Reflections on the Asian Financial Crisis

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The purpose of this essay is to provide a quick overview of the Asian financial crisis countries, what has happened to them since the crisis, and where the crisis countries are going over the next two to three years. First, let me recount briefly the nature of the crisis. Everyone has his or her own interpretation. I will give you mine.

One of the problems was very "cheap money." Money was very readily available to most of Asia, because investors were very bullish on the region, and the banks in the area, particularly the Japanese banks, were very liquid and were providers of very large sums of money through the interbank system. The American banks were much more cautious than many of the other banks, having been through a similar crisis in Mexico a couple of years earlier and elsewhere in Latin America before that. Early in the 1990s, the Japanese banks were quite bountiful in their bank lending.

A second part of the problem was that the recipients in Asia used the money, this super abundance of money, inefficiently and without proper credit standards. The banking systems in many of these countries are very highly politicized. In many cases, they do not have the kind of credit standards that we use in the United States. Although in Texas, many of the savings and loan associations never raised their credit standards a decade ago either and severely suffered for it. So it is not just a developing country problem. We are very harsh in blaming Asia, but Texas had similar problems in a much more regulated financial environment. Further, it happened elsewhere, for example, in Sweden over a decade ago. So it can happen to a broad range of countries. Therefore, we should not go around saying this is an "Asian only" problem. It is not, although Asia suffered from it very recently. We have banks worldwide making very poor decisions.

And then the third part of this crisis was that an overhang of leverage had built up. Excessive borrowing took place internationally and domestically. Korea is a good example:

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huge leveraging of big Korean chaebols (i.e., conglomerates). This would not happen in the United States today because banks have to report their financial position, and high leverage would be seen as so dangerous that they would not obtain any more money, if an institution had that kind of leverage. But in any environment where there is not much transparency and there is a lot of bullish sentiment, companies got away with this. As a result of all of this, there was a huge build-up of excess capacity and exorbitant leveraging of the books of banks and in the private sector.

Now an aspect that made this leveraging worse was that there was a generally accepted view that the exchange rates of these countries would be kept stable. As such, this was, in a very substantial way, a problem that affected most of the regions and led to what I consider to be an enormous "moral hazard." The "moral hazard" was the notion, ultimately incorrect, that governments could and would hold the exchange rates relatively stable. I am not talking about Hong Kong, where there is a Currency Board. The other countries did not have Currency Boards. Essentially, it was a pledge by the government to hold the exchange rate. Well, what happened was that there was a dramatic increase in lending by lenders who figured that they had no exchange rate risk or very low exchange rate risk (almost zero). So that built in a measure of confidence that, in the end, was unwarranted.

On the other side of the coin, many borrowers began saying: "Look, my currency, for example, the baht, is not going to be devalued, so I do not have to worry about currency risks. And if I can find money at five percent abroad, compared to ten percent in bahts or won, I am going to take it."

So one begins to find a lot of borrowing internationally from the banks, which lend money to corporate sectors. This was an enormous problem because it built up an incorrect set of assumptions. On these assumptions, excessive borrowing took place. This also meant that the normal hedging techniques that one uses when currency risks are perceived were not used. One did not have to develop these kinds of techniques, so governments socialized the risk. The risk was the perception that one would do the borrowing and the government would make sure the exchange rates stayed the same. Well, ultimately what happened was that these countries built up very large currency debts over a period of time, because these currencies were perceived to be tied to the dollar. But the dollar began to appreciate, the yen began to fall, and these countries all suffered deterioration in their current account and trade balances. This turned out to be the major factor that began to affect the financial markets.

Much blame has been placed on the hedge funds. But it was not just the hedge fund. Domestic investors perceived the problem, pulling their money out. In many cases, the domestic investors were the first movers. They perceived that their governments could not sustain high interest rates and protect the currency. They perceived that reserves were being lost in many of these countries. They perceived that a lot of the loans were not good loans. And it was found, for instance, in Thailand, that many Thais themselves were moving money out and pulling their money out of the stock market and putting it into Hong Kong, Switzerland, New York, or wherever was thought to be a safer haven.

What tended to happen then was when one lost money in one country, say Thailand, one became very nervous about other countries and one's banks began calling for margin calls; thus, one had to sell. And where does one sell? You sold in the next most liquid market of the next most vulnerable market moving from Thailand, Indonesia, Malaysia, then north to Taiwan, which had some impact, and then, of course, north to Korea. So there was this problem with investors being nervous, pulling their money out of many markets and looking

at all of them more or less the same way, although there were obvious differences among East Asian markets.

