THAILAND'S EXCHANGE-RATE CRISIS: RELATIONSHIPS TO EAST ASIA AND THE GLOBAL ECONOMY

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Introduction of Dr. Supachai Panitchpakdi by Wisarn Pupphavesa, Dean, School of Development Economics, National Institute of Development Administration, Thailand.

Wisarn Pupphavesa, Dean, School of Development Economics, National Institute of Development Administration, Thailand: Dr. Supachai Panitchpakdi received his Ph.D. in Economic Planning and Development from Erasmus University in Rotterdam where he was a student of Professor Jan Tinbergen. He also received an honorary Ph.D. from the National Institute of Development Administration. He is now a member of the Thai Parliament and Deputy Prime Minister and Minister of Commerce. He formerly served at the Bank of Thailand in the capacity of Director of Financial Institutions Supervision. In his private sector career he served as President of the Thai Military Bank, Ltd. before becoming Deputy Prime Minister the first time. He has received the Most Exalted Order of the White Elephant, a Royal decoration. May I please present Dr. Supachai Panitchpakdi.

Dr. Supachai Panitchpakdi, Deputy Prime Minister of Thailand: Ladies and Gentlemen, my speech won't be very long, because I do not want just to repeat things that might already have been said, and am actually more interested in your comments. I will not focus on things that happened in the past or the

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ABBREVIATIONS

ADB: Asian Development Bank
APEC: Asia-Pacific Economic Cooperation forum
ASEAN: Association of South-East Asian Nations
CIS: Commonwealth of Independent States (most of the former members of the Soviet Union)
EU: European Union
FDI: Foreign Direct Investment
G7: Group of 7 (United States,* Great Britain,* France,* Germany,* Japan,* Italy, Canada) *original members of G5.
GDP: Gross Domestic Product
IMF: International Monetary Fund
OECD: Organization for Economic Cooperation and Development
RMP: renminbi

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causes of the present financial turbulence in East Asia. I think enough has been said about the causes—rightly or wrongly—and there has been a lot of blame. There is still a need for more analysis and work to determine the true causes and turn of events that have led to the crisis that we are witnessing today.

I would rather reflect upon the process of changes that we are going through at the moment to be sure that we are in touch with the reality of the situation and aware of the things that we have to go through and the kind of measures and adjustments that we have to put into action. There are four points.

Economic Change

Firstly, I would like to establish one fact—the present crisis is not limited to Asia. Present adjustments cannot be said to be an "Asian flu" that has resulted from Asian ways of working or because the Asian miracle cannot really be sustained. I think the present process of adjustment will have to come sooner or later, considering the processes of economic change that have gone on throughout the whole world. Earlier, economies in Asia were able to reap the benefits of high growth, cheap labor, breaking into new territories, less competition. Now is a time for adjustments. Sooner or later, with or without any of the attacks on our currencies, Asian economies are bound to change and make adjustments. So, I wouldn't say that this is something very much different from any normal economic cyclical movement.

Secondly, while blaming some of the these things on governments throughout Asia, I don't think we can exaggerate or over emphasize the limited power of governments. We all have to realize that the process of liberalization willy-nilly results in lessened autonomy in the determination of government actions and policies. It makes government intervention and government policies probably less potent, less effective. That is a fact that we have to realize. Even as governments may know about on-coming changes, many times they are left rather, I wouldn't say inefficient, but somewhat helpless, in directing changes in flows of trade and financial flows.

Number three, this is a time for us to realize that markets really do dictate the terms and conditions of economic changes and markets can really force changes these days, particularly in the globalized market. The power of the market is much more than we realize, or most governments realize. There still are governments in Asia, probably, that continue to believe that they can withstand the force of markets. I think the sooner we realize that markets are all powerful these days, and take note of information coming from markets, the earlier we can try to make consequential changes. Ultimately, one will be forced to go through the changes and if one does not make the right kind of changes at the right time, then the scale of the changes would escalate to disastrous proportions.

Number four, experiences such as we are going through at the moment have been witnessed before in various parts of the world. The United States went through the savings and loan associations trauma, towards the end of the 1980s and beginning of the 1990s. Northern European nations, such as Sweden and Finland, went through periods of financial reform. Even England has relied on the International Monetary Fund. So, there is nothing wrong or unique about the kind of process that we in Asia are going through at the moment. And, if you look at how western economies have come out of crises, and have come out of the IMF programs—in spite of all the pros and cons about IMF programs we hear discussed today—we see that this is not the end of the world. All of these economies have come out of their crises and again pursued normal paths of economic growth. Also, currencies do come out of crisis. They probably will not return to the old strength, but will regain balance somewhere, not necessarily at the depth of the depreciation.

The Current Crisis and the Global Economy

I would next like to discuss the meaning of the present crisis to East Asia and to the global economy, as this was assigned to me as a topic. Here, I have seven points.

Number one, of course growth will be affected. For the first time in recent history, growth in Asia may fall below the level of growth in the United States or in Europe. But one cannot avoid drawing the conclusion that if Asia is affected severely and reaches the brink of a recession, then the rest of the world will not remain unaffected. We should not forget the fact that at least 50% of the new growth in international trade is derived from Asian trade. We should not forget that a growing proportion of U.S. and European trade—export-import trade—is associated with Asian nations. A prolonged period of economic slowdown or a recession for Asia would surely jeopardize the rest of the world. I have been informed by various analysts that, for example, U.S. growth for 1998 may have to come down from close to 4% for 1997, perhaps to 2½% to 2%. Major sectors in the advanced economies in the west, like energy, infrastructure, tourism, the aircraft industry, the defense industry, all these will surely be effected. From day to day you'll be hearing that various Asian countries will suspend energy programs, suspend their infrastructure programs. We'll have to buy fewer aircraft, and we may ask to delay delivery for those we have already ordered. Defense expenditures have gone under the ax many times, and will again go under the ax, and that will effect the western economy.

