9. The Nordic and Asian crises: common causes, different outcomes

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INTRODUCTION

During the spring and early summer of 1997, there was widespread speculation against the Thai *baht*. The currency was closely tied to a basket dominated by the US dollar. The gradual appreciation of the dollar after the early 1990s had made the Thai *baht* more expensive, weakened export competitiveness, and contributed to a current account deficit of around 8 per cent of GDP. Worsening the problems related to the increasingly overvalued currency, there were also severe troubles in the financial sector. Asset prices had risen rapidly with an export boom that started in the late 1980s, but both real estate and stock market prices had collapsed when GDP and export growth rates had begun to slow in the mid-1990s. This left banks and finance companies with masses of non-performing loans (although it was not known at the time how serious this problem was). Most banks and financial institutions were also heavily exposed to currency risk. The high domestic interest rate needed to maintain the fixed exchange rate had made it favorable to borrow abroad. The financial sector was largely financed by Japanese and European investors.

While it was clear to many foreign observers that a currency adjustment would be necessary – for instance, in its consultations with the Thai government, the IMF had pressed for action already from the beginning of 1996 – most Thai observers seemed to believe that there was no need for any devaluation. The *baht* had maintained a stable value against the dollar since 1984, and the fixed rate was thought of as an anchor for macroeconomic stability. The overall growth rate of the economy was still respectable, at about 6 per cent. Moreover, the Central Bank had demonstrated its willingness to defend the currency, both by raising the interest rate and by spending considerable amounts from the foreign exchange reserves to support its fixed value.

Yet, by early July 1997, it was no longer possible to defend the fixed exchange rate. The reason was simply that the currency reserves had run

dry: with few foreigners willing to invest fresh dollars in the economy, the Central Bank had been forced to use most of its foreign exchange on investors wanting to reduce their holdings of *baht*. On 2 July 1997, the Thai Central Bank announced that the *baht* would no longer be tied to the US dollar. It was left to float, and the intention was to manage a controlled depreciation of the currency.

Actually, the *baht* sank like a stone. In the following six months, the *baht* lost more than half of its value as the price of a US dollar increased from 25 *baht* to 56 *baht*. The Bangkok Stock Exchange fell by more than 30 per cent in local currency over the same period. A Thai share portfolio that had cost 100 US dollars at the end of June 1997 could be bought for a mere 33 US dollars a year later. The cost of servicing foreign currency loans grew rapidly: nearly half of the lending stock of the Thai financial system was classified as non-performing in 1998.

The real effects were also significant. Economic growth, which had averaged nearly 10 per cent over the previous decade, collapsed. In 1998, GDP fell by more than 10 per cent. To handle the problems, the Thai authorities and the IMF jointly designed a comprehensive reform program featuring macroeconomic stabilization, restructuring of the banking system, and new laws and regulations to increase transparency and accountability throughout the economy. For instance, four commercial banks were nationalized, 56 out of 91 finance companies were liquidated and a new bankruptcy law was introduced. A short period of fiscal and monetary austerity was implemented to absorb the excess liquidity created as people withdrew their savings from the weakened bank system.

The crisis spread rapidly to the rest of the region. Within a few weeks after the collapse of the Thai *baht*, the currencies, banks and stock exchanges in the Philippines, Indonesia and Malaysia were infected with the Thai disease (known alternately as *Bahtulism* or the *Tom Yam* effect). Indonesia was particularly badly affected, with both economic and political problems following the banking and currency crisis. Seemingly stable economies, such as Singapore and Taiwan, were also shaken during the following months. In October 1997, Hong Kong's currency was attacked. Thanks to its massive foreign exchange reserves and support from China, Hong Kong fought off the attack, but the stock exchange fell by 50 per cent over the following months.

In November, it was South Korea's turn. There, the current account deficit and the short-term foreign debt were larger than in Hong Kong, and the defense of the currency failed. Both share prices and the value of the Korean *won* halved very rapidly. Just as Thailand and Indonesia had already done, South Korea was forced to turn to the IMF for help.

The Japanese economy, which had struggled with massive losses in the

financial sector since the early 1990s when its stock market and real estate bubbles collapsed, was also hit by the regional crisis. Japan had been able to delay necessary financial and structural reforms for more than half a decade – the economy was not dependent on foreign capital and policymakers did not have to worry much about foreign confidence and transparency – but a string of bankruptcies and a 2.5 per cent fall in Japanese GDP in 1998 revealed the depth of the problems.

Much of this description of the Asian crisis – in particular the Thai crisis – appears familiar for observers of the Nordic region. A similar boom-to-bust cycle took place in both Finland and Sweden between the early 1980s and early 1990s, culminating in the financial and currency crisis of 1992.[1] Like Thailand and several other Asian countries, both Finland and Sweden maintained fixed exchange rates which reduced the perceived investment risk and encouraged inflows of foreign capital. In both regions, the acute crisis was closely connected to the reversal of these capital flows. There were also significant similarities in the short-term measures taken to resolve the crisis and to reform and restructure economic institutions.

In fact, the Asian reform measures drew to a large extent on lessons learned from the Nordic crisis: from the summer of 1997, there was a steady stream of Asian study tours to Finnish and Swedish central banks, finance ministries and other institutions in the financial sector. However, there are notable differences between, on the one hand, Finland and Sweden and, on the other hand, the Asian countries when it comes to reforms and recovery in the medium term. While the Nordic countries managed to complete the necessary reform and restructuring programs, restore the health of the financial system, and return to 'normal' growth in about three or four years, developments in Asia were slower. None of the East Asian economies that were most severely hit by the crisis had recovered after three or four years, and none of them have still been able to reach the investment and growth rates they recorded before the crisis. Problems with non-performing loans (NPLs) and heavy corporate debt remained serious in several of the regional economies for many years after the crisis.

The purpose of this chapter is to provide a comparative analysis of the Nordic and Asian crises. To illustrate some general, or at least common, features of financial crises, it is useful to point to some similarities between the two crises. The next two sections, Sections 9.1 and 9.2, provide a brief summary of some of the causes and consequences of the Nordic and Asian crises. The description of the Nordic crisis focuses on Sweden – the Finnish crisis followed much the same course, although the domestic problems were aggravated by the substantial fall in exports resulting from the collapse of the Soviet Union.[2] Section 9.3 concludes with a discussion about reforms and recovery in Asia.

Apart from the point that the causes of the crises in the Nordic countries and East Asia are very similar, our main argument is that the relatively quick resolution of the Nordic crisis constitutes a special case. The typical course of events is more similar to that experienced in large parts of Asia. Reform and change are painful and are typically opposed by vested interests. The main question emerging from the comparison between the Nordic countries and Asia is therefore 'Why were the Nordic reforms so successful?'. We suggest that the keywords are EU membership, IT and political structure.

9.1 THE NORDIC CRISIS

In retrospect, it is possible to distinguish four stages of the Nordic financial crisis. As we will see later, the same stages reappear in several of the Asian economies.

First, there was a collapse of the real estate and stock markets. In Sweden, real estate prices had risen continuously for a period of 15 years, to a peak that was reached in 1989. Over the following five years, property prices fell by more than half. Three-quarters of the forty or so real estate companies listed on the Stockholm Stock Exchange during the 1980s encountered such serious problems that they went bankrupt or had to be restructured (*Affärsvärlden*, 1992, p. 9). The stock market bubble that had developed during the decade preceding the crisis also collapsed. Between 1980 and 1989, prices on the Stockholm Stock Exchange rose by 1144 per cent, compared with a world average of 333 per cent (*Affärsvärlden*, 1992, p. 79). Over the next three years, the index fell by 50 per cent.

Second, the financial market went into deep crisis. Weighed down by substantial credit losses from bad loans on real estate and for share purchases, three major banks – *Nordbanken, Första Sparbanken and Gota Bank* – went bankrupt, while the two largest banks, *SE-Banken* and *Handelsbanken*, saw their share prices fall by around 80 per cent. Some 200 of the 300 finance companies disappeared from the market. Total credit losses during the period 1990–93 are estimated at almost SEK 200 billion, or roughly 10 per cent of GDP (Lybeck, 1994, p. 23).

Third, there was a currency crisis. The fixed exchange rate, which was seen as an anchor for Swedish economic policy, could no longer be maintained, given that the overheating of the economy in the late 1980s had lowered competitiveness and the financial crisis had weakened the economy. Despite the stubborn defense of the *krona* – with overnight interest rates reaching 500 per cent in September 1992, several crisis packages intended to strengthen Sweden's international competitiveness, and

the commitment of around US$ 30 billion in defense of the currency – the *Riksbank*, the Swedish Central Bank, was forced to abandon the fixed rate for the *krona* on 19 November 1992. Over the next few months, the floating *krona* fell by 25 per cent against the *Deutschmark* and 40 per cent against the US dollar.

