. Among the most talented is my partner in this endeavor, the Director of our Banking Law Center, Joe Norton.

The initial focus of this conference was the Asian Financial Crisis, but unfortunately, the conference grew as the crisis expanded. In August 1998, the contagion spread to Russia; somewhat before that, it hit South Africa. Brazil and other countries in South America then caught the disease to the point that Brazilian financial markets were at times dysfunctional. Equador has experienced political unrest. The crisis spread to the United States in August 1998 and the stock market plunged in a relatively short period of time. In response, the Federal Reserve took quick action to reduce interest rates several different times and the stock market shot up. The Dow Jones average even broke the magical 10,000 barrier and briefly exceeded 11,000.

Whether that most recent vertical rise represents a utopian economy in which cycles are a thing of the past or whether we have a bubble, as many economists fear, remains to be seen. Mr. Greenspan was worried when the Dow reached the 6,000 to 7,000 level. According to the *Financial Times*, the stock market has risen ninefold since 1982, yet only one-third of this rise is attributable to rising profits with the rest coming from increases in price-earnings ratios.<sup>1</sup> Another measure that the Fed tracks is the forward price-earnings ratio on the S&P 500 compared to the ten-year treasury bond yield.<sup>2</sup> By this measure the stock market was overvalued by twenty-seven percent last March, a level that has been reached

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1. Philip Coggan, *A Fairy Tale Ending: All Eyes Are On The Dow Jones Industrial Average As It Approaches The 10,000 Landmark*, FIN. TIMES, Mar. 13, 1999, at Comment & Analysis 8.

2. *Id.*

only two other times.<sup>3</sup> When the Dow passed 10,000, the price-earning ratio was thirty-four to one.<sup>4</sup>

The *Financial Times* also reports corporate debt incursions of \$359 billion to repurchase stock or to engage in merger activity.<sup>5</sup> If a bubble exists, it could present big problems if we are unable to grow out of it before it bursts. Even if a bubble does not exist, former Treasury Secretary Robert Rubin stated that the United States cannot continue to function as the only engine sustaining world growth as this has caused a serious balance of payments problem, which we cannot sustain indefinitely.<sup>6</sup> During what became the global financial crisis, the American economy served as the bulwark holding up the world economy.<sup>7</sup>

The crisis even traveled to Europe with the German, Italian, and English economies suffering. For example, during the last part of 1998, the German economy contracted by about 0.4 percent.<sup>8</sup> Such a contraction presented a particularly difficult problem for Germany as unemployment has hovered at ten percent or above for some time.<sup>9</sup> However, conditions now seem to be improving. The Institut fuer Wirtschaftsforschung, one of Germany's leading economic institutes, predicts the German economy will have grown 1.7 percent in 1999 and foresees 2.5 percent growth next year, which is above the expectations of the German Finance Ministry.<sup>10</sup> French officials expect economic growth this year between 2.3 and 2.5 percent.<sup>11</sup> Overall expectations for the Euro-zone economies has improved over the course of this year.<sup>12</sup>

For some time, the Chinese economy has been weakening. China played a very constructive role throughout the crisis by refusing to devalue the RMB.<sup>13</sup> A devaluation of the RMB would have set off another chain reaction of devaluations in Asia, which would have stunted the nascent recoveries in such economies as Korea and Thailand. An RMB devaluation may also have thrown the Asian economies back into chaos and perhaps meltdown.<sup>14</sup>

China has suffered from its failure to devalue the RMB. Its GDP growth has slipped from 8.3 percent at the end of the first quarter of 1999 to 6.9 percent at the close of the second quarter. Some think that the Chinese economy is now hardly growing at all.<sup>15</sup> My friends in China tell me that because of population growth, the Chinese need five percent annual growth just to stay even with employment. Chinese exports have declined by 4.6

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3. *Id.*

4. *Dow, Wow!*, FIN. TIMES, Mar. 17, 1999, at LEX col. 18.

5. Coggan, *supra* note 1.

6. Robert Dodge, *Rubin Urges Nations to Rebuild Economies; G-7 Ministers Vow to Help Troubled Countries*, DALLAS MORNING NEWS, Apr. 27, 1999, at 1D.

7. See Jacob M. Schlesinger & Michael M. Phillips, *Ignition Keys: Overseas Economies Rally, Giving the U.S. A Very Mixed Blessing*, WALL ST. J., Aug. 19, 1999, at A1.