Secondly, I wouldn't say that financial institutions from the west should be blamed, but they have been part of the process that created opportunities for us in Asia to borrow. Those institutions stand to be negatively affected because they will have to look after their clients in Asia. They may have to reduce their exposure, or to write down some of the bad loans, or try to work out some solution for these loans. Over-borrowing to my mind is the other side of the same coin as over-lending and I would say that our friends from financial institutions in the west have been rather inventive in creating different borrowing instruments for us. And, of course, we all jumped in. I wouldn't want to blame any particular institutions or markets, but I think we are all in it together.

Number three, investment results will also be affected, particularly for European nations, which have become larger and larger investors in Asia. Some companies and major multinationals from Europe have been earning half of their profits from Asia. Investment results will be affected. Some banks have already announced that because of the Asian crisis their profits will drop something like 10% to 20% in 1998.

Number four, trade liberalization may be jeopardized, but this is not because we want to slow down trade liberalization. I think most Asian governments still adhere to our original commitments to trade liberalization. Being confronted with growing rates of unemployment and bankruptcies, I think priorities lie more with the need to address social problems than with the expediting of trade liberalization. But, we in Asia have announced our commitment. As a representative of the Thai government, I would still maintain that we would try our best to remain committed. But pressure is growing on us from day to day to delay trade liberalization, to provide more protection somewhere, so that some respite, a period for recovery, will be given to our domestic industries. I'm not saying that we are going to yield to that kind of pressure, but the pressure is growing. In the case of my own country, I think we have been rather successful in trying to resist this pressure, and have gone forward on the path of liberalization, not only on the trade side, but also on the investment side, as we have committed ourselves in the past.

Number five, I want to make sure we understand that this is not a normal economic crisis or management crisis, per se, but that this is mainly a financial crisis, out of which we cannot emerge without fully addressing the reform of the financial system, the reform of prudential supervision, and the reform of our central banking activities: I wouldn't say the reform of our central bank, but the reform of some central banking activities. This will be a rather drastic reform and will take a lot of time. So, the on-going crisis is mostly related to the lack of liquidity, the net outflow of funds, the need to consolidate financial institutions, the need to change management, to re-capitalize financial institutions. This will have to be done and these reforms cannot be done in a short period of time. You all know that banks will have to be strengthened. Non-bank financial institutions will also have to be re-capitalized or merged, and that will take a couple of months. In our case in Thailand, we have to complete some major re-capitalization of our major banks within the first quarter of this year, but it will take a longer period of time to strengthen the whole management system.

Number six, the disease has spread throughout Asia. We must be able to stop the contagion. I don't think the rest of the world can sit back and relax and allow the contagion of this disease to go on and on, ending with rounds and rounds of competitive devaluation which will do no one any good. So, this must be stopped somewhere. China must be protected—I don't know whether that is the right word or not—from the need to enter in the devaluation tournament that we have been in.

My strategy would be that the contagion must be contained somewhere, and the origin of the disease, which unfortunately is Thailand, is a good place to stop the disease. Because we entered into the crisis first, we have already made many corrective efforts, beginning during the former government. We therefore stand to come out of the crisis earlier, should more effort be put into this rehabilitation program.

Lastly, effects on the world government bond market cannot be ignored. Japan is the number one holder of U.S. treasury bonds; China is the second largest. I don't think they will both withdraw from the U.S. government bond market; there is no threat for them to withdraw. If there should be any need for more liquidity, which has been sucked away from the East into the West, then some effects might be felt in the U.S. bond market. So that also will have to be prevented.

Going Forward

Finally, here are my suggestions. Firstly, I think most of us agree that exchange rate corrections have gone too far, and I would definitely say they have gone beyond the rightful corrective scale. The correction has overshot. Everyone in the world knows this, but because of the lack of confidence, and because of the easily spread panic, we understand that the present overshooting will not go away easily. So, I have suggested time and again a G-7 meeting to address the Asian financial crisis. Today's news suggested that Britain may be in agreement with the U.S. to call this meeting. I think that is much needed. As much as we needed the Plaza Accord to renew the strength of the Japanese yen and create more growth for the world economy, I would say we will need a "reverse" Plaza Accord, this time to confirm the strength of the Japanese ¥en. The Japanese ¥en today, I would say, is rather undervalued and the U.S. dollar may not be overvalued, but is definitely on the strong side. It would cost the United States probably nothing if the dollar were allowed to become less strong and the ¥en to find a stable position which should be somewhat stronger. It would also be helpful if the existing mechanisms of the World Bank, the Asian Development Bank, IMF, export import bank, or any funding arrangement, could be used to recycle some of the foreign exchange liquidity that has been absorbed away and cannot be put elsewhere without the effects on your monetary aggregates.

Number two, I think we should all adopt the Manila framework that was agreed upon a few months ago when the deputies of the financial authorities met. The Manila framework is important because it emphasized the fact that all Asian governments must be reminded that financial reform should be pursued with no delay. At the same time, however, we should conceive of some mechanism that would provide additional surveillance, apart from the IMF. This would be in the form of regional surveillance, or what we now fashionably call "peer" surveillance. A forum of meetings among economic ministers of Asian nations would be used to exchange views, learn from one another's mistakes, and learn what alignment or coordination policies will be needed in the future. We have to conceive of some sort of mechanism to function as an early warning system, a task that I would rather leave in the hands of academics like yourselves. We need this because the warning system through the IMF that we have been using has worked sometimes, but not always. Of course the IMF has issued some warning signals, but admittedly they were not very strong. And coming from the IMF, in Asia because we have our reservation, we do not always accept this kind of warning easily. Within this context, I would like to recommend that we move, for our own economic cooperation, more in the direction of an Organization for Economic Cooperation and Development type of economic cooperation rather than a trade negotiating forum, particularly with regard to Asia-Pacific Economic Cooperation forum activities. I am sure that APEC can continue to pursue trade liberalization as we have done in the past, but I wish that APEC could concentrate more on OECD type activities, analyzing macroeconomic policy and so on.