The fourth part was a crisis in the real economy and in government finances. The banking crisis led to a tighter credit policy, with higher interest rates and stricter requirements for collateral. At the same time, the collapse in asset values led to a reduction in private consumption and a reduced willingness to invest on the part of companies. For example, the level of industrial investment halved between 1989 and 1993. The result was a fall in total demand in the domestic market, with a consequent reduction in the demand for labor. The stimulus from the export sector, which benefited from the depreciation, was not sufficient to 'restart' domestic demand for several years. Open unemployment rose from 1.1 per cent in June 1990, to 9 per cent three years later, and real GDP fell every year during the period 1991–93, by 6 per cent in all (Lybeck, 1994, p. 15; Bäckström, 1998). In Finland, the crisis was worsened by the simultaneous decrease in exports to the former Soviet Union. Finnish GDP fell by about 12 per cent between 1990 and 1993, and total employment dropped by about 15 per cent over the same period. This led in turn to problems with government finances in both countries. The rapid growth in unemployment increased state spending, at the same time as tax receipts fell. At its peak, during 1994, the Swedish public sector's budget deficit had grown to almost 12 per cent of GDP (Bäckström, 1998, p. 11). In Finland, central government debt grew from 10 per cent of GDP in 1990 to 60 per cent in 1994.[3]

9.1.1 Why was there a Crisis?

What were the reasons for these crises, the combined effects of which were almost as serious as the deep recessions of 1921–22 and 1931–33? The simple answer is that there was an asset bubble that inflated over a period of several years and then suddenly collapsed. The causes of the development of the bubble can be analyzed systematically. It is difficult to explain the timing of the collapse in an equally systematic manner. Once a sufficient number of market actors started doubting the sustainability of the high asset prices, the collapse was arguably unavoidable. However, with most investors wishing to stay in the market as long as prices might still rise, the precise onset of the collapse probably had more to do with specific news events than more fundamental market characteristics.

The causes of the growth of the bubble are found in the simultaneous increases in the supply of and the demand for capital and credit during the

1980s.[4] The most important factors on the supply side were the deregulation of the financial sector that began in the mid-1980s, and the government's expansive monetary and fiscal policies. The demand side was also stimulated by financial deregulation, since requirements for security were eased, which meant that the collateral value of property and other assets increased. The most important events on the demand side, however, were the devaluations of 1981 and 1982, which created a long-lasting economic boom and rapid increases in the demand for credits, from both business and the household sector.

9.1.2 Increased Supply of Credit

The deregulation of the Swedish financial market in 1985 led to a very substantial increase in the supply of credit. Both the liberalization of various lending restrictions – interest rates were freed and property could now be fully mortgaged – and the fact that banks were now permitted to compete fully with the finance companies, contributed to the credit expansion. Increased competition meant that banks and other financial institutions replaced their traditional strategy of minimizing risk and maximizing profitability on a fairly constant volume of loans with a new strategy, which involved chasing volumes and market shares.

In only five years, the indebtedness of the private sector increased from 100 per cent to 150 per cent of GDP. At the same time, the average lending risk also rose. For example, the first-mortgage loan institutions increased their loan ratio from 75 per cent to 85–90 per cent. Deregulation also supported the internationalization of the Swedish capital market, and an increasing share of bank lending was financed on the international interbank market. Almost one-third of the financing of the *Gota Bank* in 1990, for example, originated from foreign banks (Urwitz, 1998, p. 56). This introduced an important element of currency risk.

The activities of the finance companies were particularly risky. During the 1970s and the 1980s, the restrictions on the operations of commercial banks had created space for finance companies specializing in leasing, factoring and other 'new' forms of financing. Most people believed that the deregulation in 1985 would mean the end of the finance companies' golden age. On the contrary, their lending continued to grow. In the first year after deregulation, lending by the finance companies increased by one-third. In particular, the companies that expanded most were involved in lending for investments in securities and property, such as *Nyckeln* and *Gamlestaden*. Their operations were, however, more risky than those of the banks. The finance companies had weaker collateral than the banks: the majority of their property loans were last-mortgage loans. Furthermore,

their borrowings were short-term – often it was the commercial banks that financed the finance companies – while their lending was long-term. With hindsight, it is obvious that this imbalance would become problematic.

However, from the borrowers' point of view, deregulation was clearly beneficial. Anyone who wanted to borrow to invest, to buy property, to buy a car, to make a trip abroad, or for any other form of consumption, no longer had to go cap in hand to the bank. Now it was the banks' turn to seek out and market their services to the customers.

The increase in private indebtedness was made possible by expansionary monetary and fiscal policies. Throughout the 1980s, Sweden had a fixed exchange rate regime, which meant that monetary policy could not be used to counteract a credit expansion. A more restrictive monetary policy would have involved higher interest rates, and an inflow of capital from abroad, which would have made it difficult to keep the exchange rate unchanged. Any tightening would have had to come from fiscal policy. No such proposals were, however, made. One reason was that the central government budget looked unusually strong in the mid-1980s, thanks to full employment and the economic boom. In addition, there seemed to be no political reasons for a tightening of policy (Wohlin, 1998, p. 28). The government's preference, with the imminence of the 1988 election, was for tax cuts and a guaranteed fifth week of vacation for all employees (*Affärsvärlden*, 1992, p. 25).

9.1.3 Increased Demand for Credit

On the demand side, the most important factor was the long-running economic boom that began with a pair of devaluations at the beginning of the 1980s. Profits in export industries doubled in both 1983 and 1984 and remained high over the following five years. Despite substantial investment, both at home and abroad, several of the leading export companies had problems with 'excess liquidity', which was invested in the share and money markets. The corporate demand for commercial property and financial investments contributed to the high level of asset prices.

The high level of current demand resulted in high wage increases. In combination with the fixed exchange rate, these cost increases would gradually lead to the erosion of industry's competitiveness and the bursting of the bubble. Before this happened, inflation had expanded the bubble even more. The real interest rate on borrowing (after tax deductions) fell continuously during the second half of the 1980s, from about 2 per cent in 1986 to minus 1 per cent in 1990. This contributed to reduce the households' financial savings during the period 1985–90, to a nadir of minus 8 per cent of GDP in 1990 (Bäckström, 1998, p. 14). Quite simply, households lived

beyond their assets. As noted earlier, the indebtedness of the private sector increased from 100 per cent of GDP to 150 per cent of GDP.

9.1.4 The Crash

The Swedish bubble began to burst on 25 September 1990. A leading finance company, *Nyckeln*, announced that it expected credit losses of SEK 250 million for the year. As a consequence, the general public and the banks began to back off and refused to roll over the maturing securities of *Nyckeln* and the other finance companies, that is, the short-term assets that financed a large part of their long-term lending. *Nyckeln*, *Gamlestaden*, *Independent* and most other finance companies found themselves in an acute liquidity crisis, and struggled to obtain capital injections and guarantees from their shareholders, but their credit losses grew too rapidly. Several of the companies were forced into bankruptcy, and the great majority went into liquidation over the following years.

The cause of the credit losses was, naturally, that the rate of growth of asset values began to weaken. There were several concurrent reasons for this. The overheating of the economy had created a cost crisis and, given the fixed exchange rate, eroded the competitiveness of the export industries. Interest rates had begun to rise as a result of the reunification of Germany. Iraq's invasion of Kuwait in August 1990 had led to falls in many stock markets. Each of these factors on its own could have burst the bubble. Now they came almost together, and as the beginning of the recession became more obvious and the increases in interest rates reduced property prices even further, the banks also found themselves in a crisis. The situation was aggravated by a tax reform in 1991 which limited interest deductions for tax purposes and made it more expensive to borrow, putting even more downward pressure on asset prices. The new focus of economic policy on price stability (which can be illustrated by the unilateral linkage of the *krona* to the *ecu* in May 1991 and the defense of the *krona* in the following year) also contributed to raising real interest rates.

9.1.5 Bank Support and Recovery

All the large Swedish banks were affected by serious losses during the crisis. Six of the seven largest banks required capital injections from the state or from their shareholders. For instance, the government injected over SEK 16 billion into *Nordbanken* in 1991 and 1992. The growing credit losses were also a contributory factor in the currency crisis in autumn 1992, since the reduced international confidence in the Swedish banking system led to several banks having difficulty in managing their foreign

borrowing. The loss of foreign credits not only led to a weakening of the *krona* when the inflow of foreign currency slowed but also threatened the liquidity of the financial system.