8. Edmund L. Andrews, *Slowdown Starts to Rattle Europe; Finance Ministers Disagree Over Plan To Limit Turmoil*, INT'L HERALD TRIB., Feb. 20, 1999, at 1.

9. John Schmid, *Pressure on Bonn Mounts As Unemployment Surges*, INT'L HERALD TRIB., Jan. 9, 1999, at 9.

10. Venessa Fuhrmans, *European Stock Market Looks Ready To Take Off; Profit Taking Reins in Asia After Recent Gains*, WALL ST. J., July 7, 1999, at C16.

11. Tony Barber & Robert Graham, *Industrial Figures Boost French Economy*, FIN. TIMES, May 22, 1999, at Europe 3.

12. See generally Christopher Rhoads, *Euro's Future Brightens on Shift In Perceptions of Big Economies*, WALL ST. J., July 28, 1999, at A20.

13. *China's Currency: The Final Throw*, THE ECONOMIST, Aug. 14, 1999, at 64 [hereinafter *China's Currency*].

14. *Id.*

15. *Can China Change?*, THE ECONOMIST, Oct. 2, 1999, at 23.

percent in the first half of the year,<sup>16</sup> while imports have surged by 16.6 percent. Consequently, the Chinese trade surplus will decline very substantially this year.<sup>17</sup> At least the recent interviews of Premier Zhu indicate that China will refrain from devaluing for the present. The Chinese population is feeling the pain of the crisis. This pain is exacerbated by layoffs connected with the downsizing of state enterprises, a phenomenon that preceded the crisis.<sup>18</sup> The crisis may have rendered these moves more urgent, however, as it may have increased the losses that these highly inefficient state enterprises were already experiencing.<sup>19</sup> The Chinese government is saying that these harsh economic conditions have sparked civil unrest.

The growth rate of the Asian economy slipped from 6.5 percent in 1997 to 1.8 percent in 1998; however, some project a rise to some 3.5 percent in 1999.<sup>20</sup> This predicted growth rate includes twenty-one Asian developing countries, but excludes Japan.<sup>21</sup> The Asian crisis is still felt in the dominant economy of Japan, which grew by a meager 0.2 percent between April and June, beating consensus projections of a marginal decline.<sup>22</sup> The government hopes to continue this growth by recently announcing 500 billion yen (\$4.63 billion) in new spending.<sup>23</sup> This stimulus package comes on the heels of a disappointingly modest 0.8 percent growth in personal consumption, a widely used indicator of Japan's recovery.<sup>24</sup> Irrespective of short-run results, the insolvency problem with the banks is so large that some think that it will take a long time to fix the Japanese economy.<sup>25</sup>

On a more optimistic note, we have seen good rallies in the Korean, Japanese, Hong Kong, Singapore, and Thai stock markets, which may indicate that investors are feeling a sense of relief that we have turned the corner.<sup>26</sup> Korea is expected to grow between five percent and six percent this year, in contrast to its 5.8 percent contraction in 1998.<sup>27</sup> Korea has problems with structural reform of its chaebols. Stanley Fischer, Robert Rubin, and Lawrence Summers have expressed doubt about the amount of reform that has actually taken place in Korea.<sup>28</sup> Slow growth in middle-class and lower-class spending has resulted from fears of unemployment.<sup>29</sup> Unemployment fell in May to 6.4 percent, from its peak of 7.9 percent last December.<sup>30</sup> Thailand is now fashioning an economic stimulus package of \$3 billion to ease the credit crunch that has undermined its banking system.<sup>31</sup>

16. Leslie Chang & Karby Leggett, *China is Unlikely to Devalue Despite Slowdown*, WALL ST. J., July 19, 1999, at A10.

17. *China's Currency*, *supra* note 13.

18. See Elisabeth Rosenthal, *China Vows to Stay the Course*, INT'L HERALD TRIB., Dec. 1, 1999, at 1.

19. *Chinese Official Urges Union Help On State Enterprise Reform*, XINHUA NEWS AGENCY, Oct. 8, 1999.

20. *World Economy in 1998 and Its Prospective Development in 1999*, 1999 WORLD DEVELOPMENT REVIEW (FT Asia Intelligence Wire), Feb. 1, 1999.

21. *Id.*

22. Howard French, *Japan Economy Marks Modest Victory*, INT'L HERALD TRIB., Sept. 10, 1999, at 1.

23. *Id.*

24. *Id.*

25. See generally Adam Posen, *Financial Fragility and the Risks of Crisis: The Case of Japan*, 23 FLETCHER J. WORLD AFF. 109.

