Currency Meltdown in Southeast Asia: Global Capital as the New 800 Pound Gorilla

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Abstract

The story of East Asian ***miracle*** *economies now appears to have been one part illusion and another part momentary bingeing that involved massive mobilization of inputs that contributed to unsustainable growth spurts. Those who detected a new form of capitalism in Japan's development model or in that of its East Asian protégés will be disappointed to find that there is nothing new under even the rising sun.*

Currency Meltdown and Asset Deflation

After several decades of impressive growth, various Southeast Asian countries were humbled by a wave of speculative forays that revealed weaknesses in their economic fundamentals. A currency meltdown and a regional momentum of asset deflation started at the beginning of July 1997 when Thai authorities severed the baht's peg to the dollar. In short order, shock waves rippled through the region's currency and stock markets. In the initial round, there were precipitous declines in the Thai baht, Indonesia's rupiah, Malaysia's ringgit, the Philippine peso, and the Singapore dollar. Meanwhile, the stock exchanges in most of these countries are on a downward slide of a wild roller coaster ride.

It appears that there is ample evidence prompting a reappraisal of the long-term health and performance prospects of the Asian *miracle* economies. In retrospect, the signs of impending economic weaknesses that are so evident in much of Southeast Asian were ignored by overeager investors. Among the signs were ballooning current account and trade deficits that made fixed values in terms of a rising dollar unsustainable.

At the same time, the increasing demands of global capital markets required more flexible responses to external shocks. Unfortunately, the institutional framework associated with the East Asian development models hampered the self-adjusting mechanisms of their markets.

Initially, trade deficits occurred in response to declines in demand for electronics in North America and Europe. Meanwhile, an inflow of foreign capital contributed to an exacerbation of these imbalances. In the case of Thailand, a considerable fraction of the investments that were credited with high rates of economic growth were in property development that added a one-shot boost in incomes.

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Consequently, the fixing of the local currencies to the dollar became untenable as the US currency appreciated against the other important currency for the region, the Japanese yen. With their currencies *overvalued* and with a coddled banking sector undisciplined by market forces, the *miracle* economies became over-leveraged both in US dollar and local currency terms. At the same time, bank loans to the overheated property markets in the region constituted a perilously high percentage.

Despite some announcements by the leadership of the Southeast Asian economies of plans to move up the value-added chain, diminishing returns set in as an internal source of slow growth so that productivity in manufacturing sectors began to lag. Inevitably, the sources of comparative advantage for many Southeast Asian economies began to slip away.

While policy makers inside the region were fiddling despite the looming problems, policy makers outside the region did little to clarify these issues. In some cases, public sector officials were entrapped by diplomatic niceties and so avoided official criticisms about the looming problems in East Asia. In the private sector, multinational corporations active in the region were too busy feathering their own nests, often serving as spokespersons for governments in the region to cement cozy relationships.

At the same time, upbeat financial analysis were offered by investment advisors queuing up to sell securities for the region's governments. All this smoke and mirrors could not hide the faultlines that had formed from the heavy property overhangs, inappropriate government policy, and the realities of shifting comparative advantage.

Baht-ulism and the Tequila Crisis

In 1994, problems with the dollar peg of Mexico's currency caused a similar currency meltdown in other parts of Latin America. Similarly, knock-on effects of Thailand's adjustments indicate that such problems can rock an entire region. However, these shared woes are avoidable if financial markets are sufficiently exposed to international competition and if the banking system is sufficiently grounded by the rule of law.

Interestingly, at the time of the free fall in the value of the peso and the shock waves felt in much of Latin America, there was a momentary pause to ask whether Southeast Asia might be in for a similar ride in the future. This questioning was provoked by some minor hiccups in valuations in the Asian emerging markets. Clearly, there was inadequate introspection by all parties that led them to overlook an impending crisis when the otherwise clear signs began to emerge in early 1996.

There are a variety of striking similarities and decisive differences in the Mexican meltdown and the baht breakdown. Unfortunately, both incidents were seen as an opportunity for increased government intervention as a remedy for the problems at hand. The proposed remedies involved a case of international corporate welfare to benefit Japanese and American banks that were exposed to heavy losses.