In September 1992, the government introduced a bank guarantee that meant that all creditors – apart from shareholders – were protected against loss. A special Bank Support Board, *Bankstödsnämnden*, was established to administer the guarantee. The aim was to avoid a liquidity crisis – the *Riksbank* deposited a great part of its foreign reserves in the banks – and to maintain or restore confidence in the Swedish banking system. For this latter aim, transparent accounting of problem credits was particularly important. It was presumably also important that bank support came before the fixed exchange rate was abandoned in November 1992. The currency crisis made the situation worse for most of the banks, both because interest rates were raised substantially and because the cost of foreign debt increased considerably with the depreciation of the *krona*.

The public bank support funds were used largely as a shareholder's contribution to *Nordbanken* and *Gota Bank* and to detach the delinquent loans of these banks into two separate asset management companies, *Securum* and *Retriva*. In all, the payment of bank support amounted to SEK 63.3 billion, which was balanced by the government's holdings and income from shares and equity in *Nordbanken*, *Securum* and *Retriva* with an estimated value of more than SEK 60 billion in July 1997 (Jennergren and Näslund, 1998, pp. 70–1).[5] The guarantees to the rest of the banking system, which amounted to more than SEK 84 billion, were not utilized.

The recovery was surprisingly quick. After 1993, no new commitments were made by *Bankstödsnämnden*, and the banking sector as a whole showed a profit as early as 1994 (Ingves and Lind, 1998, p. 54). One reason was that the banks' interest margins rose substantially. Other important reasons were that the tight economic policies caused real interest rates to fall and that an upturn in the international economic situation contributed to an expansion in the export sector. By 1995, the situation was arguably back to normal, at least in the financial sector.

Ingves and Lind (1998) believe that the emergency treatment and aftercare given to cure the Swedish crisis were comparatively successful for four reasons, which might also comprise the conditions for a rapid recovery in confidence for any financial system in crisis:

- A political consensus was created on a broad solution to the crisis.
- The authorities encouraged the greatest possible openness about the problems and the financial situation of the individual banks.
- Bad loans and property values were entered in the accounts in an open and transparent way, and the banks and finance companies

that were not likely to recover from the credit losses were allowed to go into liquidation.
- Bad loans were transferred to special asset management companies, but at realistic market values.

We will return to this list below, in the discussion of the cures for the Asian crisis. Before turning our attention to developments in Asia, however, it should be noted that not all dimensions of the crisis had been solved by 1995. Apart from the recovery in the financial sector, Jonung and Hagberg in Chapter 5 argue that real income growth and industrial production growth were also back to their trend rates by 1995. However, the crisis in public finances remained serious. Automatic stabilizers in the government budgets had created serious deficits in both Finland and Sweden – in 1994, Sweden recorded a budget deficit of over 10 per cent of GDP – and the high unemployment rates in both countries continued to trouble public finances. Considering the history of both Finland and Sweden as developed welfare states with strong interest groups protecting their relative positions, it is remarkable that both countries were able to contain public expenditure and return to balanced budgets within only two or three more years. We will return in the next section to a discussion of the special conditions that facilitated the rapid and broad recovery after the crisis in the Nordic countries, contrasting it with the slower and perhaps more 'normal' processes in most of Asia.

9.2 THE ASIAN CRISIS

The four related problems emphasized above – stock market and property bubbles, a financial crisis, a currency crisis, and a downturn in production and employment – recur in several of the crisis-hit Asian countries. This section starts by summarizing some common features of the crises in different Asian countries, and highlights some of the similarities with the Swedish financial crisis. Thereafter, we point to some of the special characteristics of the Asian crisis that made the problems in the region more severe than in Sweden and contributed to slowing down the Asian recovery process.

9.2.1 Four Crises

Just as in Finland and Sweden, the crisis in Asia was preceded by speculative bubbles in the stock and property markets. In the greater part of the region, economic growth rose sharply in the early or mid-1980s, and the

stock markets began to rise rapidly a few years later. In the most developed economies – South Korea and Taiwan – the peak in the stock market was reached even before the end of the 1980s (in the aftermath of the Plaza Accord, which led to an appreciation of the currencies in Northeast Asia) but in other countries share prices continued to rise. At the same time, property prices shot up. The number of property and finance companies grew rapidly. Transactions were financed with borrowed money, and, as in Sweden, borrowing on property and share portfolios often exceeded their market value. This seemed rational, since the economies were growing by almost 10 per cent per year and there were no clear signs of any slowdown.

But the expectations of high economic growth and continuous increases in asset prices proved to be over-optimistic. Real estate prices began to drop as early as 1993–94. The main reason was declining profitability – the yield on property fell as the supply increased. In Bangkok, one square meter of office space cost almost US$ 3000 in 1991. Five years later, before the real collapse in the property market, the price had fallen to US$ 2200. The square meter price in Jakarta fell from US$ 2200 in 1991 to US$ 1600 five years later (Dollar, 1998). The stock market indices in both Bangkok and Kuala Lumpur also peaked in 1993–94, and fell by half by 1996. When prices began to drop, both borrowers and lenders found themselves in trouble. Many borrowers had insufficient cash flow to pay interest. Lenders found that their security and collateral were worth considerably less than they had thought. The financial sector became vulnerable.

The high level of demand and the increase in asset values also led to higher production costs and wage increases. The productivity growth in the export industries could not keep up with the increase in costs, and competitiveness was eroded. The trends in exchange rates made the situation worse. Several of the countries in the region had tied their currencies to the dollar, which began to appreciate in the mid-1990s. In countries that had floating exchange rates, large inflows of foreign capital – both loans and direct investment – contributed to maintaining the strength of the currency.

However, the inflow of foreign currency was based on expectations of high growth and high yields. When foreign investors began to realize that these expectations could not be fulfilled, the problems became acute. Thailand was the first country to be affected. Foreign financiers began to withdraw from the beginning of 1997, and short-term loans were not rolled over as they fell due. When the inflow of capital dried up, the currency weakened. There were several waves of speculation on devaluation in early summer 1997. The repeated defense of the *baht* drained the foreign exchange reserves, until it was no longer possible to resist the pressure.

This happened by the beginning of July 1997, and the fixed rate was abandoned.

The depreciation of the *baht* worsened the financial crisis that had begun with the fall in the stock and property markets, since debts in foreign currency immediately became considerably heavier to service. The turbulence and uncertainty in the market was also too great for new capital to come into the market in the short term. The reduction in import capacity, and the financial market's problems with capital adequacy requirements and liquidity, led to a fall in production and employment – a real crisis. In its major features, the process was the same as in Sweden and Finland half a dozen years earlier.

Given the increased risk of credit losses, lenders also began to review their interests in the rest of the region. It was soon clear that other countries in Southeast Asia had much in common with Thailand regarding the state of the financial sector. The critical assessments also revealed various risks and weaknesses that had been overlooked earlier, when investors were still blinded by high growth rates. In Indonesia, the uncertainty applied both to political stability – mainly concerning Suharto's successor – and industrial structure, where nepotism, corruption and excessive investment in capital-intensive and high-technology sectors caused concern. In Malaysia, attention was directed at several gigantic investment projects under government auspices and at Prime Minister Mahathir's attacks on the market – could the market trust someone who so obviously distrusted the market? For South Korea, a long list of potential problems was discussed, each more serious than the next. These included question marks on the stability and efficiency of the financial markets, the massive indebtedness and weak profitability of industry, which had forced six of the country's 30 largest industrial conglomerates, the *chaebols*, into liquidation within a short period of time; and the links between the large industrial companies and the political leadership. The market reaction was harsh. Capital flows dried up, the currencies weakened, and the financial markets were shaken.

Even nations like Singapore and Taiwan, with relatively sound economies, suffered from stock market falls and depreciation. In these cases, it was an adjustment to a new market situation rather than the result of domestic weaknesses: as a result of the substantial exchange rate changes, the competitiveness of neighboring countries had been strengthened, at the same time as their ability to import had fallen. The two nations that chose to retain their fixed exchange rates against the dollar were also affected. In Hong Kong, an attack on the currency was fought off, which meant that the adjustment to the changes in the regional economy had to come through changes in nominal asset prices and salaries.

China declared that no devaluation should be expected, although the turbulence had some impact on GDP and export growth rates in the short term. The Chinese currency did not come under serious attack, both because the country's foreign exchange reserves were thought to be sufficient to ward off any attack and because remaining restrictions on current and capital account transactions left only limited room for the market to exploit. This notwithstanding, the problems of ineffective financial markets and bad loans, often to government-owned companies, were at least as great in China as in any of the crisis-struck Asian countries before 1997. It is likely that some kind of adjustment will eventually occur in China as well, but the mix of political control and a free-market economy makes it difficult to predict exactly when and how. In Vietnam, the crisis contributed to slower GDP and export growth rates, but the acute problems plaguing some of the neighboring countries were avoided. The Vietnamese currency was not convertible, and it had neither a real estate market nor a stock market where substantial asset bubbles could have developed.