26. See Craig Karmin, *Asia's Emerging Markets Show Renewed Life*, WALL ST. J., July 1, 1999, at C14.

27. Michael Schuman, *Daewoo Clouds South Korean Economy*, WALL ST. J., Aug. 3, 1999, at A19.

28. See generally Michael Schuman & Jane Lee, *Won World: Dismantling of Daewoo Shows How Radically Korea Is Changing*, WALL ST. J., Aug. 17, 1999, at A1.

29. *Falling Unemployment Rate Boosts Recovery Prospects*, FIN. TIMES, June 19, 1999, at International Sec. 4.

30. *Id.*

31. Thomas Crampton, *Thais Unveil \$3 Billion Bid to Stimulate Economy*, INT'L HERALD TRIB., Aug. 11, 1999, at 11.

Many remain pessimistic or at least cautious because businesses have not restructured in many of these countries, and we may not have seen the worst of the bad loan problem. For example, nonperforming loans have hit sixty to seventy percent in the Indonesian state banking sector.<sup>32</sup> Recently, Indonesia merged four failing state-owned banks into the largest bank in Indonesia. However, fifty-five to sixty percent of these banks' loans were classified as having no hope of repayment.<sup>33</sup> The Japanese Diet has recently appropriated \$67 billion to bail out its banks from the problem of bad loans.<sup>34</sup> However, Japan's financial institutions had amassed \$720 billion in problem loans as of March 31, 1999.<sup>35</sup> Thai banks' nonperforming loans growth has decelerated, but the peak will not be reached until the second half of the year.<sup>36</sup>

I have already mentioned Ecuador and the leaders' claims of unrest in China. Indonesia, the fourth biggest population in the world, has experienced considerable unrest. But the big black hole as far as unrest goes is Russia. Russia has descended into an abyss from which few people think that it will soon climb out. The hole was not dug by the crisis, but the crisis may be filling in the grave. Before the crisis, the Russian economy and stock market were rallying and the Russian economy appeared to be pulling out of the doldrums that have afflicted it for much of this decade. However, the slowdown produced by the contagion effected a sharp drop in oil prices, which sent the Russian economy into free fall last August.<sup>37</sup>

An overlooked factor in the Russian chaos is the liquidity crunch that the crisis imposed on lending institutions like the IMF and the World Bank. These bodies may have been more willing to overlook some of Russia's foibles and outright shenanigans while world economic growth soared and conditions remained good. Massive bailout packages sent to Korea and Thailand imposed enormous pressures on liquidity rendering bailouts of Russia more difficult. Simultaneously, the creditworthiness of Russia plunged along with the price of its major asset, oil.<sup>38</sup> In the wake of the Russian stock market collapse, the center lost power so that some commentators now consider it a "failed state."<sup>39</sup> What does one do with a failed state that has at least 6,000 long-range nuclear warheads?

Since I lived in Russia in 1990, the ruble has declined from an official rate of six to \$1 and a reported black market rate of sixteen to thirty to \$1, to between 25,000 or 26,000 to \$1;<sup>40</sup> really it is a failed currency as often barter and dollars are used for exchange. Even before the crisis, life expectancy for Russian males declined from sixty-two to fifty-eight since 1980—ten years less than in China.<sup>41</sup> The Russian economy has shown some improvement with oil prices having doubled this year,<sup>42</sup> but the increase has not restored the

32. Sara Webb & Jay Solomon, *Indonesia Tries To Weld a Showpiece in Banking with Failed Firms' Assets*, WALL ST. J., July 12, 1999, at A15.

33. *Id.*

34. Peter Landers, *Japanese Banks Stir, But Bad Loans Remain*, WALL ST. J., Aug. 23, 1999, at A1.

35. *Id.*

36. Craig Karmin & Jane Lee, *Thai Stock Prices Tumble 2% on Profit Taking*, WALL ST. J., July 8, 1999, at C14.

37. *Russia's Ailing Economy*, INT'L HERALD TRIB., Aug. 15, 1998, at 6.

38. *See id.*

39. *See id.*

40. *See Currency Trading*, WALL ST. J., Oct. 8, 1999, at C13. Russia lopped off three zeros from the ruble several years ago.

41. Paul Lewis, *Men Die Early in the Ex-Soviet Bloc*, INT'L HERALD TRIB., Aug. 2, 1999, at 7.

42. *Money Report*, INT'L HERALD TRIB., Sept. 25, 1999, at 15.