In the case of Mexico, a $40 billion rescue program was organized by the Clinton administration to try to bailout Mexican banks and to protect foreign lenders. Of these funds, $20 billion came from the US with the IMF providing most of the rest with some support from Canada, the World Bank and the InterAmerican Bank. Mexico's currency crisis was principally caused by the inflow of hot capital lured in by high returns on government securities. In particular, a substantial amount of funds went into the Tesobono market for government debt issued in pesos but indexed to the US dollar.

In the case of Thailand, the Japanese government tried to induce the IMF to establish a special fund to bail out Asian monetary basket cases. Actions taken in both instances were based upon looking after the interests of the larger banks that were otherwise exposed to heavy losses. During the IMF - World Bank meeting in Hong Kong in September, Japan launched a proposal for a new emergency rescue fund of $US100 billion that would be financed and used exclusively by Asian countries.

Its aim is to restore some sense of control over their own destinies since it could be used to defend national currencies against speculators. It also serves as a statement of Asian solidarity, whereby neighbors band together in face of outside adversaries. It also serves to weaken American influence in the region by excluding the US while providing Japan with a mechanism to increase its economic and political leverage over the rest of Asia. The proposal would make Japan the fund's largest contributor and its controlling shareholder.

Certainly the biggest problem with repetitive government intervention in the capital markets is the *moral hazard* that emerges from bailing out banks or countries that make mistakes. Provision of an escape mechanism from paying the full costs of poor planning or inept policies will only encourage bigger and more costly errors. Whereas the market sends signals to clear up messes, public sector intervention sends a signal that the costs of fixing the mess will be picked up by someone else. The result that greater risks will be taken is inevitable.

One of the lessons that should have been learned from earlier monetary crises is that political leaders should act quickly to restore confidence in their economies. This lesson seems to have been lost on some in East Asia. In particular, Malaysian Prime Minister Mahathir Mohamad announced himself to be a sworn enemy of international currency speculators and called for the regulation or outright banning of foreign exchange trading. The Malaysian ringgit declined to its lowest level since independence after losing about 30 percent of its value.

Putting the Tigers Back on Track?

Optimists point to the general openness of Southeast Asian economies and their past successes in export-led growth. However, this is not possible unless there is a substantial diversification in their current product mix. Even if the correct path is known today, there will be considerable time lags before specific enterprises can enact the necessary changes.

In all events, actions by government officials have limited the capacity of their economies to respond. The weakening of their currencies might have prompted corrections in their trade imbalances by making their exports cheaper and imports dearer. However, these effects may be offset by central bank actions to raise interest rates to bolster the currencies or by regulatory obstructions to the market's self-adjusting mechanisms.

Meanwhile, shrill accusations against foreign and domestic speculators and attempts to interfere with their activities undermined confidence when steps should have been taken to calm, not roil, markets.

While high savings rates in the East Asian economies were coincidental with high growth rates in the recent past, there success depended upon access to mature markets in the West. As these markets become increasingly contested, continued growth in Asia's *miracle* economies will increasingly depend upon internal demand. Much of the high savings has been squandered by ill-starred industry policy or banking crises.

In theory, floating currencies should force these economies to become more flexible and adaptable to changing market conditions. As a practical matter, however, it is doubtful that a freely floating exchange rate will overcome the rigidities in other institutional areas to prevent further crises in Asian economies. While pervasive corruption blocks rapid adjustment in many of the East Asian economies, an inherent conservatism also impedes necessary responses. For example, despite pressing economic need to reform lending and disclosure practices, Japan's banking sector remains enmeshed in the bureaucratic snares that contributed to the property and asset bubble that burst in the late 1980s. Financial institutions in Korea, Thailand, and Malaysia face similar problems due to outmoded lending practices to businesses based upon asset values instead of cash flow. Clearly, basing loans on surges in property values is a recipe for disaster.

To date, efforts to improve disclosure by Asian banks have borne little fruit. For example, new regulations require Thai banks to disclose the proportion of non-performing loans in their portfolios. This reform has been averted by the willingness of loan officers to reclassify these bad debts as *restructured,* regardless of whether the extension of more relaxed terms reasonably insures ultimate repayment. The damage from these write-offs is unlikely to be limited to the Thai financial establishment.