9.2.2 The Supply of and Demand for Capital

A closer look at how the bubbles in the East and Southeast Asian markets were inflated strengthens the impression that the problems developed very much like those in the Nordic countries. The rapid increase in asset prices was caused by simultaneous increases in the supply of and demand for capital.

As in Finland and Sweden, financial deregulation was an important factor in increasing the supply of credit, but in a more comprehensive way than in the Nordic countries. Up until the first half of the 1980s, most of the economies in the region had been relatively inward-oriented, and the growth strategies were largely based on import substitution.[6] Even Korea, which had implemented a strong export-promoting policy between the early 1960s and the mid-1970s, had opted for a strategy involving more import substitution and support to heavy and chemical industries. The results, however, were disappointing. The regulations and trade barriers that were erected to shield domestic producers from foreign competition gave rise to inefficiency, and many of the industries that should have grown strong with the aid of protective tariffs and subsidized credit never became competitive. Consequently, the inward-looking policies were revised throughout the region, from around 1980 in South Korea and 1985 in Thailand, Malaysia and Indonesia.

The new approach emphasized export orientation and greater openness. Most of the countries devalued their currencies and the inflow

of foreign investment was encouraged. Credit markets were gradually liberalized, as the need to direct investment capital to selected strategic industries diminished. The result was a large increase in domestic credit to the private sector. The deregulation and liberalization of financial markets continued into the 1990s, but now with reference to the so-called Washington Consensus. This development paradigm, strongly promoted by the IMF and the World Bank, prescribed fiscal discipline, privatization, deregulation and financial liberalization as a recipe for economic development (Williamson, 1994). However, much of East Asia was weakly prepared for the shift to a liberalized financial system, and the expansion in the supply of credits took place without the prudential regulation and supervision that would have been needed to safeguard the stability of the system. For instance, Lee (2003, p. 19) argues that 'financial deregulation in Asia created an institutional hiatus, as it removed government regulation without putting in place institutions necessary for a market-based financial system'.

Parallel with the gradual deregulation of the domestic financial markets, the supply of capital was boosted through large inflows of foreign investment. The US already had substantial investments in Taiwan, Singapore and Malaysia, and Japanese investment started flowing in on a large scale from the mid-1980s. At this time, Japanese export industries had already grown so strong that the trade surplus with the US had become a serious problem. The Plaza Accord in 1985 was intended to help even out the imbalance and involved a gradual appreciation of the Japanese yen, from JPY 239 per dollar in 1985 to about JPY 135 per dollar two years later. The strong yen drove up production costs in Japan, and forced Japanese export companies to move a substantial part of their labor-intensive production to countries such as Thailand, Indonesia and Malaysia, and later also to China.

The inflow of foreign capital – this time with greater emphasis on portfolio investment – increased once again at the beginning of the 1990s. In Japan, the years after 1985 were noteworthy not only for the continuous strengthening of the yen but also for expansive fiscal and monetary policies. The aim was to ward off the downturn in domestic demand that was expected to follow from the appreciation of the yen. The expansionary policies were also encouraged by the US as a way of stimulating Japanese import demand. The chief result was not, however, a reduction in the trade imbalances. Instead, the Japanese exporters succeeded in adjusting their costs, partly thanks to their foreign investments in the region and in the US. The combination of a strong currency and high demand created a substantial asset bubble in Japan. Many economists may recall the anecdotes about Tokyo's high land prices: it was said that the value of

the Imperial Palace and the palace grounds matched that of all the land in California.

The Japanese bubble did not last very long. The Japanese stock market and property market began to contract from the beginning of 1990, after worries about increasing inflation had prompted the Japanese Central Bank to raise interest rates. The prices of many assets had soon halved. However, the collapse of asset prices did not result in any acute crisis although many investors, finance companies and banks were badly hurt. Unlike Sweden and most of Southeast Asia, Japan was a large exporter of capital, and the bursting of the bubble did not cause any currency crisis nor did it affect the liquidity of the Japanese financial sector in the short run. Hence, Japan could choose not to address the problems in the financial sector at that time. Instead, bankers and politicians put a lid on the situation, and began to wait patiently for the problems to disappear of their own accord. Meanwhile, to ensure the survival of companies that were burdened with debt, it was essential that interest rates fell significantly.

At the same time as many finance and property companies were burdened with problem credits, the Japanese continued to save, and export companies continued to generate large profits. Rather than invest their savings at a low interest rate in Japan, many banks chose to invest in other Asian countries, where growth and yields were higher – in particular in Thailand, South Korea and Indonesia.[7] The supply of cheap Japanese capital with few restrictions was so great that some observers see this as an important cause of the Asian crisis. Martin Feldstein (1997), for example, believes that Japan's expansive monetary policy and the lax handling of credit by the Japanese banks contributed to many of the countries in the region taking on an unsustainable level of foreign debt.

It was not only the Japanese who were enticed to offer loans to the region. From the beginning of the 1990s, European investors also began to see opportunities in Asia, and, just before the crisis broke, EU banks were, in fact, the largest lenders to the region. Of the total loan stock, the EU was responsible for about 41 per cent and Japan for 32 per cent, while the US share was only 8 per cent (Ostrom, 1998, p. 6). Table 9.1 summarizes the available information on the foreign borrowing by selected countries in East and Southeast Asia at the end of June 1997. Japan, Hong Kong and Singapore are not included in the table, since none of these countries had any significant net foreign debt.

In addition to the high level of indebtedness in the countries hardest hit by the crisis, it is also noteworthy that a very large proportion of the loans were short-term. In South Korea, Thailand and Indonesia, short-term debt alone amounted to more than 50 per cent of the previous year's exports. In all three countries, short-term foreign debt was also far larger

Table 9.1 International bank loans to Asian economies, June 1997

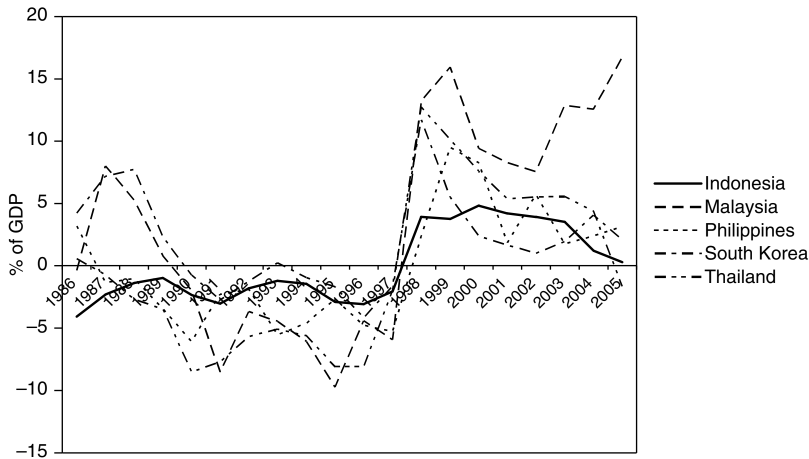
Borrower	Total loans (US$ million)	. . . as share of GDP (%)	Lender (% of total loans)			Short-term loans (US$ million)	. . . as share of exports 1996 (%)
			Japan	EU	USA		
South Korea	103 432	21.3	23	35	10	70 182	54.1
Thailand	69 382	38.1	54	28	6	45 567	81.8
Indonesia	58 726	26.5	39	38	8	34 661	69.6
China	57 922	7.1	32	48	5	30 137	19.9
Malaysia	28 820	29.3	36	44	8	16 268	20.9
Taiwan	25 163	9.2	12	57	10	21 966	19.0
Philippines	14 115	16.2	15	48	20	8 293	40.4

Source: Komine (1998, Tables 6–7).

than the foreign exchange reserves – in South Korea almost three and a half times as large (*The Economist*, 7 March 1998, p. 6). When confidence in the regional market began to fall, it was the problems with refinancing of the foreign short-term debt that triggered the crisis.

Another indication of the significance of capital flows, and the vulnerability of the region's economies, is the growth of trade deficits. Figure 9.1 shows how the current accounts of the countries that were worst hit by the crisis (Indonesia, Malaysia, the Philippines, South Korea and Thailand) turned to deficits in the late 1980s or early 1990s, even though export growth was accelerating. A deficit in the current account does not only mean that imports exceed exports, which requires a net inflow of foreign capital in the form of loans or investment. It also reflects the gap between domestic saving and domestic investment. This financing gap was largely covered by foreign resources. After the crisis, all of these countries have been forced to generate current account surpluses, in order to pay back their foreign loans. The countries that managed the crisis best – Singapore and Taiwan – had avoided building up current account deficits and foreign debt stocks before the crisis. Instead, their domestic savings were sufficiently high to finance domestic investments and to accumulate large currency reserves that facilitated the management of the crisis.