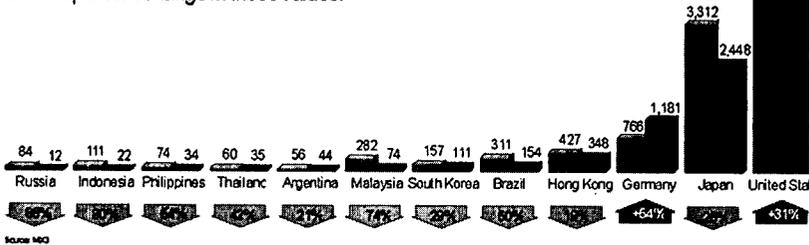
## Plunging Market Values

The emerging economies of Southeast Asia have seen the value of their stock markets decline dramatically since last summer in a crisis of confidence that spread to Russia and South America. In some countries, like Indonesia, overall values have fallen more than 75 percent.

ESTIMATED VALUE OF THE STOCK MARKETS IN BILLIONS OF DOLLARS

JUNE 1997 DEC. 1998

Here is a comparison of the estimated values of 12 nations' stock markets in June 1997 and December 1998, in billions of dollars, and the percent change in those values.



value of the ruble. Tellingly, the ruble has not regained the three-fourths of its value lost since last August.

One little-known consequence of the crisis that may spawn unrest stems from its distributive effects. The following chart is taken from a recent issue of the *International Herald Tribune*, which took it from the *New York Times*.<sup>43</sup>

It shows how much value so many of the world's stock markets lost during the crisis, and, in turn, the sums that some of the world's stock—those in Europe and the United States—gained. Inevitably, as markets collapsed around the world, investors sought safe havens in countries such as the United States and Germany. With time, however, gratitude for the "miracle" economy that saved the world may fade as people realize these redistributive effects.<sup>44</sup>

People's anger may be fueled by stories that the Clinton administration's strong policies of free capital flow may have helped to precipitate the crisis by unduly exposing small economies to the predatory behavior of currency speculators.<sup>45</sup> Some former members of the Clinton administration admit this connection.<sup>46</sup> In 1996, \$93 billion flowed into Indonesia, Korea, Thailand, Philippines, and Malaysia. In 1997, \$12 billion flowed out.<sup>47</sup> A

43. Nicholas D. Kristof, *Of World Markets, None Is An Island*, N.Y. TIMES, Feb. 17, 1999, at A1.

44. David Sanger, *U.S. Is 800-Pound Gorilla*, INT'L HERALD TRIB., July 19, 1999, at 1.

45. See generally Walden Bello, *End of an Ideology*, THE NATION, Jan. 20, 1999; Nicholas D. Kristof, *Experts Question Roving Flow of Global Capital*, N.Y. TIMES, Sept. 20, 1998, at sec. 1, 18.

46. Richard Stevenson, *A New Economic Team: The Policy Impact*, N.Y. TIMES, May 13, 1999, at sec. C, 1.

47. Roberto Chang, *Understanding Recent Crises in Emerging Markets; Statistical Data Included*, ECON. REV. (Atlanta), Apr. 1, 1999, at 6.

French scholar, Charles Wyplosz, argues that “financial market liberalization is the best predictor of a currency crisis.”<sup>48</sup> The American Congress may get some blame too for balking on its IMF obligations at a crucial point in the crisis.<sup>49</sup> Widespread reports have emerged of Western businesspersons journeying to Asia to purchase cash-strapped Asian businesses for fractions of their actual worth.<sup>50</sup>

One also cannot help but compare the response to the European and American crises with the medicine that we prescribed for our Asian, African, and South American brothers. To solve their problems, the large economies forced these others to tighten their belts by restructuring, allowing their currencies to float, and shooting interest rates up—which just about everyone thinks was a big mistake.<sup>51</sup> When the crisis hit the United States and Europe, we immediately sent interest rates rocketing down. Interestingly, so now has Japan. A cynical view of this contrast would have it that the large, economically powerful states can cut their economies some slack when they experience problems, while smaller economies that are dependent on these big economies do not have such options available.

Another expression of resentment focuses on the growing incursions on sovereignty that many international traders, investment banking and brokerage houses have effectively imposed. How long will less powerful countries tolerate such incursions, and how much will resentment grow? Resentment is growing in the United States, too, relating to jobs and free trade. The United States and Europe have had trade skirmishes over bananas, hormone fed beef, and other products.<sup>52</sup> Under pressure from the Asian financial crisis, the U.S. trade deficit has ballooned, and one response has been some protectionist tendencies emerging in Congress, notably in the steel area.<sup>53</sup> Of course, trade barriers helped to ignite the Great Depression.