In Conclusion

I think if one looks at the fundamental economic figures for Thailand these days, there are some positive signs. I would not claim that this is to the credit of the present government, but I would say that it's probably partly and mainly the result of the substantial devaluation of our currency that we have gone through in the past couple of months. We are beginning to see the signs of a healthy current account and I would like to repeat this message in case hedge fund people have not noticed the figures. We have had four consecutive months of current account surpluses in the last four months of 1997, altogether totaling something like $2.4 billion U.S. This is not much, but it is a turn for the better and it is something that we have not seen in the recent history of Thai economic conditions. Given orders that have been placed for Thai products, January will also show a surplus. That will be the fifth consecutive month of current account surplus. Because the surplus has been created by the slow down in import demand, and not purely because of export expansion, it is not really the most desirable picture for the Thai economy, but it is a turn for the better. It is still better than having four or five consecutive months of current account deficit.

So I would say that for 1999 there should be no bleeding of foreign exchange from Thailand though the trade and services account. Problems will remain mainly and only on the financial account. There are definite signs that headquarters of more international firms are moving to Thailand. Of course the cost of living is rising in other countries, while our relative cost is coming down more rapidly than others in the region because of the devaluation.

Thailand has sustained baht depreciation of around 110%, but inflation is kept under 10%. The month to month figure now amounts to something like 7.7%. Now if you look to the case of Hong Kong, which has not devalued at all, and has an inflation rate posted at around 6%, then you would say that Thailand's performance on inflation is rather satisfactory. I was told that in the Mexican case inflation went above 50%. So that is another positive point for our economy.

We have been complaining a lot about interest rates in Thailand in the last couple of months. And in the last few days, after having done a lot of soul searching among ourselves and with the responsible authorities, we have arrived at the conclusion that the IMF prescription of interest rates from 15% to 20% should be adhered to. But in our case, we have gone beyond that. To go over that level for overnight rates, for short term periods, should be all right. But our overnight rate has become, I would say, an "over month" rate, because for months now rates have gone beyond 20%. It is not really overnight, it is the over month rate that has peaked at around 25%. The last few days saw a slight drop to the level of 22%. There was no political intervention in this. Instead of keeping the rate high, the market mechanism was allowed to operate more than in the past to let the interest rate come down a little bit. I emphasize that we accept the guideline of a 15% to 20% range as prescribed by the IMF. We can expect more export financing forthcoming from the ADB, I think $1 billion (U.S.). This is not a part of the $17.2 billion (U.S.) stand-by arrangement, but is an additional $1 billion (U.S.) for export financing. Japan's export-import bank also is offering us some loans to finance our export sector. This would be rather helpful because I project, and I set the goal for, Thai exports this year to be at the level of $62 billion (U.S.). Financing for roughly 20% of this total figure will have to be found somewhere, and I don't think that opportunities within our own financial system will be adequate. So the task is now for us to find supplementary financing from abroad.

And, finally, in the last couple of days the IMF chairman has issued statements pointing in the direction, I would say, of the IMF understanding the situation. The IMF would also like to be more flexible in the arrangements that they have made with countries like Thailand. I think this is really a positive sign and, coming from the IMF itself, it shows that the IMF program review is a good thing. We talked only about *review*, but when the press reports this, it always abuses the word and wrongly turns review into re-negotiate. Just as a parting remark, Thailand never, never, had it in our mind to re-negotiate any conditions. We have agreed with the IMF people that we will be in close consultation at all times, and a second review will be forthcoming in the month of February. This review is a normal process and through the review we hope that, with the IMF being more flexible in the arrangement, we will have a new letter of intent tailored to the present economic conditions in Thailand and the current needs of the Thai economy.

I wish all of you success in your deliberations during this important conference and would like to take this opportunity to offer my appreciation for your invitation to me to contribute a small part. I look forward to reading your reports and your recommendations, which we may put to use to solve our economic crisis. Thank you very much again.

Thomas R. Saving, Professor, Texas A&M University, *Moderator*: Let me introduce our panelists today, in the order in which they will speak. First, Professor Steven Cheung, who is the head of the School of Economics and Finance at the University of Hong Kong. Next is Masahiro Kawai, who is Professor at the University of Tokyo, Dr. Ammar Siamwalla, who is a Distinguished Scholar and former President of the Thailand Development Research Institute, followed by Anwar Nasution, who is Dean of the University of Indonesia in Jakarta, and finally Dr. John Tatom, who is Vice President of the Union Bank of Switzerland, now a subsidiary of Swiss Bank.

We will have each panelist speak for 10 or 12 minutes to give us a view of either what they believe the current crisis to be, or what we might be going to do about it. I am not sure what the panelists are going to do, but I think that they are going to address the background of the crisis, and the "foreground" in the sense of what's going to happen in the future.

The only thing I want to say at the beginning is that I am struck, being really a monetary economist, not an international economist, by the similarity between the things that we used to talk about in monetary economics—runs on banks and so on—and what is happening here. For everyone here who is interested in this phenomenon, it would be useful to read the book, *On Lombard Street*, by Walter Bagehot, editor of the *Economist* and a noted observer and critic of Bank of England's policy in the 19th century. There you see Bagehot really discussing runs on currencies, and it's exactly the same kind of thing except that then it was at a domestic level. There is nothing really any different about it. We'll proceed now, with Professor Cheung.