The increase in the supply of capital – both from domestic and foreign sources – makes up half of the explanation for the growth of the bubble. The other half, the increase in the demand for capital, is largely explained



Source: *East Asian Economic Perspectives* (2006), **17** (1).

Figure 9.1 Current account balance as a percentage of GDP 1986–2005

by the shift to a more export-oriented and outward-looking development strategy from about 1985.

When import substitution was abandoned and resources were permitted to flow to industries in which countries had comparative advantages – many countries also carried out substantial devaluations to support the profitability of their export industries – economic growth accelerated. The average annual growth rate nearly doubled in several countries, from 4–5 per cent in the first half of the 1980s to over 8 per cent in 1987–92. The Philippines were an outlier, with only 3–4 per cent growth in the latter period: however, even this was a marked improvement on the first half of the 1980s, when the economy had been in a recession. As the yield on land, capital and other resources increased, so did the demand for and prices of assets.

Until the beginning of the 1990s, the bulk of investment went into the export sector, but as costs began to rise and the real exchange rate began to appreciate, the pattern changed. The growing domestic market became increasingly important, both for manufacturing industry and for a rapidly expanding service sector. The high rate of growth did not only create great individual wealth; it also created a significant middle class demanding consumer durables, cars and homes. The demand for capital for investment in infrastructure and real estate increased strongly.

The large interest differential between domestic and foreign loans was

one reason for the high demand for foreign capital in particular. As a result of higher inflation and various limitations on competition, domestic interest rates in several Southeast Asian economies were several percentage points higher than international rates. In 1993, for example, short-term interest rates in Thailand were about 10 per cent per annum, while foreign financiers could offer dollar loans at below 5 per cent interest (Kobayashi, 1997, p. 16). As long as exchange rates were fixed, it was highly attractive to borrow in dollars rather than in the local currency. In Thailand, a special financial market was established to channel international capital to local investors – the Bangkok International Banking Facility. With both a massive supply of and massive demand for capital, all the conditions were present to create bubbles.

9.2.3 The Bubble Bursts

As we noted earlier, the peak in several of the region's stock markets was reached as early as 1993–94 (and even a few years before that in South Korea and Taiwan). The property markets showed signs of excess supply at about the same time, even though the collapses in Thailand, Malaysia and Indonesia did not occur until 1996. The falling asset prices contributed to the vulnerability of banks and financial institutions, but there was a longer time-lapse than in Finland and Sweden before the collapse of the bubble led to serious instability and a financial and currency crisis.

One reason was that the accounting procedures in most Asian companies were (and continue to be) less transparent than they are in Europe. There was, quite simply, insufficient public control of industrial companies, banks and financial institutions for the financiers – in particular the foreign lenders – to realize at an early stage that they had something to worry about (Lim, 1999). In particular, it was not apparent how highly indebted many companies were, and how large their short-term loans were. As an example, South Korea's short-term foreign debt in late 1997 was estimated at US$ 65–70 billion (Table 9.1). It is now believed that the real figure was over US$ 100 billion. To a very great extent, these short-term credits financed long-term investments. It was only after the crisis had broken that it was noted that the average debt–equity ratio among South Korea's 30 largest *chaebols* was over 400 per cent at the end of 1996. The corresponding figure for the USA was 70 per cent (*The Economist*, 7 March 1998, pp. 6–7). This lack of transparency has also been noticed in Thailand, Malaysia, Indonesia and the Philippines, where debt–equity ratios exceeding those of Korean *chaebols* have been revealed after the crisis (ADB, 2001, p. 124).

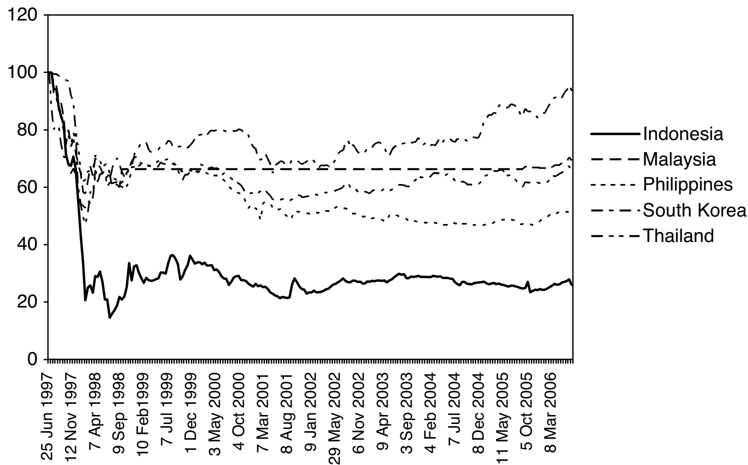
Many investors seem to have underrated the investment risks in the

region. In addition, the strong links between political office-holders and business interests that are common in the region seem to have been interpreted as an implicit credit guarantee. On the one hand, the state directed capital to sectors that were, for some reason, considered particularly important, such as heavy industry in South Korea and Indonesia and infrastructure investment in Malaysia. On the other hand, selected individuals and companies – Suharto's relatives and friends in Indonesia, *chaebols* in South Korea, politically influential businessmen in Thailand – were granted special advantages, such as lucrative government contracts, licenses and subsidized credit. Some investors and many lenders probably concluded that banks and companies with such strong political backing would hardly be allowed to go to the wall. This explains why the initial price falls on the asset markets were not seen as a sign of major risk, and why capital continued to flow in.

The combination of implicit loan guarantees, insufficient transparency and weak supervisory authorities has been interpreted by several observers as the principal reason for the Asia crisis. Paul Krugman (1998a, 1998b), for example, argues that the crisis was primarily a financial crisis rather than a currency crisis. The problems caused by the weaknesses in the financial market are known as moral hazard. The lack of supervision and the dilution of individual responsibility meant that banks and other intermediaries took excessively great risks and pushed up asset prices. In the best cases, the projects were successful, and the investors made large profits; in the worst cases, they expected the government to step in and compensate their losses. This worked for a while, but when the bad investments and losses finally became so large that the state could no longer cover them, the crisis broke out. Capital flows dried up and currencies collapsed. The fall in liquidity led, in turn, to a further decline in asset prices.

Figures 9.2 and 9.3 illustrate some of these consequences. The development of the US dollar exchange rates for Indonesia, Malaysia, the Philippines, South Korea and Thailand are shown in Figure 9.2 (with an index value of 100 for 25 June 1997). The Thai *baht* was floated on 2 July, and the currencies of neighboring countries began to slide a few days later. The largest depreciation took place in Indonesia, where the currency lost 80 per cent of its value by early 1998. The currencies of the other countries included in Figure 9.2 fell by some 40 per cent during the first half-year after the outbreak of the crisis.

It appears that several of the currencies initially fell more than what was justified by the underlying economic problems. One reason for this is, presumably, that there was a certain amount of panic among foreign investors when they began to realize the full extent of the region's problems. Another reason may have been that the effect of the depreciation of the



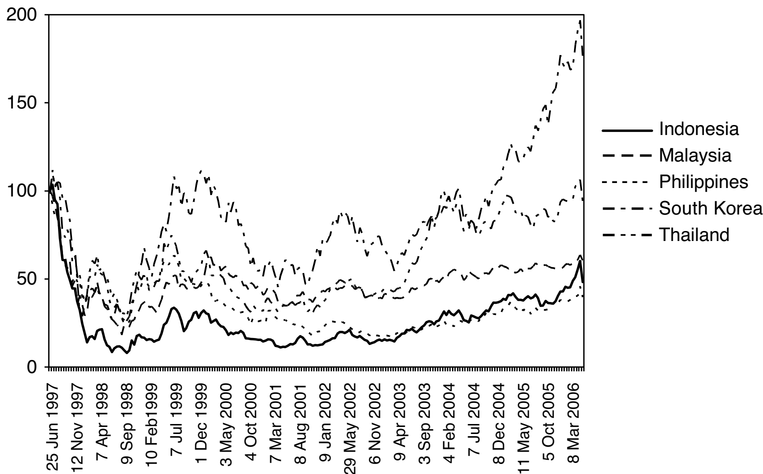
Source: *The Economist*, various issues.

Figure 9.2 Exchange rate changes June 1997–May 2006 (June 1997 = 100)

Thai currency on competition in export markets was overestimated. At the same time as Thailand's competitiveness was improved by a cheaper currency, the opportunities for increasing exports were limited by the instability of the financial markets. The export sector, therefore, was not able to expand as rapidly as Thailand's competitors in the region feared.