A worse case scenario is a hard landing from the bursting of the region-wide property bubble. This scenario arises out of the problems in Thai financial markets that initially set off the run on the baht that might be repeated in some of the neighboring countries. The knock-on effects will be felt by firms that provide support for other financial interests throughout Southeast Asia that are equally dependent upon the property markets.

Those who think that these *miracle* economies can grow their way out of the problem through their tried and tested model of export-led growth may be in for a rude surprise. In the first instance, many of these tamed *tigers* are running sizable and growing current account deficits due to saturation of their export markets. These deficits are being enlarged by the effect of large foreign capital inflows. Second, China's 75 percent excess capacity in manufacturing will make it increasingly difficult for their East Asian competitors to find buyers. In sum, what is happening in Southeast Asia is more than a passing hiccup. It is just the beginning of an adjustment phase to the new wave of global competition.

Japan's Development Model

The recent decline in Japan's economic fortunes has been as dramatic and complex as the rapid growth spurt that made it the world's second largest economy. As measured by the Nikkei average, values on the Tokyo stock market are now less than one-half of what they were in the late 1980s, in an increasingly volatile market. A similar deflation has occurred in prices of other assets, including commercial properties. Indeed, Japan's economy has been in a no-growth or slow-growth recession for all of the 1990s. A cautionary tale might lie in Japan's experiences for those neighboring countries that have followed the Japanese economic development model.

Initially, the Japanese economy seemed to benefit from the corporatism associated with the *iron triangle* of industrial relations wherein businesses, bureaucrats, and politicians interacted harmoniously to promote growth, especially in the export sector. Many of the arrangements in the ensuing *social contract* involved high degrees of government intervention in economic affairs. These interventions included so-called lifetime employment as a payoff to workers and restrictions on competition for domestic producers from their foreign competitors. More benign policies involved the promotion of specific export-oriented industries that were expected to provide a spark to other sectors of the economy. The impressive economic performance of Japan's corporations in concert with the *helpful hand* of government officials seemed to herald the emergence of a new and superior scheme for development. The message seemed to be that other countries should follow this model or ignore it at their peril.

For much of the post-War period, Japan and many of its East Asian neighbors enjoyed a virtuous cycle of high rates of domestic saving and high investment in productive capital. This cycle was encouraged by positive and relatively high real interest rates, accompanied in many cases by policies that encouraged foreign direct investment of multinational corporations (MNCs). Recently, it has been Japanese MNCs that have increasingly provided the external capital that has aided the growth enjoyed by its neighbors.

Now there is good reason to question the performance of the development approach initiated by Japan and followed by other East Asian governments. In the West, economic growth apparently emerged from gains in productive efficiency stimulated by individuals who harnessed the forces of scientific creativity and initiated technological advance. While Japan's development model was guided by government initiatives, growth in the West depended upon decentralized entrepreneurial initiatives.

Similarly, many Asian Pacific countries share Japan's traditions for the reliance of human interaction upon group cohesion and harmony. Given the success of the high-growth East Asian economies, it is legitimate to ask whether Western individualism is a necessary component of growth or if the communitarian practices of East Asia constitute the appropriate model for developing countries in the next millennium. Individualist cultures encourage and reward initiative and invention while collectivist cultures promote passivity and imitation. Put bluntly, it remains to be seen whether an East Asian *parasitic* approach to adopting new technologies can outstrip the more original, creative set of forces of the West.

In keeping with the notion of *social harmony*, many Asian academics tend to display a lockstep tendency towards education. In such a setting, it is doubtful that Asian universities can provide the environment for lateral and creative thinking required of a homegrown class of entrepreneurs.

Asian universities too often operate as factories for the production of state bureaucrats. Intellectual debate is neither necessary nor appreciated by herds of students who are being trained to follow rules and to adhere unquestioningly to authority. This point was confirmed by former Japanese Prime Minister Morihiro Hosokawa who pointed out that the rote-learning educational system common in Asia endangers his country's future.