Now having said that, what was the legacy of that financial crisis and where does one go from here? Let me just make a few general observations. First, a major problem at this point is not so much the growth rates in these economies: the growth rates in these economies are all, one way or another, except in Indonesia (which is in a very different category), going to look better this year than last. If China is taken out of the equation, probably there will be a growth rate in the region (leave Japan out too, this will be discussed below) of about five percent, as opposed to negative five percent in 1998. Now that looks good. Although sceptics refer to this in some cases as a "dead cat" balance, in other words, whenever there is such a major decline there is going to be some balance. That is not true in all countries. For example, I think that Korea actually has done a number of very constructive things, and Korea will probably enjoy a somewhat higher growth rate than most other countries in the region. But most of these countries are going to experience a fragile economic recovery or are dependent largely on exports unless reforms continue.

But I do not want to focus so much on this, because numbers really do not tell one much. The real issue I think, and the one I want to focus on, is not the "macro" issues because the real problem, the real restructuring, the real need for focus in Asia is on the "microeconomic" activities. Let me just "tick off" what I mean.

When I say "*microeconomic*," I include *capital market regulations*. Do you allow more flexible capital markets? Some countries, actually, have done quite well in this respect. Malaysia, the Philippines and Singapore have all made real progress. For instance, Singapore is developing a robust bond market. Most of these countries, however, do not have liquid bond markets. Lack of a bond market means that there is no benchmark for determining the risks. The banking system makes the risk judgment. If you had a market-oriented instrument, such as a bond that traded off American bonds or European bonds (Eurobonds), then one could have some way of judging how the market perceives risk. But, as many of these countries are without a long-term bond market, it is much harder to perceive market risks. So capital market deregulation is one "micro" issue that needs addressing.

Do these countries have a *bankruptcy system*? In many of these countries, there is no such system. Hong Kong has made much progress in developing an effective one, as has the Philippines, Singapore and Taiwan. But many of these countries do not have a smoothly functioning bankruptcy system. For example, in Japan, the banks continue to protect companies and therefore, there are not many large bankruptcies. The problem with that is not so much that anyone wants anyone to go bankrupt, but if one has a huge amount of an overcapacity, as there is in much of Asia, then one has very few options for dealing with it. One can subsidize either the inefficient excess capacity, or one has some process for companies going bankrupt that shuts down the most inefficient capacity. One has techniques like debt equity swaps, which enable banks that have debt outstanding to transfer that debt into equity, so that the debt is taken off of the books of the companies and there is a restructuring of the balance sheets. Now this does not deal with the problem entirely. Bankruptcy is the right answer for some of these companies, but there are other ways of shifting the risk from debt to equity, which I will address below.

Then there are *disclosure requirements*. Disclosure requirements in Asia, often referred to as *transparency*, are largely inadequate in much of the whole region. This is partly because many companies are family-owned, partly because there is not the same "Madisonian tradition" that we have in the United States of a free press that goes in and actually looks at the books of

companies and puts pressure on companies to open up their books. And, in most other countries, there are not the big pools of money available like those in the United States that insist on better disclosures. So disclosure throughout most of Asia is really a problem. Singapore and Hong Kong are the best in that respect in much of Asia. Indonesia is terrible. Many of these other countries are just not very good in the disclosure department.

Then there is the other side of disclosure, which is *accounting and auditing*. Most of these countries have in fact improved auditing and accounting over the last several years. China, for instance, has focused to a very substantial degree on tighter auditing and tighter disclosure requirements. This is particularly true for Chinese companies that are expected to list on the New York Stock Exchange or NASDAQ companies that are listing in Hong Kong. While there have been real improvements in auditing and accounting, it is far from perfect; but, it is essential first of all, for companies internally to audit accounts; and secondly, if they want additional capital they are going to need a better auditing and accounting process for obtaining that capital. Foreign investors now are very suspicious of the "books" of many Asian companies for good reason. Unless there is credible accounting, it is going to be very hard to entice anybody to put large sums of money into Asian companies.