All of the currencies saw some strengthening from the end of 1998, but only the South Korean *won* has slowly moved towards its pre-crisis parity since that time. The exchange rate of the Malaysian *ringgit* was fixed in 1998, at two-thirds of its old value (3.8 *Ringgit* per US$, compared with 2.5 MR/US$ before the crisis). The Thai *baht* has been fairly stable at a similar level, whereas the Philippine *peso* weakened further after 2000. The Indonesian currency has not strengthened appreciably since 1999, and remains at about 30 per cent of its value before the crisis. Both Singapore and Taiwan saw depreciations of around 15 per cent, while China and Hong Kong have maintained their fixed rates to the US$.

Figure 9.3 shows the response of the stock markets over the same period. The turbulence meant that all the major stock exchanges in the region lost heavily in dollar terms. A temporary recovery during 1999 turned into a new slump in 2000, as a result of a global downturn in the IT sector. A more sustainable recovery occurred between 2003 and 2007, but the overall performance of the five countries included in Figure 9.3 varies substantially.



Source: *The Economist*, various issues.

Figure 9.3. Stock market index in US$, June 1997–May 2006 (June 1997 = 100)

While the South Korean stock market has been able to nearly double its pre-crisis level, the other countries are struggling. Thailand managed a recovery in late 2003, but has not been able to progress since that time. The stock markets in Malaysia, Indonesia and the Philippines are all at about 60 per cent of their dollar index values recorded just before the crisis. The development in Indonesia has been particularly dramatic. The dollar value of the Jakarta Stock Exchange fell by 90 per cent during the first year after the crisis, and remained at roughly that level for more than five years. Even Singapore and Taiwan (not shown in Figure 9.3) lost half of their stock market value during the first year after the crisis, but both had recovered by late 1999 or early 2000. However, the slump in the IT and electronics industries in 2000 turned out to be more severe than the financial crisis for these two countries, with further setbacks in connection with the September 11 attacks in the US the following year. The Taiwanese stock market has remained stagnant since that time.

The reduced import capacity and the contraction of the financial sector also led to considerable real effects. Several countries recorded significant GDP falls in 1998, with declines of over 13 per cent in Indonesia, 10 per cent in Thailand, and 5–8 per cent in Hong Kong, Malaysia and South Korea. Several million jobs were lost throughout the region. Hence, the real crisis was much more serious than in the case of Sweden. It was also

more severely felt by the population, since the social security networks in Asia were not well developed. The automatic stabilizers in the Swedish public budget generated overall deficits of about 10 per cent of GDP each year between 1992 and 1994. In most East Asian economies, it was difficult to channel funds to the most severely affected population groups, and the budget deficits were generally quite low, rarely exceeding 3 per cent of GDP (EAEP, 2006, p. 8). The main exception was Japan, where the public budget recorded substantial deficits every year from 1992.

9.2.4 Why was the Asian Crisis More Serious than the Nordic Crisis?

Although the roots of the Asian crisis are similar to those of the Finnish and Swedish financial crisis of the early 1990s, there are also some important differences that explain why the Asian crisis was more severe and required more extensive reforms than the Nordic crisis. We have already touched upon three such issues. The first difference is the weak development of supervisory institutions and the unclear accounting rules, accompanied by a lack of transparency in the operations of banks and finance companies. One result of the weakness of the institutions meant to handle a free-market economy was that much of East Asia's deregulation and liberalization turned out to be premature (Lee, 2003). The second difference refers to the link between political and economic interests throughout Asia, which made managers, investors and lenders act as if the state guaranteed some of the business risks. In combination, these two factors contributed to making the bubbles larger than would otherwise have been the case. The third difference is the lack of automatic stabilizers in the government budget, which meant that the drop in economic activity following the crisis was not balanced by any rapid increases in public spending.

A number of other factors made the Asian economies more vulnerable and contributed both to the rapid spread of the crisis and the substantial fall in growth rates following the crisis. These include over-ambitious industrial policies, more intense competition on the world markets for the region's export products as a result of China's rapidly increasing exports, and a shortage of skilled workers. The following sections include a brief discussion of these issues. Of course, there are significant differences across the individual Asian economies that cannot be discussed in detail. For instance, the economic crisis led to political tensions throughout the region, in some cases – primarily Indonesia – with dramatic consequences.

Industrial policy ambitions

The development strategy in many of the East Asian economies was based on Japan's successful industrial policy of the 1950s and 1960s.

Characteristic of the Japanese model was a coalition between the government bureaucracy and the major private industries, which coordinated economic development, channeled investment funds to selected projects, and protected new industries. The country that most obviously attempted to apply a similar model is South Korea. Even though the coalition between the South Korean government and the country's *chaebols*, the great industrial conglomerates, has been remarkably successful over recent decades, it is also clear that the industrial policy aggravated the problems that created the Korean currency crisis in November 1997.

As we noted earlier, in the second half of the 1970s South Korea experimented with a development strategy of import substitution, which emphasized shipbuilding, steelworks, oil refineries and other chemical and heavy industries. The experiment was largely a failure. The bias against other industries created bottlenecks, and many of the investments never became profitable (Kokko, 2006). At the beginning of the 1980s, the program was therefore terminated. A new development strategy was adopted, with a more neutral trade orientation and less systematic intervention in favor of heavy industries. Yet, the state retained a significant influence over development. Growth continued to be markedly capital-intensive. 'Strategically' important industries were promoted in various ways by industrial policy, primarily through investment support. Motor vehicles, steel, consumer electronics, chemical products and computer components were among the products regarded as having the greatest potential.

During a long period, total investment in the economy amounted to 30–35 per cent of GDP. Even though domestic savings were high, they were not sufficiently high to finance all this investment. Thus, it was necessary to mobilize foreign resources. The preferred source of funds was foreign borrowing, since inward direct investment was not encouraged. The current account deficit grew, and with it the vulnerability of the economy. Many of the *chaebols* that dominated the South Korean economy also became heavily indebted. The average level of debt in the large companies was four times higher than equity in 1996, as mentioned earlier. Even relatively limited setbacks could easily become critical with this kind of exposure. Six of the 30 largest conglomerates were bankrupt or on the brink of bankruptcy already before the depreciation of the Korean *won* aggravated the problems.

It is probable that the large debts, and the risks associated with them, were rational from the companies' point of view. Many of the investment projects were encouraged and supported in a variety of ways by the state; the companies, therefore, also expected that the state would guarantee the investments. The projects constituted part of a long-term strategy, and it was not reasonable to expect that all investments would return a profit in

the short run. The banks were also in a tight position. During the 1960s, the banking system had to all intents and purposes been nationalized, but the gradual liberalization of later years reduced the level of state control. Yet, the banks were still expected to channel subsidized funds to strategic industries. The concentration on heavy import substituting industries in the late 1970s had been very costly for the banking system, since the stock of bad debts grew rapidly. In the mid-1980s, almost 10 per cent of the lending of South Korean banks was bad debt – the borrowers were unable to service their loans (World Bank, 1993, p. 309).

It is interesting to contrast South Korea and Taiwan. The two countries recorded almost equally high economic growth from the beginning of the 1980s to the mid-1990s, but, while South Korea took on considerable foreign debt as a result of its focus on strategic capital-intensive investments, Taiwan implemented more market-oriented policies with less emphasis on heavy industry. In that way, Taiwan managed to match the performance of Korea with an investment ratio of somewhat above 20 per cent of GDP. Since the Taiwanese saved almost a third of their incomes, Taiwan became a significant exporter of capital, at the same time as it was able to build up very large foreign exchange reserves. These reserves shielded the economy from the worst effects of the crisis.

South Korea was not alone in having adopted an industrial policy involving strong state control. Similar ambitions have, to varying extents, appeared in the other Asian economies as well, with the possible exception of Hong Kong. In both Malaysia and Indonesia, the state had a major influence on the industrial structure, and both nations invested heavily in capital-intensive projects from the late 1980s. In Indonesia, the investment ratio reached close to 30 per cent, while Malaysia's investment ratio exceeded 40 per cent between 1994 and 1997. Massive investments in infrastructure, a domestic automotive industry and high-technology ambitions were found on both sides of the Malacca Straits. Many analysts lay part of the responsibility for Indonesia's massive problems on the former President, B.J. Habibie, who used his earlier position as Minister for Technology to push through a large number of expensive, high-technology projects. A large proportion of them did not become profitable, but added to the country's foreign debt. This grew to almost two-thirds of GDP before the crisis, despite the fact that the domestic savings ratio was remarkably high for a poor country, thanks to the incomes from the petroleum sector. In 1998, after the outbreak of the crisis, Indonesia's foreign debt amounted to nearly 150 per cent of GDP (EAEP, 2006, p. 86).

Governments have had high ambitions for industrial policy in Thailand and the Philippines as well, but weaker state control has made it more difficult to realize these plans. Only a few individual strategic projects

– particularly in steel and petrochemicals – have been implemented in Thailand. In the majority of cases, lobbying and pressure from different interest groups have made it difficult to favor some industries or investors over others. In retrospect, it is therefore possible that the weak political systems in these two nations may have been a blessing in disguise. As the economies have gradually begun to recover, Thailand and the Philippines have been spared a problem that continues to handicap growth in South Korea and Indonesia: massive investment in import-dependent projects that do not benefit very much from a cheaper currency.