Steven N.S. Cheung, Head of the School of Economics and Finance, University of Hong Kong: The monetary crisis in East Asia is serious, more serious than most people think (or would like to think). I myself am in a sense involved, because I played some part when Hong Kong adopted a currency board back in 1983. I have also closely followed China's economic development and reform for nearly 20 years.

I must begin by telling the audience some bad news. This is that the situation in Thailand or Indonesia or South Korea will not be corrected in a few months' time. It is not even going to be all over in a year's time, or even in two years' time. Unless some very dramatic, bold and lucky action is taken, the current crisis, in my view, is going to drag on for years. Think of Mexico in 1994, when the peso collapsed and the economy ground to a halt. Even today, the country is not close to recovery. There was a long period of adjustment in inflation, unemployment, and the like, with no durable signs of recovery. It takes a long time.

So this is a bad situation in East Asia. What kind of options do we have now, in the present crisis? I saw on the news last night that the IMF is going to sign a tentative agreement with Indonesia to lend it an enormous amount of money, force the country to carry out economic reforms, and so on. I do not believe there is a quick fix there. When an entire country is practically falling into bankruptcy, when it is led by a decadent government, it is just not that easy. Reform is something that cannot be forced.

When the currency of a country collapses into a black hole, it suggests there is something to do with government officials manipulating the foreign exchange market. People in the know would find it possible to make a killing. With a computerized trading system, one can pick up a telephone and short or long a currency in amounts of millions of U.S. dollars. It takes about thirty seconds. This can happen even in the case of the Korean won, for example, where the currency has no delivery outside of Korea. You cannot go to a bank in Hong Kong to buy any substantial amount of won and expect delivery just like that, because one has to go through some kind of government agency inside Korea. And yet, in the foreign exchange market, betting on contracts—even on a currency to which there is no direct access at all—can cause the Korean won to drop 25% in a few hours' time. In a situation like this the remedy is not going to be some quick fix, or piecemeal reform, or the IMF, or borrowing money from this place and from that place.

Some very basic structural change is required, all the way through to the government.

The situation is not, I believe, the kind of thing external institutions like the IMF or the World Bank can relieve. You really need internal structural reform. Even if a new currency is introduced, it would still be years before problems in the financial sector are worked out.

What other options are there? One is a currency board, but for a collapsed economy I am skeptical a currency board will help *now*. A currency board is essentially based on an outside standard that backs a country's base money. The backing may consist of a basket of hard currencies, or a single hard currency like the U.S. dollar. Through contraction/expansion of base money, you have an automatic mechanism which adjusts the domestic money supply to support the exchange rate. In a situation where there is a confidence crisis, however, a currency board is not going to perform this magic adjustment *tout court*—especially where there is a central bank, because the two are basically incompatible institutions. The classic currency board is supposed to work without a central bank. I have been quarreling with the Hong Kong Monetary Authority (we are very good friends), because as far as I can see what Hong Kong has now is an unhappy mixture of currency board and central banking. Other East Asian countries are thinking of introducing currency boards, but I don't think any of them would be prepared to give up its central bank. Interest rates in Hong Kong are very high and sharply fluctuating, and the economy is hard put to it to adjust, because its currency board has been behaving too much like a central bank. The deterioration in Hong Kong's economy the past three months has been faster and steeper than at any other period of the same length in my memory. If a "clean" economy like Hong Kong is suffering so much pain running a currency board, a decadent economy is not likely to stand too good a chance.

Deputy Prime Minister Panitchpakdi (of Thailand) just gave a very honest and candid speech. However, I was disturbed by the fact that he is so encouraged by the current account improvement. Among other things, it could just be because capital inflows have stopped. If you have a positive trade account, that has to be balanced by a negative capital account. So looking at the balance of trade alone isn't going to give you any great comfort, or a great deal of information.

The longer I live the more I appreciate the genius of Milton Friedman, who recognized the importance of sound money at an early date. Thirty years ago in Chicago, he talked about money, money, money all the time. We thought he was overdoing it. Now I am convinced, with the history of the last 10 years, including Mexico's collapse and China's experience in strengthening the RMB, that Milton is right. But I told Milton that fiat money would be well-supported only if you have somebody like Alan Greenspan looking after it. Asia's fiat money system is in disarray. My point is this: if you have corrupt officials at the top, or if you have officials possessing inside information who are willing and able to make a quick buck in the foreign exchange market, fiat money would not work well for long. The RMB is a fiat money, and it has done remarkably well these past few years. I believe one of the main reasons is that top officials in China are clean.

I think there is only one way out for collapsed economies in East Asia. Adopt a fully-backed currency. It may not be possible to return to the old gold standard, because the free supply of gold may not be enough. They should try to use a basket of commodities, any futures-traded basket of commodities which includes sound outside currencies. You're free to define your basket; sound currencies, or sound futures-traded commodities, including gold and silver if you like, should be in there. Go to full-backing. This is the only way out that I can identify. Friedman, who is mainly in favor of fiat money, observed that it is going to cost a bit more, maybe half of 1% more, to bring in a fully-backed currency. Many other reputable economists are also in favour of full-backing. It is more costly, but you are talking about half of 1% maybe 1%. That is really a low cost to pay, compared to the situation in East Asia right now.

Audience Question: How do you find the money for backing?

Response, **Cheung**: The backing doesn't really have to all be in liquid assets. It can be done with all kinds of commodities. This is a technical question that a group of us are discussing. Strictly speaking, you can actually do it with U.S. bonds, use the bonds to back up the currency. You can do it that way or with any future traded commodity.

Saving: So what you are suggesting is something like Bagehot's idea of flooding this crisis with liquidity, and the liquidity in this case is U.S. bonds?