Ironically, the large capital flows into Germany, the United States and other countries may be inflating a stock market bubble that worried Alan Greenspan and many other economists even before the crisis, when the stock market was at 6000.<sup>54</sup> But many insist that such alarmist thinking is based on antiquated notions of economic cycles. Asia may well tell the story of what problems not believing in cycles can cause. The funny thing about cycles is that they follow the laws of physics: what goes up a lot very fast, generally comes down a lot very fast. One of the most frightening statements I have heard in the last few months by a CEO of an American subsidiary of a Japanese company was that the United States looks like Japan did ten years ago.

So how did this mess happen? That is for our distinguished conferees to say, but I cannot resist speculating. The computer driven, high-expectations, unregulated world economy is now geared like a high strung, finely tuned, high performance car. When everything is right, it really hums; however, it is very temperamental. All is premised on rapid continuous

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48. Roberto Chang, *Understanding Recent Crises in Emerging Markets; Statistical Data Included*, ECON. REV. (Atlanta), Apr. 1, 1999, at 6.

49. Bob Davis, *With GOP Support for IMF Weakening, Danger Is the Slow Erosion of U.S. Leadership Globally*, WALL ST. J., Apr. 27, 1998, at A24.

50. Michael Alan Hamlin, *Restructuring Asia*, BUS. WK., Aug. 30, 1999, at 36.

51. See generally *Malaysia's Selective Currency Controls and Why They Worked*, NEW STRAITS TIMES, Sept. 3, 1999, at 10.

52. Barry James, *EU Ministers Agree on Stricter Labeling of Biotech Crops*, INT'L HERALD TRIB., June 26, 1999, at 2.

53. Eamonn Figleton, *Service Exports Don't Do the Job*, INT'L HERALD TRIB., Sept. 24, 1999, at 8.

54. See Jacob Schlesinger, *Fed 'Bubble' Policy: Watch, Don't Pop*, WALL ST. J., Aug. 30, 1999, at A1.

high growth, which puts a lot of pressure on the system. If anything goes wrong, breakdowns occur. As with a high performance car, breakdowns can be substantial and costly to fix.

But what do I know? People who give introductions are only responsible for provoking thought. They are also responsible for thanking people, and I have many to thank. I want to thank the Lee Trust for being the principal sponsor of the conference. I would also like to thank H.D. Vest Financial Services for their substantial support of the conference. The chairman of the SMU Law School's Executive Board, Alan Feld, secured a number of our illustrious speakers. Joe Norton—one of the most distinguished banking lawyers in the world—was my partner in crime in this endeavor. Joe also organized a number of satellite conferences in London, Bangkok, Johannesburg, Stockholm, Hong Kong, and Cologne, which have tracked the crisis around the world. SMU Law School joined with some of the finest institutions around the world to present these conferences—the Universities of London, Wittwatersand, Cologne, Thamasaat, and Hong Kong.

The London conference on the Russian crisis took place in late May and featured the general counsels of the IMF and the European Central Bank. The Hong Kong conference featured the chairman of the Hong Kong Securities and Futures Commission and the Dean of the Faculty of Law at Hong Kong University. The Dallas conference featured the former General Counsel of the U.S. Treasury, the Senior Economist of the Bank of China in the United States, and the former Japanese Ambassador to the United Nations. Our own distinguished alumnus Dr. Helmut Sohmen began the conference with the Center of Pacific Rim Studies lecture on the critical importance of controlling corruption. A distinguished group of lawyers, economists, financiers, bankers, CEOs, and others graced this conference. Among the notables were the President and Chief Executive Officer of the Dallas Fed, Dr. Robert D. McTeer, Jr., and the Vice-Chairman of Goldman Sachs, Robert Hormats. Others followed after the conference, including Senator Phil Gramm. The interdisciplinary nature of the conference enhanced the discourse. Partners on Campus included the Economics Department and the John G. Tower Center for Political Science, and within the law school, the Center for Pacific Rim Studies and the Banking Institute.

Finally, I want to thank Associate Dean Christine Szaj, my wife Kathy, and Rebekah Bell for their exceptional work in organizing the Dallas conference. I hope that the written materials that emerge from this global enterprise shed some light on these developments so that people will not have to suffer through them again soon.