Excess supply of strategic products

The concentration on strategic industries has had an additional effect on the crisis. Even if an individual government succeeds in identifying the 'right' sector for its strategic investments, it is not possible to repeat the plan in several countries simultaneously. When production starts in many places at the same time, the increased supply will inevitably lead to price falls. What seemed to be a sensible strategy ex ante, when there were few producers, becomes less attractive ex post, when it emerges that everyone else has done the same. There is good reason to believe that this type of failure in coordination contributed to the crisis in Asia. During 1996 and 1997, there were clear signs of an oversupply of several of the region's export products. The prices of oil products, steel, semiconductors and other computer components fell substantially, contributing to a fall in the export growth of the region. Thailand's exports of computer components, for example, increased in volume by 30 per cent during 1996, while the value of the exports was unchanged.

The appreciation of the US dollar, which began in 1995, should also be noted. Many of the region's currencies were tied to the dollar, and were dragged along with the appreciation. Although changes in exchange rates within the region were relatively limited, the dollar-pegged currencies had risen by about 35 per cent against the Japanese yen by 1997. The region's exports to Japan stagnated from 1995. In the preceding years, they had grown at an annual rate of over 20 per cent. The growth rate fell to 6 per cent in 1996, with China accounting for over half of this. In addition, competition from Japan increased in technologically more advanced industries, which affected the region's exports to the rest of the world.

China's entry into the world market

Another factor which altered the market picture in the region, and which led to many investments giving a poorer return than had been expected, was China's large-scale entry into the international market at the beginning of the 1990s. The Chinese export market had begun to grow as

early as the beginning of the 1980s, when a number of coastal regions were designated as special economic zones and permitted to experiment with the market economy. To start with, only eight cities were involved, but the reforms were soon extended to the greater part of the Shenzen, Guangdong and Hainan provinces along the southern and southeastern coasts. The experiment was very successful and generated exceptionally rapid economic growth, which led to a gradual diffusion of the reforms to the rest of the country. Deng Xiao Ping's famous inspection tour of the coastal provinces in 1991 – when he was reported to have stated that it did not matter what color a cat was, as long as it caught mice – was interpreted as a clear indication of a more general transition to a mixed economy.

As openness and market orientation in the rest of China increased, so did Chinese exports. At the beginning of 1994, a further step towards the world market was taken when the currency was devalued by almost 40 per cent. Over the following years, this had a very tangible effect on the supply of exports from the region. Total Chinese exports increased by over 60 per cent in only three years, between 1993 and 1996. At that point China and Hong Kong together were responsible for about half of the total exports from the region. China's entry into the market had a similar restraining effect on the prices for labor-intensive products – textiles, shoes, home electronics and other light industries – as the contemporaneous strategically-motivated investments had on more advanced industries, such as chemicals, steel and computer components. Prices fell, and this had a negative impact on the profitability of investments throughout the region.

Lack of educational investment

In certain parts of the region, serious deficiencies in education and infrastructure have contributed to the difficulties. While the more developed economies, such as Hong Kong, South Korea, Singapore and Taiwan, have been investing in education for years and have built up a well-educated and efficient workforce, there are major problems in other places. In Thailand, only 39 per cent of children in the 12–16 age group attended school in 1994. In Indonesia, the figure was 44 per cent and in Malaysia 56 per cent (*The Economist*, 7 March 1998, p. 14). All these figures are significantly lower than the equivalent measures for South Korea and Taiwan 20–25 years earlier, when these countries were at about the same income level as Thailand was at the time. The result of inadequate investment in education is a serious shortage of skilled workers, which has meant that increases in productivity have not been able to keep pace with increases in wages.

The best illustrations of this problem are found in Thailand. The acceleration of growth at the end of the 1980s was based on large numbers of uneducated workers streaming into Bangkok from the rural areas to

manufacture clothes, shoes and toys, and to assemble electronic products. For a number of years, it was possible to expand production without costs becoming a problem. But from about 1992, when growth in the domestic market also took off, the supply of cheap labor began to dry up and competition drove up real wages. By 1996, real wages for unskilled labor had risen by 60 per cent. Because of the low average level of education, it was not possible to increase the degree of value added in export production, with the result that competitiveness declined (Warr, 1997). The depreciation of the Thai currency cut real wages and restored competitiveness, but the shortage of skilled labor still limits Thailand's capability to upgrade its production structure. Extensive investments at all levels of education are essential to support sustainable increases in wages and living standards in Thailand as well as in other Southeast Asian economies.

9.3 REFORM AND RECOVERY

The short-term responses to the Asian crisis were in many ways similar to those in the Nordic region. Most countries allowed their currencies to depreciate in order to strengthen the competitiveness of exports and to reduce current account deficits. Banks and financial institutions were recapitalized or restructured: those whose owners were unwilling or unable to provide more capital were closed or nationalized. Most countries opened up their financial sector (as well as other formerly protected sectors) to foreign direct investment. Various institutional reforms were undertaken to clear out problem credits and to restore public confidence in the financial system. Asset management corporations and financial supervisory agencies were set up across the region. Reforms also sought to increase transparency and to improve corporate governance with stricter accounting rules and revised bankruptcy laws. Negotiations with foreign creditors aimed to establish realistic schedules for debt repayments and to maintain the international credit lines needed to keep the economies operating. In many cases, the IMF was instrumental in closing these financing deals. Most countries also went through a brief period of fiscal and monetary restraint – mandated by the IMF and heavily criticized by many observers – in order to avoid inflation in a situation where the public was withdrawing large amounts of cash from the ailing banking system. The exception was Malaysia, where the government opted not to seek IMF assistance or advice and chose to handle the crisis with more expansionary fiscal and monetary policies. Unlike the other countries in the region, Malaysia also chose to introduce various controls on international capital flows to stop the outflow of capital.

The effects of the reforms in Asia were not as strong as in Finland and Sweden, where most of the impact of the crisis had dissipated by 1995, only three years after the crisis erupted. Figure 9.3 shows that the stock markets in most of the crisis-hit countries remained well below their pre-crisis levels until 2006: South Korea was the only economy where the stock market index had exceeded its pre-crisis level. Investment rates have also remained well below the levels of the mid-1990s. The most substantial contraction has occurred in Malaysia, where the ratio of fixed investment to GDP fell from over 40 per cent in 1995–97 to just over 20 per cent in 2004–05. In the other severely affected countries, the ratio has shrunk by one-third (*Asian Economic Perspectives*, 2006). The same picture holds for overall growth. Although most countries recorded one or two years with growth rates above 7 per cent, none of the severely affected countries have been able to return to pre-crisis growth rates.

The recovery at the micro level was also relatively sluggish. In particular, the asset management corporations in the region were slow to dispose of their NPLs, at the same time as corporate restructuring was slower than expected (Hanna and Huang, 2002). ADB (2001) reports that more than half of the loans in Indonesia were still classified as non-performing in 2001, the share of NPLs in Thailand was over one-fourth, and Korea, Malaysia and the Philippines recorded NPL ratios of over 15 per cent. In Korea and Malaysia, the asset management corporations had managed to sell or restructure about a third of the NPLs in the economy, but little had happened in the three other countries by that time. Four years later, in 2005, the Malaysian and Korean AMCs had largely completed their operations, but corporate debt still remained a problem in Indonesia, the Philippines and Thailand.

One consequence of the slow corporate restructuring process was that the export response to the crisis was delayed. In the case of Sweden, exports started growing rapidly once the currency was allowed to depreciate in late 1992, and the export volume increased by nearly 40 per cent during the following three years. In most of the worst-hit East Asian countries, exports did not begin to grow substantially until after 2002. South Korea and Malaysia exhibited the most rapid increases in exports, which may have been related to their successful short-term performance in terms of corporate debt restructuring: without a debt overhang, the financial system was able to provide fresh credits to the growing export sector. However, their early export success was interrupted by the turbulence in the IT market in 2001, which led to negative export growth throughout East Asia that year. With more favorable external conditions, it is possible that some of these economies (notably South Korea) would have been able to achieve an even faster recovery.

Yet, there are more important reasons than external conditions why the Asian recovery has been relatively slow. A first point, noted already in the previous section, is that the causes of the Asian crisis were deeply embedded in the Asian model of development. Government intervention (in the form of ambitious industrial policy programs) reduced the role of market-determined prices and profits, and the government guarantees that were implied by the active interest of the state led entrepreneurs to accept unusually high levels of risk. It has taken a long time to change the relationship between the government and the corporate sector. Both debtors and creditors delayed realizing their losses as long as possible, hoping that the government would eventually step in to bail them out. However, this also meant that they were not able to invest wholeheartedly in areas with growth opportunities, such as the export sectors.

