Remembering the Asian Financial Crisis: Lessons for Emerging Economies

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JULY 2007 marks the tenth anniversary of the Asian Financial Crisis which erupted in 1997 following sudden speculative attacks on the Thai baht. The last decade has witnessed intense debates within scholarly and policymaking circles regarding the exact causes of the crisis, as well as the lessons from this painful experience.Recently, however, the focus has shifted to the possibility of another crisis in the near future. The current economic conditions of some Asian economies have been compared with the state of affairs in the run-up to the crisis in 1997, giving rise to some concerns.

The recovery

Such prognoses, however, fail to give credit to the massive macro and microeconomic reforms that have been undertaken in these Asian countries since 1997/98. In the past decade, Asian economies have sought to improve their macroeconomic fundamentals to boost their resilience to future crises. Trade has grown rapidly since the post-crisis recovery, hence leading to reserve accumulation and consequently, a greater degree of self-insurance. Growth rates and investment levels, which have not returned to pre-crisis levels, nevertheless continue to be high by international standards. More importantly, the national and regional financial architectures have been strengthened through prudential supervision, and corporate and banking sector reforms which have allowed for greater transparency and accountability.

Moreover, exchange rate regimes have been made more flexible. Exchange rate flexibility coupled with a prudent fiscal policy has added to the credibility of monetary policy in the region, hence allowing for more cautious financial integration. Surveillance activities have also improved. This is due not only to changes in the international financial architecture, but also to increased emphasis on the importance of regional surveillance. The ASEAN + 3 framework which brings together the ten ASEAN countries with China, Japan and South Korea, is a critical step in this direction. Regionalism is also being promoted by means of regional reserve pooling through the Chiang Mai Initiative (CMI).

New Threats

Nevertheless, several threats continue to pose a challenge to the economic and financial architecture in Asia. Excess liquidity at the national and international level, combined with the euphoria created by high growth rates, has resulted in asset price inflation; asset price bubbles are part of the urban economic profile of most Asian countries. Furthermore, despite the international financial community's adoption of new financial innovations which reduce and diversify risk, herd behaviour continues to guide investor decisions. Such herd behaviour, which is not necessarily irrational,

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together with the threat of reversal of capital flows, places the Asian economies in a vulnerable position. While the CMI marks a considerable effort in the direction of regional insurance against such vulnerabilities, the effectiveness of this initiative is limited. This is because the CMI requires IMF conditionality before 90% of the available funds is disbursed to the member country in need of liquidity support.

In addition, some structural weaknesses within the politico-economic system call into question the future prospects of the Asian economies. Despite extensive corporate governance reforms and privatization of state-owned enterprises, cronyistic relationships between the state and the business class continue to govern lending decisions in some Asian economies. Several formal standards and regulations have been introduced in the past ten years to curtail the influence of such cronyism, but their implementation and enforcement remain questionable in at least some, if not all, crisis-hit economies. This continued prevalence of cronyism can partially explain the weak loan quality controls, which in turn lends itself to greater banking sector vulnerability (in terms of non-performing loans or NPLs), especially in countries like Indonesia. Furthermore, the competitiveness of the region as a whole has been declining, thus challenging future growth prospects.

Implications for emerging economies

Emerging Asian economies such as India and China have considerable lessons to learn from these post-crisis experiences of the Asian region. China's commitment to a fixed exchange rate regime till 2005 resulted in a continuous accumulation of foreign reserves. Such accumulation, combined with a policy of limited sterilization, implies continuous injection of liquidity into the economy, creating the potential for less prudential lending by banks, overheating of the economy and rapid inflation. Thus, China's adoption of a managed float exchange rate regime seems to be a step in the right direction, at least in the medium term. However, other international factors are now at play. Global payments imbalances are an important source of concern for Asia in general and China in particular. Washington's recent concern over the large North American trade deficit with China may have important future implications for Beijing and the rest of Asia in terms of encouraging greater protectionism in the US.

India, however, is a different case. While exchange rate policy is being managed very cautiously and effectively in India, New Delhi's lessons are more focused on bureaucratic and corporate sector reforms. The business environment in India is marked by excessive bureaucratic red tape, especially in new corporate ventures. These conditions generate the ideal breeding ground for cronyistic relationships, a concern that Prime Minister Manmohan Singh, voiced with special reference to bank lending in his recent May Day speech. Time and again, foreign companies have called attention to the difficulties they face in setting-up new entities in the country. Thus, administrative/bureaucratic and corporate governance reforms should head India's list of priorities if it wants to maintain its position as an investment magnet.

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