Cheung: Yes.

Saving: Thank you Steve. Now we have to let him run for the airport. He has a plane to catch. Our next speaker is Dr. Masahiro Kawai.

Dr. Masahiro Kawai, Professor, University of Tokyo: Now, what I would like to do is explain the causes of the East Asian currency crisis, discuss some of the characteristics we can observe, and draw some lessons. I have to do it in about 10 minutes, so I will be breathless, but I will try.

We have been talking about regional contagion. There have been very remarkable movements of the exchange rates of the East Asian countries and of stock prices. Thailand devalued its exchange rate on July 2nd, then the Philippines, Malaysia, and Indonesia followed the depreciation path. The Hong Kong stock market reacted, and this reached to New York, to the global market, and then Korea was hit. Korea saw its currency (the won) start depreciating in late October. In November and December things got really bad. Korea abandoned its stable exchange rate regime and moved to a flexible exchange rate regime on December 16th (1997).

Now we know that the fundamental cause of this recent crisis should be found in the financial system. Thailand, Indonesia, and Korea, all of these countries had weak financial institutions. In the case of Thailand, many finance companies and some small commercial banks had problems. In Indonesia, there are too many weak commercial banks. In Korea, merchant banks and commercial banks were troubled. Another point that I want to mention is that Japan, where I am from, is the biggest economic presence in East Asia, and we have also had financial system problems. Japan is a very weak lender of last resort in East Asia and that has really been a problem.

Now I want to talk briefly about four factors in the present East Asian currency and financial crisis. The first is the deterioration of external account performance. The second is the excessive inflows and rapid outflows of capital, in particular short term capital. The third factor is the financial system fragility. The fourth is the surprising speed and scope of the contagion. This contagion really played an important role in the cases of Indonesia and Korea. Now I will elaborate a bit on these four factors.

Many of these economies saw rapid declines in exports in 1996. Current account deficits were also sustained at high levels, relative to GDP, in 1996. We want to remember that the current account deficits in these countries were generated basically by private sector investment. There was excessive domestic investment over savings, rather then a government sector budget deficit. This is a very important point we want to remember.

Excessive inflows of short term capital, followed by rapid outflows of short term capital in many of these economies, in particular Thailand, Indonesia, and Korea, were generated by high domestic interest rates and also by private investors' belief that exchange rates would be stable. Now of course this belief turned out to be wrong, but the point is that the exchange rate system has something to do with massive inflows of capital. And then, the financial system fragility was revealed. People lost confidence in the financial system. There was a curtailment of inflows, and net outflows of capital started. Financial system fragility has therefore been an underlying cause of this currency crisis.

In the case of Thailand and also in the case of Korea, financial institutions absorbed large foreign capital inflows, which were directed to the domestic private sector, and which sustained high private sector investment. Some of this capital went into the non-tradable sectors, including real estate and construction, and to consumer spending. Many of these were unproductive sectors of the economy in terms of building up productive capital stock.

Now I want to briefly touch on the IMF packages. The IMF came in to Thailand, Indonesia, and Korea. They prescribed standard contractionary macroeconomic adjustment policies—monetary and fiscal policy. The IMF required tight fiscal policy in all these countries, despite the fact that the major underlying causes for the current account deficits did not lie in the government sector. The IMF also required financial system restructuring. In Thailand, the IMF de facto required liquidation of 56 finance companies out of a total of 91. In

Indonesia, the IMF required the liquidation of 16 commercial banks. In the case of Korea, the IMF required the liquidation of 14 merchant banks out of a total of 30. So the financial system restructuring is now underway, but this has a tremendous contractionary impact on the economy.

The IMF also, in my view, entered a non-traditional area in terms of structural reform. In the case of Indonesia, the issue of general economic governance was taken up. In the case of Korea, it is the issue of business groupings. The IMF has become engaged with the very deep roots of economic problems in these countries. One interesting observation regarding this is that regional financial cooperation has been emerging. In the case of Thailand and Indonesia, the neighboring countries have decided to make financial contributions in addition to those of the IMF, World Bank, and ADB. In the case of Korea, developing East Asian countries did not contribute much, but industrialized OECD countries have decided to provide financial rescue money. So, this regional financial cooperation framework has been emerging, That is a very interesting aspect.

I want to draw three lessons from what we have observed. The first lesson is that proper sequencing of capital account liberalization is really needed. When a country opens up its capital market to the rest of the world, sequencing matters. You have to go through current account liberalization and domestic financial liberalization. In addition to that, before opening up to the international capital market we need a good, sound financial system. Financial institutions must have the ability to assess the risk of their own operations; asset liability management has to be very sound. Also, a system of adequate supervision and prudential regulation has to be there. Otherwise, we will again face financial and currency crises.

The second lesson is that we may want to have a better framework for exchange rate adjustments. One view may be a currency board or commodity-based system, but I go in the opposite direction. In the case of Thailand, and also in the case of Korea, they have adopted policies of stabilizing exchange rates vis-à-vis the U.S. dollar. Global investors put too much money in these economies, and in the process currencies got over valued on a real and effective basis. The renminbi (currency) of China was devalued in 1994; the Japanese ¥en started to depreciate at a very fast pace in mid 1995. These events put tremendous stress on the international price competitiveness of Thailand and Korea. My suggestion is that they may not want to have a completely flexible exchange rate system, in particular for the ASEAN countries. ASEAN countries are expected to complete a free trade agreement by the year 2003 and they may not want to see very volatile exchange rates within the ASEAN countries. My suggestion would be to adopt a loose currency basket system for the ASEAN countries. The U.S. dollar, the Japanese ¥en, and the Euro (which will be introduced in the beginning of 1999) would reflect underlying trade patterns and also foreign direct investment patterns. This would be a loose currency basket system and ASEAN currencies would not fluctuate too much.