The links between business and government have also influenced the Asian governments' willingness and ability to implement difficult decisions. Various interests groups have been able to influence politicians, delaying necessary reforms, such as forcing ailing firms to go bankrupt or preventing banks from rolling over debt to insolvent companies. The best example may be Japan, where the intimate links between political leaders, banks and enterprises (particularly in real estate and construction) contributed to a policy environment where even very weak firms managed to survive. Expansionary monetary policies pushed interest rates to zero, and several costly fiscal support programs generated the world's largest public sector debt. Yet, the economy remained stagnant for more than a decade after the crisis in 1990, and it is only recently (in 2006) that the Central Bank of Japan has raised the prime rate above zero again. Similar problems have been encountered in most other countries as well, although the slow speed of corporate restructuring is also related to the weaker institutional structure in many of the Asian economies.

Recalling the four points emphasized by Ingves and Lind (1998) as explanations for the rapid Swedish recovery – a political consensus on the solutions to the crisis, transparency regarding the financial situation of banks, a willingness to liquidate insolvent firms, and the efficient operation of asset management companies – it appears that few Asian countries have been able to follow the Swedish example. In particular, it seems that the political consensus that facilitated the Finnish and Swedish recovery from the crisis has been missing in Asia.

At the same time, it is important to note some crucial caveats regarding the comparison between Asia and Northern Europe. First, it is essential to define what constitutes 'recovery'. If the arguments regarding excessive investments and asset price bubbles are taken seriously, it is obvious that recovery does not necessitate a return to pre-crisis levels of investment,

GDP growth rates and stock market valuations, since these were too high to be sustainable. Second, the recovery should involve structural change to the extent that a crisis is related to structural problems (or weak fundamentals). This necessarily takes time. Third, structural changes are often painful, and defensive reactions from vested interests should be expected. Capital owners that risk losing their investments typically lobby for support from the government, workers whose jobs are in danger are likely to protest, and citizens who see little improvement in economic conditions in spite of painful contraction are likely to suffer 'reform fatigue' and vote for more popular alternatives.

Taking these characteristics into account, it may be normal that the recovery from a deep crisis takes time. In fact, the Asian crisis is not the only one where recovery has been slower than in Finland and Sweden. For instance, the Latin American debt crisis of the early 1980s was not resolved until the early 1990s (Kokko and Zejan, 2000). This suggests that the appropriate question might be 'How could Finland and Sweden manage such a rapid recovery?' rather than 'Why are others not able to recover equally fast?'

9.3.1 Why was Nordic Recovery so Fast?

Looking for special features in the Nordic economies during the 1990s, it is impossible to disregard two major events: the Finnish and Swedish accession to the EU in 1995 and the emergence of the 'new economy', characterized not only by telecom giants like *Ericsson* and *Nokia*, but rather by the emergence of a dynamic IT sector. Both these events had a profound impact on the recovery after the financial crisis.

It is hard to overestimate the role of EU membership. On the one hand, it is clear that participation in the European Union provided some economic benefits to the Nordic countries. In particular, the combination of a sharply depreciated currency and EU membership stimulated significant inflows of FDI to Sweden, providing capital, technology and links to important export markets. Between 1990 and 2000, the share of foreign-owned firms in Swedish manufacturing industry grew from 18 per cent to 32 per cent. At the same time, exports grew faster than ever before. The Swedish export-to-GDP ratio increased from 29 per cent to 48 per cent during the 1990s. Although the main explanation for the export boom was probably the depreciation of the currency in 1992, it is likely that the improved market access in the EU was also important.

The growth of telecommunications and information technologies provided further stimulus. The expansion of companies like *Ericsson* and *Nokia* and the clusters surrounding these firms absorbed much labor and

contributed to investment, production and exports. Hence, the deeper integration with the rest of Europe and the emergence of the new economy together facilitated the necessary structural change towards industries with strong comparative advantages. In addition, the stock market boom of the second half of the 1990s was based on the new economy and this accounted for most of the recovery in the stock market indices. Without the IT boom, it would have taken much longer for the Nordic stock markets to exceed the levels attained before the financial crisis.

On the other hand, EU membership imposed a great degree of discipline on macroeconomic management and public finance. As EU members, Finland and Sweden were obliged to meet the Maastrict criteria for participation in the European Monetary Union. These criteria – and the convergence programs required to meet the criteria – aimed to reduce the variation in inflation and interest rates among the EU countries. To do that, caps on national government budget deficits and the level of public debt were also necessary. The restrictions from the convergence program were relevant mainly for the medium-term reforms. The immediate aftercare of the crisis was not much affected by the preparations for EU membership, but the need to balance public budgets made it possible to resist calls for compensation from various interest groups.

Similarly, the contraction of the public sector that was necessary to turn the large deficits of the government budget during the first half of the 1990s into surpluses towards the end of the decade would hardly have been possible without external pressure. Considering the Swedish history of strong interest groups and coalitions between labor, capital and government – at times, even characterized as democratic corporatism (Katzenstein, 1985) – it is remarkable that government managed to distribute the costs of the crisis management across most groups of society. It is equally remarkable that government finances, investments, exports, stock markets and growth rates were back on pre-crisis level within five years of the crisis.

While the EU accession and the IT boom are largely exogenous events that can hardly be counted on to solve the next crisis, it has also been suggested that there are systematic differences between Nordic and Asian political structures that may explain the faster recovery in the North. In particular, Suzuki (2006) argues that Finland and Sweden have a higher degree of 'organizational learning capacity' in policy-making, and that this facilitated the design and implementation of effective reforms. By 'organizational learning capacity' he means the ability of an organization – in this case, the policy-making system – to collect and interpret internal and external information and to find efficient solutions for the policy challenges faced by the organization.

Suzuki (2006) asserts that the Swedish policy-making system is stronger

in the generation, dissemination and interpretation of information, as well as in the implementation of agreed policy responses. The advantages regarding collection, dissemination and interpretation of information are mainly related to the more transparent and less hierarchical character of the Swedish policy systems. Government collects the opinions of various interest groups in an extensive consultation process with civil society, information is exchanged relatively freely between various actors in the policy-making system, and relatively horizontal decision structures contribute to exchanges of views between policy-makers and experts in the government bureaucracy. As a result, rules are typically relatively transparent, and decisions are implemented with little interference from interest groups. Asian (particularly Japanese) policy-making systems, in contrast, are hierarchical and compartmentalized, with fewer sources of information, fewer challenges to established interpretations of information, and more discretionary decision-making and interference from interest groups in the implementation phase.

Although the structural features of the Nordic policy learning processes probably exhibit systematic advantages compared with those of most Asian countries, there is reason to acknowledge the importance of favorable external circumstances (and perhaps some degree of luck) in explaining the rapid recovery after the Nordic crisis. The next crisis – which may well contain some of the features discussed above – may take longer to resolve even in Finland and Sweden. At the same time, there is reason to highlight those features of the Nordic policy-making system that may be replicated elsewhere. Consensus regarding the necessary reforms and transparency in legislation and implementation of policies appears to be particularly important. Governments and bureaucrats in countries like Japan, where strong domestic interest groups have for a long time obstructed painful but necessary restructuring, may also appreciate the practicality of suitable external pressure. In those Asian countries where these elements were lacking, the recovery process was significantly slower than in the Nordic countries.

NOTES

1. See the account of the Nordic crisis in Chapters 2 and 3 in this volume.
2. See Chapters 2 and 3 in this volume. See also Jonung et al. (1996), who make a more explicit comparison between the Finnish and the Swedish record; Drees and Pazarbasioglu (1998), who look specifically at the banking crises in Sweden, Norway and Finland, and Bordo and Schwartz (1996), who discuss currency crises in a historical perspective.
3. See Chapter 2 in this volume.

4. Chapters 2 and 4 in this volume. *Affärsvärlden* (1992), Lybeck (1994), Jonung et al. (1996) and *Ekonomisk Debatt*'s theme issue on the financial crisis (*Ekonomisk Debatt*, **28** (1), 1998) are examples of detailed analyses of the Swedish crisis. The following paragraphs are partly based on these sources.
5. If the opportunity cost of the bank support – the interest payments which were made or the potential interest income which the government failed to secure – taken into the calculations, Jennergren and Näslund (1998) believe that the bill for the taxpayer amounted to approximately SEK 35 billion.
6. For a more detailed analysis of growth strategies in the region, see Kokko (2006).
7. See Ostrom (1998) for a more detailed analysis. A great deal of Japanese capital was also invested via Hong Kong and Singapore.

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PART III

Lessons from the Nordic crises