Then there is the issue of *market opening* (i.e., liberalization). Have these countries opened the opportunities for foreigners to sell financial services in their market? In many cases, markets in these countries have been relatively closed. Not in all cases, but generally, that has been true. In Korea, there has been a major opening of the financial markets. For example, Hong Kong-Shanghai Bank Corp. has purchased Seoul Bank. Now that would have been virtually impossible five years ago for a large non-Korean bank to buy a large domestic bank. Most probably, there is going to be more of this happening. I think that is a remarkable development. That is true in Singapore, but that has been true in Singapore for a period of time and it is true in Hong Kong. In most of the region, however, it is very hard for foreign firms to purchase domestic financial institutions.

Here again, Texas is a very good example. One of the economic turnarounds in Texas was when non-Texas banks bought Texas banks. In the mid- and late-1980s, Texas banks had major problems. Now North Carolina banks, New York banks and other banks have bought into the Texas financial system. These larger banks actually helped the domestic institutions to recuperate, as one saw an influx of foreign money (i.e., the foreign being "outside of Texas"). In Asia, there is a need to internationalize the banking system to reduce volatility, which is to say overexpose. A lot more spreading of risks among foreign banks and financial institutions can assist.

Another "macroeconomic" point that is critically important is *management changes*. That is to say, in many of these companies there is a need for fresh management. That does not necessarily mean it has to come from outside. It can come from within the ranks of the company. But it is very important that when fundamental changes occur (as we have seen in the United States), when there is a major crisis in the banking system or in the corporate sector, getting new management is frequently very important, in part because management comes in with a new style, a "fresh approach." This is beginning to take place in Asia, but it is not taking place very rapidly. A place such as Hong Kong has superb management. There is actually some very interesting progress being made in Taiwan with new management in some of the companies. But some of the older Asian companies simply do not want to part with control, which presents a problem with restructuring because, obviously, if one does not change the management, the old management does not have quite the same attitude toward restructuring as the new one will.

Then there is what I call *financial restructuring.* Let me use Korea as an example, where there was an enormous amount of cross-guarantees from one part of a chaebols to another. Restructuring is needed to get rid of those things because one could not really read a Korean balance sheet and know the exact exposure of the company since one part of the company group was guaranteeing the debt of another. So there was one very good part of a chaebol, one very good business in the chaebol, in very deep financial trouble not because of the way its own business ran, but because it had guaranteed the loans of another chaebol or another part of a chaebol, that was very inefficient or underwater. Thus, this cross-guarantee process made it very difficult to read the books of these companies and that became a major problem. Korea has done a great deal to improve this situation. I use this is as an example because Korea has come from the country that had the most difficult financial structure on the corporate side to one of the countries that is moving rapidly in the right direction.

And then there is the last point, and the most tricky, which is the reason why I left it for last. This is what I call *operational restructuring* (i.e., corporate restructuring). That is to say, reducing overcapacity, reducing the debt structure of these companies, reducing their leverage. A huge amount of change is required throughout Asia in virtually all areas because of excess capacity. That requires, among many things, significant shutdowns and layoffs. It requires, in many cases, restructuring of the management. It also requires, in many cases, enormous cost-cutting and much more aggressive management in cutting costs. It requires much more careful use of capital. One of the things that Asia had in abundance for years was capital. Now there is going to be less capital. The real question for Asia when it recovers is: does it utilize the capital it has more efficiently?

If one is looking at Asia and asks what the most important thing is that one can think of to determine whether Asia is going to succeed or fail, company-by-company, bank-by-bank, country-by-country, over the next couple of years—that question is whether they utilize capital more efficiently. It is going to require enormous discipline. There is a very interesting comparison between Japan and the United States. For many years, the American industrial sector lamented the fact that capital was more expensive here. Equity capital, in particular, was more expensive here. And they said, "Look how cheap it is in Japan." It was very cheap in Japan. The stock market was going up. If you wanted to borrow, you could get money very cheaply. One would do a bond with an "equity kicker." There were numerous and very interesting financial instruments that enabled companies to get money relatively inexpensively. The problem is, and in many countries it is the same way, that when capital is cheap, the discipline or the use of the capital tends to evaporate. In the United States, capital was somewhat more expensive. But if one looks now at the return on capital in the United States versus the return on capital in Japan, it is much higher in the United States, because the cost of capital (coupled with the discipline of imports, primarily from Japan, but also from other parts of the world) has caused American companies to utilize their capital very efficiently.

Is the United States today comparable to Japan ten years ago? I do not think so, because it is an entirely different environment, largely because of the corporate restructuring. Few Japanese companies have begun to restructure. The American companies have been engaged for fifteen years in very active, very effective restructuring, utilizing capital better, with much more efficient management structures and with much greater accountability to shareholders.