My final comment is about the role of the International Monetary Fund. My feeling is that in the area of macroeconomic prescription the IMF suggestions about fiscal policy are too much. The government sector was not the source of the problem, but in order to protect the currency, the government should not run large current account budget deficits. So it is important to maintain fiscal discipline. The current prescriptions given by the International Monetary Fund, however, are too contractionary.

Saving: Our next speaker is going to present the perspective from Indonesia.

Anwar Nasution, Dean, University of Indonesia, Jakarta: Well the way I see it, Indonesia is now suffering from a twin crisis, a currency crisis and a banking crisis. At the same time we are facing political uncertainty related to the succession of our leader. We have also unfortunately experienced long droughts and forest fires since last year.

Let me start with macroeconomic policies. Here we have very weak fundamentals in exchange rate management. In the past, the main exchange rate policy was to improve our external competitiveness, meaning that we had active management of the exchange rate to increase the real effective exchange rate. Because of the capital surges starting at the beginning of this decade, this policy was changed. The authorities allowed rupiah appreciation to help reduce both inflation and the domestic interest rate. Then we have a widening current account deficit, and finance the deficit now mainly with short term capital flows. In the past the deficit was financed mainly by foreign direct investment (FDI) and borrowing from official sources. But now the role of FDI is increasing dramatically. A related issue is, then, how to finance, how to use the money. In Thailand, the money was used more for sectors that have low productivity. In the case of Indonesia, it was used to finance an ambitious aircraft project, and for a national car industry in Korea.

Now let me concentrate on another issue: the banking crisis. In terms of total assets and number of offices, the banking system is the core of the financial sector in Indonesia, so I will concentrate on the banking system. Here the first issue you see is that banking reform has caused excessive credit expansion by the banking system and new entrants in a more competitive market environment. This may well increase the pressure on banks to engage in riskier activities. Yet, bank officers with experience only in the earlier controlled environment may not have the expertise needed to evaluate new sources of credit and market risk. Lifting restrictions on lending also immediately expanded credit to land-based industries and excessive infrastructure projects mainly owned by politically well connected groups. The herd behavior of foreign investors also played a role in increasing capital inflow to Indonesia. They did buy stocks, commercial paper, and even real estate, and invested in infrastructure projects. Peregrine, the Hong Kong based financial company, collapsed last week due to a single massive bad loan to a taxi company in Jakarta.

The related issue in the banking system is that a combination of a liberal capital account, financial sector reform, and advances in technology and information processing have made it easier for Indonesians to alter the currency composition of their deposits. The ratio of float money to GDP increased rapidly during the past six years. This indicates that an increase in financial deepening was induced partly by sound financial policies, including exchange rate management, stable macroeconomic policy, and high rates of growth. When domestic interest rates are high there is a strong temptation for the banking system and banking customers to denominate debt in foreign currency. Banks turn to short-term foreign currency, denominate borrowing in the interbank market, and fund longer term bank loans in rupiah. Then you see an increase in the profile of external debt, in Indonesia for example.

The third issue relating to banking is the weak financial position of banks and some highly concentrated problem areas. Liberalization of the banking industry will surely produce long term benefits for a country like Indonesia. In the short run, however, deregulation inevitably presents banks with new risks which, without proper caution, have led to the current banking crisis. Despite relatively high economic growth of 6% plus per annum in the past six years, the problem of bad loans in the national banks appears not to have diminished significantly.

Another issue is heavy government involvement in the selection of credit customers. Despite privatization, the six state owned banks in Indonesia still retain about 30% of the country's bank assets. For decades the loan decisions of state owned banks have been subject to explicit or implicit government direction. All too often, the credit worthiness of borrowers does not receive sufficient weight in credit decisions, with the result that state bank loans are vehicles for extending government assistance to particular industries and a handful of politically well connected business groups.

The final issue is bad governments. Along with market liberalization, financial sector reform adopted more restrictive capital adequacy and asset quality rules to regulate and supervise banks. Indonesia also adopted a set of rules and regulations on legal lending limits to limit loans extended to bank insiders. The implementation of these prudential rules and regulations, however, is still very weak. You need good accountants, consultants, and lawyers. We are still lacking qualified bank supervisors and examiners. Also, in a political system like Indonesia's you can expect there to be principal agent problems. The agent is not necessarily operating in the interest of principals. How can you trust the banks if the minister owns the banks, for example?

You also see structural weaknesses in the legal and accounting systems. Most private banks belong to a group of companies that we call conglomerates in Indonesia. Banks do not get tough with affiliated companies as they can expect assistance from the central bank. And of course when property rights are hard to en-force, attaching collateral is a costly and time consuming process. The effectiveness of collateral in solving the adverse selection and moral hazard problems is therefore reduced in a country like Indonesia.

Indonesia is now under the IMF arrangement, which has two components, a broad outline of monetary policy targets, and an outline of economic reform measures covering trade, industry, and banking. The banking policy reform includes, like in Thailand, suspension of operating licenses of 16 commercial banks announced in November. In my view, even if the IMF was not insisting on closing the distressed banks as a condition for the aid, they were dying anyway, simply because they have lost a lot of money.

What is the future? I think in Indonesia our fundamentals are strong. If we can accomplish institutional reform to eliminate distortion in the economy and then improve the transparency of the information system, I think we gradually recover. We get back on our feet. This, of course, means structural reform in Indonesia, including in my view restructuring of the corporate sector, of conglomerates. I think Thailand also needs this kind of reform. And then we must also reduce high leverage financing which is widespread in Asia.

Saving: Our next speaker is Ammar Siamwalla.