For those countries dependent upon the transfer of technology from other more creative cultures, mastering the high art of imitation (or indulging in the low art of industrial espionage) is necessary to move up the innovation curve. To a great extent Asian countries have compensated for a lack of original creativity through a high imitation capability that is apparently higher than shown by Europeans and Americans.

It appears that as economies mature, the presumed benefits associated with corporatism play out and inhibit the performance of those firms that operate principally in the less competitive domestic market. Accustomed to being sheltered from competition, these firms and entire industries will lag in terms of productivity and profitability as markets become increasingly globalized. In time, regulations that once provided a firewall from the heat of international rivalries eventually smother the vital flame of the protected domestic enterprises.

Indeed, the Japanese corporations that are thriving are those with the greatest exposure to global competition. Most Japanese MNCs with offshore operations, especially automobile and electronics producers, have restructured according to the demands of international market forces.

Unfortunately, Japan's domesticated corporations that operate behind a protective wall of regulations designed to keep out foreign competition are facing financial difficulties. Perhaps the most vulnerable sectors in Japan are the insurance and domestic banking industry. Thus, Japan's economy has a bifurcated structure. It is composed of healthy and profitable internationalized firms with promising prospects while many domestic firms and most banks have a rendezvous with an increasingly bleak future.

What are the lessons from all this? These observed events apparently repudiate the notion of a superior Japanese or East Asian management model. Recently, it has become evident that Korea's economy has begun to confront the same sort of realities experienced by Japan's more nimble MNCs that were forced to undertake the restructuring strategies initiated by their

Western counterparts. Then there are the currency crises sweeping through Southeast Asia that have caused international investors to rethink placing their capital in that region. The decline in Thai baht by over 20 percent was followed by devaluation of, Indonesia's rupiah, Malaysia's ringgit, the Philippine peso, and the Singapore dollar. Even the Hong Kong dollar has been under assault. Meanwhile, the stock exchanges in most of these countries have been on roller coaster rides.

In short, there is little new under the sun. Faced with the realities of the new global economy, those countries that encourage their enterprises to hide behind protectionist barriers will inhibit the prospects for continued growth. Adam Smith would certainly not be surprised or impressed by such suggestions.

Institutional Failure

Those who wish to assess whether the economic *tigers* of East Asia can provide global leadership in the next millennium need look no farther than the smoke-filled skies around the southern rump of the region. Parts of Indonesia and Malaysia, Singapore and Brunei were covered by an acrid and noxious *haze* emanating from fires that have ravaged several hundred thousand acres in neighboring Indonesia for the month of August and into September. The choking smoke threatened the health of an estimated 20 million people in the region. The *haze* may obscure the views in the capitals of these Association of Southeast Asian Nations (ASEAN) stalwarts, but it makes perfectly clear that the ASEAN's leaders are incapable of dealing with regional problems. It beggars the imagination that such leadership could offer guidance to the rest of the world any time in the near future.

Little has been done to alleviate this problem which has been recurrent with the last and most serious bout in 1994. In keeping with its commitment to be a fully-wired Island, the Singaporean authorities offer full-color satellite pictures of the source of their affliction on a web site. Singaporean authorities dutifully report hourly measures of Pollutant Standards Index (PSI) for the enlightenment of their suffering masses. In Malaysia, there has been furtive attempts to seed any cloud that might blow over the peninsula. Flights have been delayed, canceled or re-routed and airports closed in Indonesia. However, there has been no summit to address a repetitive problem that threatens the health of citizens. With smoke blocking visibility in the Straits of Malacca, the lifeline of Southeast Asia, the economic health of the region is similarly threatened.

With no place to hide, Indonesian authorities have finally admitted that the source of the problem is within their jurisdiction. However, little has been done other than fine a few plantation owners who set the fires and threaten others with legal action. Unfortunately, there is little evidence that the rule of law pervades policy thinking in Indonesia or among most of the other ASEAN countries.

Instead of putting regional heads together, Malaysian authorities have turned to France and Canada for advice on an action plan to deal with the problem. With no efforts toward finding regional initiatives for short-term responses, it is not surprising that there is little progress toward a long-term solution to this chronic problem.