In concluding, let me reiterate a couple of points that I think are very important and touch on Japan and China.

Japan is critically important to the East Asian region. We should not forget the economic power of Japan and we should not write Japan off as a country that cannot succeed. I think, as reflected in Mr. Horii's essay in this *Symposium*, that it is a sad story in Japan, as the government really has not yet risen to the challenge of the global economy. Yes, I think the Japanese economy has probably bottomed out. Certainly the Bank of Japan is doing all it can to inject more money into the system. "Call rates" are nearly zero. There are also new restructuring announcements all the time and yet, there are a lot of risks there. There is the risk that the economy, which is now tending to rebound with consumption up, could weaken again.

As the government stimulates the economy, the question is what happens when the Japanese government stimulus ends. There also is over-capacity in the system. Unless there is process for more bankruptcies or more debt equity swaps (i.e., of ways of working down that excess capacity and working down the enormous debt over-hang), the Japanese economy is going to face major problems down the road. I think that there is a greater sense of urgency in Japan today, but it is far from "out of the woods" in putting itself on the course toward robust growth. The economy may grow a little more this year, but whether the real restructuring is going to take place remains the unanswered question.

Now I will end with China. The question that is frequently asked is: Will China devalue? I think that the answer is that China will not devalue, because it is not in its interest to devalue. It is not because Larry Summers or Alan Greenspan or anyone else says, "please do not do it" and the Chinese say, "of course, we are not going to do it. We like you so much, we are not going to do this." The Chinese know it would be disruptive. Quite simply, it is not in China's interest because, if it devalues too much, then virtually every other country in the region will likely devalue their currency. China will not be better off. Also, the problem with China is not that it has lost competitiveness as a result of the stable rembi. They haven't. Their export problem is primarily weak regional markets, as they recover, so will Chinese exports. It has not lost market share in the United States or anywhere else. China lost exports, because the region of Asia where they export a lot is weak; so, of course the exports are down. But it is not a domestic currency problem.

I think that in 2000 China may adopt a more flexible exchange rate policy, and I believe it should. The United States should not press China to hold its currency stable no matter what. But for 2000 and beyond, I think the real problem in China is this enormous restructuring of state enterprises. Again, it goes back to the "micro" point that I was making about the countries in Asia restructuring their state enterprises and restructuring their banks. The two are very closely integrated.

The Chinese state enterprises (SOEs) are very wasteful of resources. Where do the resources come from? They come largely from the banking system. So what China is trying to do is to get its SOEs to become more productive, more efficient and to utilize capital better, or as in the case of some textile industries, to phase out (i.e., to go bankrupt, in effect, or to lay off a lot of people and improve their structure). Of course, if China accomplishes this, it takes a lot of pressure off the banking system, which has to lend this money to the SOEs if they do not restructure. The problem, of course, is that one cannot restructure state enterprises too rapidly because they employ very large numbers of people; this will result in unacceptable levels of unemployment in China, particularly in urban China. The government, obviously, does not want crowds of unemployed people from steel industries or textile industries on the streets of Shanghai or Guanchou or Wuhan. So there needs to be a phased restructuring process. That means that someone has to provide capital

for these losing companies for a period of time and, unfortunately, much of that has to come from the banking systems.

So the Chinese are in the process of a very long restructuring process. But I will say this about China. This country learned a great deal from the Asian crisis and they have drawn the right conclusion. The right conclusions are that one cannot wait until the crisis hits. The kind of crisis that could hit China, if there were one, is not the kind of crisis that hit its neighboring countries, because the PRC does not have a convertible currency, thus, one cannot speculate against the currency as is possible with the won or the baht.

There have been some reports, particularly in the Hong Kong and New York papers, that the PRC has retreated. Certainly, the PRC has centralized the reform process to a degree that they did not before because they had problems with independent-minded borrowers incurring a large debt. Whether the Chinese can do what they want as quickly as they want, which is two to three years, is an open question. Are they doing the right thing? I think the answer is yes. Can they get support from the provinces? Can they get support from the Party to undertake these very market-oriented, very structural reforms? That is a very tough challenge. But certainly, at the top in China, there are very able people, very committed people. It is a race between the restructuring that is underway and concerns about employment, which of course are growing. Thus, the answer remains to be seen.

So with that "tour de horizon," I conclude. But I am optimistic that China can meet the challenge.