Ammar Siamwalla, Distinguished Scholar and former President, Thailand Development Research Institute, Bangkok: I hope you will forgive me if I provide a little autobiography for the benefit of some of our foreign colleagues. I have worked most of my life as a microeconomist; I'm a microeconomist by inclination and I'm a macroeconomist totally out of irritation. I've been a real sector economist and I have never bothered to look at the unreal, or monetary, sector. But in any case, I do not think that it is appropriate for me to go into the gory details of how we got into the current mess. Instead, I would like to try on you a little thought experiment that I have concocted, and that I found helpful in conceptualizing how we get out of this mess.

Imagine that you wake up tomorrow in "amazing" Thailand[1] where all of the balance sheets have been sorted out and the current out-of-whack situation has been resolved. That is my main point. If you want to find the locus of the problem, look at all of the balance sheets and you will see that they are now all out-of-whack. We have real capital sitting out there. We have real products. We have one of the finest petrochemical plants in the world. (We never had comparative advantage in it, but we now have it.) We can out-compete anybody as long as the value of that real capital is written down. It is only ink on paper. All you have to do is figure out how to get the value written down.

So, if you can, imagine that the balance sheet is sorted out. But, what is meant by this? Here we come to some of the issues. How does one re-value all of these assets? What assumptions does one have to make to value those assets correctly?

Assume a constant rate of inflation from tomorrow onwards, in our amazing Thailand. (You can throw in inflation if you like and then make additional adjustments.) For all of our assets, we now have to find a present value, so we have to make some assumptions about interest rates. Here I'm talking about present value in real baht, not in dollars. So, you have to find the value of all of these assets in real baht, in terms of present value, and assuming full employment of resources within the country.

In order to get there, we also have to make assumptions about the liability side, because we are owing a lot of money to a lot of foreigners in dollars. So we have to make assumptions about the dollar/baht exchange rate. What is the proper assumption? I think that in amazing Thailand, where you will find yourself tomorrow, some rule or some level of repayment will have been worked out for the huge amount of debt that we have. The balance of payments, the current account deficit, is not the real problem. The real problem is the stock of debt relative to the GNP or to the size of the economy. Even at the old exchange rate debt was on the order of 55% to 60% of GNP. At the new exchange rate I think that stock of debt is not sustainable. At 45 baht per dollar our stock of foreign debt was about 100% of GNP. We cannot generate a sufficient current account surplus to pay for the interest alone.

Now, if you go company by company, you will find that all of these companies will have

1. Thailand is running a tourism promotion for 1998 citing the wonders of "amazing Thailand."

very major repayment problems. Already at 45 or 46 baht to the dollar, the largest names in our industry are basically insolvent. This 100 billion dollars of debt; if you repay it in three years flat, that is over 30 billion dollars per year. That will give us a particular time profile of the exchange rate in the next three years, as what the exchange rate will be is dependent largely on the pattern or time profile of our repayment. When all of this is said and done, there would have to be a lot of shuffling around of assets. In other words, the names on the top of the balance sheet will have changed because the company will have to be sold. Part of it has to be written down. All kinds of swapping of assets will have to take place. In order to encourage writing down of the value, I imagine a gigantic fire sale of assets at which foreigners will be present, and all of these things will be written down.

I have sketched out the kind of situation where we will have to end up if we are going to proceed along a full employment path from then on. To get from here to there is the crux of the problem. I have mentioned the importance of the time profile of a repayment schedule for this stock of private sector foreign debt.

One more thing, a very important thing, is the financial sector. Among the balance sheets will be the balance sheets of the new financial sector. Currently, as you know, a lot of our financial sectors are insolvent. That means that essentially the value of one baht deposited in our bank is not one baht anymore. It is somewhat less, the true value. But in the new amazing Thailand all of that has been sorted out. That also has implications because in the sorting out, the government is already committed to bailing most of these companies out. That means that there is a liability from the taxpayers' point of view. So the taxpayers' liabilities will have to be factored in, in terms of our future income flow, which determines the sales possibilities of all of these companies. In other words, that adjustment will have to take place and be reflected also in the new balance sheet.

All right, to get from here to there, how does one do that? The main problem I find is that our asset prices are rather rigid. There are two asset prices that are not at all rigid, the exchange rate and the prices of stocks. The rest, including the value of your baht deposit in the bank, is very rigid. If everything else in the system is rigid and does not give, as Dornbusch has shown, the prices that are flexible end up taking the brunt. And that is one of the reasons why our exchange rate is so out-of-whack, even allowing for the need to export capital in order to repay the debt in the very short term. That's one point.

I'll sum up quickly. The second aspect of rigidity is our legal system. It is very costly and very time consuming to foreclose. We have been paying a lot of attention in this country to the bankruptcy law, but not many people have paid attention to the foreclosure law. A lot of assets are tied up in commercial banks. Commercial banks in Thailand are basically pawn shops. They take a lot of land as collateral and lend on the basis of that. The banks are stuck with a lot of land, and land prices haven't come down because banks are finding it very difficult to foreclose. So this is another policy aspect that follows from this thought experiment, you have to allow for very quick adjustments, very quick fire sales.

A third barrier is our nationalism; we do not like to see our banks in the hands of foreigners. In my view as a consumer, our banking industry should have been foreign a long time ago. Our commercial banks are basically fat cats that do not provide good services and have too much monopoly power. We need to adjust a lot of our asset markets. Concentrating on our foreign exchange and stock assets alone will not do the job.

Saving: Our last speaker is John Tatom from Switzerland.

John Tatom, Vice President, Union Bank of Switzerland: First, I should say that my views are not those necessarily of Union Bank of Switzerland, they are really my views as a macroeconomist. Since I am tied to the forecasting business, as unfortunate as that might be, I will try to provide some perspective on the relative size of the effects of the Asian currency crisis. Before I do that though, I think one major point hasn't been emphasized enough here today. What's going on here, what started this crisis, was an abandonment of an exchange rate regime. So we had some really abrupt regime shifts. This is the key to what has happened. We can debate what fundamentals might have led to abandonment of a regime, but that's the serious event.