When the problem arose in 1994, it met with the same lack of inter-governmental response. As then, children, the infirmed and elderly in Singapore have been instructed not to venture out of doors as the PSI soared above the *unhealthful* threshold. It was reported that doctors have seen a 20 percent increase in patients complaining of respiratory problems. In Kuala Lumpur, levels signaled a *very unhealthful* situation. A plan for an emergency evacuation of Sarawak is being mooted as the levels reach *hazardous* levels there. Perhaps the most fitting symbol of this whole muddle is that Malaysia's architectural monument to it own success, the Petronas Towers which is the world's largest building, is shrouded by an impenetrable fog.

Inaction and refusal to comment on the internal affairs of their partners is a defining characteristic of ASEAN relations. The quiet diplomacy of the ever-pragmatic ASEAN leaders is based upon brotherly solidarity which is a code for avoiding confrontations that might lead to the *loss of face* by neighboring regimes. While this orientation towards consensus building has been touted as a great strength of ASEAN, there are clear signs that this problem solving approach breaks down when more complicated issues are at hand.

The indifference of the regimes in this region to such crises lends support to the unfortunate perception that individuals are worth little in Asia. This response is understandable in the context of regimes based upon patriarchal, collectivist ideals where society is placed above self. Many of the ASEAN leaders insist that Asians are not interested in for promoting individual liberty or protecting individual rights.

The root of the problem is the lack of political will to take decisive actions. However, the search for solutions is also complicated by the prevalence of corruption in much of East Asia, itself a form of policy pollution. In Indonesia, corruption as nepotism makes it more difficult to resolve the effects of the *slash and burn* clearing of the rainforests of Java, Sumatra and Kalimantan. It is rumored that part of the area being burned is part of joint developments involving some of Indonesian president Suharto's children.

As reported by the Asian Development Bank, East Asia is already facing "staggeringly high costs" from environmental damage. These costs will only rise in the future until governments in the region are more accountable.

Those who expected an impending Asian Century may be disappointed to know that it has just gone up in smoke.

Speculators and Market Failure?

A common thread ran through the media reports of the assault on the weakened currencies of some East Asian *miracle* economies. Most government officials portrayed currency speculators as a pestilence preying on their good countries.

The Prime Minister of Malaysia, Dr. Mahathir Mohamad, has been conspicuous in vilifying the American billionaire George Soros publicly as a "racist," "moron" and "criminal." Unfortunately, Dr. Mahathir is not alone in his buffoonery and slander. Other leaders in the region have expressed deep anger with US speculators like George Soros whom they blame for aggravating the region's unfolding economic crisis. Most portray it as something more than pure market speculation. ASEAN leaders, representing an entire region and more than half a billion people, issued a joint communiqué darkly blaming "outside forces" for "well co-ordinated efforts to destabilize" their currencies and their economies.

In fact, such exaggerated depictions are not only untrue, but they are also a distraction from the underlying economic realities often put into motion by the same self-righteous politicians. Their misrepresentations are an enduring fiction often trotted out when emperors fear that their nakedness will be noticed by others. At moments of crisis or unrest, politicians often hoodwink their citizens with unifying themes not well understood by the masses. And so it is that they served up for images of currency traders as detestable individuals who become rich by inflicting suffering upon others.

Politicians and finance ministry officials denounced speculators who targeted their currencies as people determined to ruin their economies. Their own citizens were branded as traitors while foreigners were portrayed as agents of some dark international conspiracy.

A basic understanding of economic principles provides another view. Quite literally, speculation is the norm for successful economic activity. In essence, it is the act of *buying low and selling high*. Rewards are provided to those who make correct predictions about the future just as punishments are the fruit of imprudent choices.

Examples of everyday experience with speculative behavior involve stock market purchases or sales or the activity of a firm to hold inventories of raw materials in advance of anticipated price rises. Even the search for a *bargain* or responding to clearance sales involves the same impulse whereby something is bought at a momentarily lower price. In short, anyone participating in most market transactions often behaves in a speculative manner. Therefore, we are all equally *guilty* as are those who look for weaknesses in the economic fundamentals behind an exchange rate policy of a given country.

Despite this simple truth, many politicians assert that speculative behavior is harmful due to a presumption of destabilizing consequences. However, in absence of political interferences, markets tend to be generally stable despite extensive speculative activities that constantly occur.

Most economists agree that speculation may actually reduce price variations. This is because speculators tend to be knowledgeable about the markets where they look for profit opportunities. As specialists, they will attempt to buy things when prices are low and sell when a higher price is offered. Prices tend to be low when people wish to buy less than is available at the current price. This is what economists refer to as *excess supply* as might be observed in agricultural markets after an unusually abundant harvest.

Such a situation offers speculators an opportunity to buy when there is an over-abundance in order to sell at a later date (or in another place) when less of a good might be produced. The speculator takes over the costs of storage and risks of lower prices in the future that would have to be borne by the producer who may have been unable to absorb these costs or risks.

Amazingly, all parties can be made better off by these transactions. The producer benefits by selling more products and avoiding additional costs and risks. They may also be protected from a complete collapse in prices due to the presence of speculative buying of the surplus. Consumers are better off since there will be a more stable flow of commodities and at less volatile prices.

Finally, the speculator receives the differential in buying and selling prices. Part of this profit is a compensation for absorbing risk and part is a compensation from the community for providing a service to them.

Of course, if speculators guess wrong, this could lead to destabilization of prices. However, speculators tend to be specialists in specific markets and are less likely to make serious errors. It they do make consistent bad judgments, they will be eliminated due to financial losses.

The same logic holds true for currency speculation. From the end of June and early part of July, the currencies of Indonesia, Malaysia, the Philippines, Taiwan, and Thailand were besieged by speculators. Basically, certain foreign exchange traders believed that these countries'-respective monies were over-valued in the international market, almost always due to government intervention.

For example, they would borrow Thai baht and sell it immediately at its *over-valued* price. If the speculators guessed right, they could repay their debt by buying back the baht at a lower price. This meant that they earned a profit by selling at a high price and buying back at a low price while pocketing the differential. Of course, if they guess wrong or if there is no change in the value of the currency before the initial debt must be repaid, then the speculator will lose money.

Ironically, the opportunities for speculation arose from government policies that meant that the rate of exchange for these currencies was based more upon a political decision rather than wider economic fundamentals. Unfortunately, neither wishful thinking nor good intentions are a substitute for sound economics.

So, when searching for the identity for who are the speculators and profiteers in a market economy, we should begin by looking into the mirror.

If we are looking to find faults when currency speculation occurs, we should point to the politicians and bureaucrats who shape or enforce economic policies. Speculators are not the cause of the underlying problems that lead to currency devaluation; they are only the messengers of the bad tidings. Leaders of those countries wishing to avoid an unhappy experience with currency speculators should put their own house in order.

Global Capital and the Future

The increasing integration of financial markets with the increasing flow of private capital to developing countries is probably the hallmark of the global economy. While each country will have its own unique experiences and teething problems, the overall expectation should be that there will be opportunities for widely shared improvements in overall wealth.

These expectations stem from enhanced efficiency that will facilitate trade and promote growth. Countries with underdeveloped financial markets will be able to tap into a modern financial system and will learn how better to channel their own savings for domestic projects including necessary infrastructural investments. It should also be easier to attract more stable commitments of financial capital and foreign direct investment.

However, credible mechanisms must be implemented to assure investors of the ability and willingness to enforce contracts and protect private property rights. Despite a widespread impression to contrary, East Asian governments tend to be highly active in guiding their domestic markets. In many instances, market access and outcomes are based upon political connections. Therefore, deregulation will be more difficult since it requires profound changes in political culture.

As such, much of East Asia has a long way to go before internal reform and the initiation of market innovations can break the logjams imposed by bureaucratic entrenchment and overregulation. This is most clearly evident in the resistance to change among Japanese technocrats despite the heavy burden of costs from continued hesitation. These costs will only mount in face of several trillion dollars of non-performing loans and a stagnating domestic economy.

The story of East Asian *miracle* economies now appears to have been one part illusion and another part momentary bingeing that involved massive mobilization of inputs that contributed to unsustainable growth spurts. Those who detected a new form of capitalism in Japan's development model or in that of its East Asian protégés will be disappointed to find that there is nothing new under even the rising sun.