Economists have spent a lot of time in recent years talking about regime shifts and how they affect the economy and expectations. In terms of event studies, if you want to look at risk, at what happens at different stages and at so called contagion, I think it is the exchange rate regime shift at every stage that gives you the biggest changes in observed asset prices, in the exchange rate, stock prices, bond prices, what have you. At each stage since last July the abandonment of an exchange rate arrangement in the various countries was pivotal. When Taiwan chose to float, for example, it had big impacts all over Asia and the world. Each attack on Hong Kong in turn created doubts about the Hong Kong peg holding, and had major impacts on asset prices in Hong Kong and elsewhere. This was, I think, because other economic policy regime shifts were threatened.

I think that governments made mistakes in abandoning their regimes and they did this at very high cost. We could argue about the relative cost of maintaining regimes or the cost they are going to face for abandoning their regime. I think the cost from abandoning regimes is going to be much higher. Maybe I shouldn't overstate governments making mistakes in these regime shifts, but my first point is that the people who make mistakes are the ones who tend to pay for it. There can be external effects on others, but in terms of the general economic effects, Thailand is going to bear the biggest loss. Thailand had flat GDP last year after being the fastest growing economy in the world for the previous decade. We expect that output will decline 3% in Thailand this year. Output growth is going to slow on the order of 8.8% from what we forecast before this crisis. Inflation is going to rise temporarily due to price level adjustments, and it will rise more in Thailand. We think inflation will be about 8% in 1998. It is going to be about three percentage points more than previously expected because of the exchange rate changes we have observed. In Indonesia, these effects are also quite large. We have reduced our estimates of Indonesia's 1998 growth by about six percentage points to 1.1%. And, inflation there will actually rise more. We have revised up our forecast by five percentage points on inflation. In other ASEAN countries, in the Philippines and Malaysia, the effects are smaller, but they are the same, smaller growth in output and higher inflation: on the order of 3% more inflation in the Philippines and about that much less growth than we had forecast before the Asian currency crisis, and about 2% loss in Malaysian growth and about 1% higher inflation in 1998 because of the currency problem.

As you move to other countries, if you have seen the IMF forecast or the OECD forecast, you know they show very large numbers for the impact of the Asian currency crisis. I would urge you to look at the forecasts themselves and the forecast changes, because what you find is that the forecast changes don't show much of an effect of the Asian currency crisis on the rest of the world. It's sizable in absolute numbers, but if you knock half a point off a growth rate that's not such a big number in a way. That's the problem; people throw out very large numbers. For the U.S., for example, I have seen numbers as high as a 1% slowing in output growth, and yet most people as recently as last June had forecast about the same growth for the U.S. in 1998 as they would today. There's really been not much of a markdown in the expected growth rate of the U.S. economy. In fact, I could tell you that the Union Bank of Switzerland forecast has actually gone up for the U.S. economy, from 2% to 2.7%. Two point seven is in the ballpark of what the Clinton administration, the OECD, the IMF, et cetera says. So, there really is not much of an impact.

On the other hand, you can estimate impacts by looking at trade effects and the size of the exchange rate changes and looking at trade patterns and then try to estimate current account effects and then effects on real GDP. You can come up with some numbers, but they are not as large as the OECD and IMF numbers. For the U.S., for example, doing that kind of exercise yields about a 0.4% reduction in growth for 1998. For Japan, it's much larger, about one percentage point. For the EU, it's about three tenths of a percentage point, and for all of the OECD, about four tenths of a percentage point. But, if you look at the OECD and IMF forecasts, they estimate much larger impacts. Now let me hasten to add that these are what I would call the *maximum* effects of the Asian currency crisis on GDP, because there are also asset price changes going on which will ameliorate some of these effects. In particular, there has been a large reduction in capital flows to Asia that's going to have, and has already had, large impacts on what you might think of as risk adjusted interest rates or, say, interest rates in the industrialized countries of the world. We have seen very large reductions in long term interest rates world wide since last June largely related to the big decline in capital flows to Asia. Those real interest rate reductions will have a positive impact on growth, off-setting these depressing effects on current accounts. So I think the effects aren't really very large. To get to the bottom line, the U.S. economy will slow in 1998, I think by anyone's forecast, but it is going to slow to a pretty healthy growth rate. So, I don't think too many people would think the U.S. should really stimulate the economy because of a collapse in aggregate demand there, and aggregate demand in the world is not really collapsing for that matter. For Japan, our estimate is that growth will be about 1% in 1998 and it was 1% in 1997. So, Japan's slowing is not really impeding the world expansion, but it is certainly not doing anything for it either. One percent is a fairly low number. I think many people would say that if somebody should stimulate their economy, it might be Japan.

On another point. Many economists now talk about world deflation, the possibility that in the industrial countries inflation will perhaps fall to negative levels. I think that this is really mis-stating the point. Again, as I have said, the people who make the mistakes will be the ones who pay for them. A corollary of that is that most of the price effects resulting from currency changes will occur in Asia, not in the rest of the world. It seems to me that most Asian countries are price takers in virtually all of the manufactured goods markets that they sell in. So to talk about excess capacity in computer production when Thailand is a very small part of the world market is really silly. There isn't excess capacity in most of these industries. There might be excess capacity in structures related to the cyclical problems they have, but it is hard to argue that they have excess capacity in traded goods sectors. With one exception, they are just too small. Thailand is a major exporter of high quality rice and the devaluation will have an impact on the world price of rice. We've seen this in the past when Thailand has devalued. Except for a few cases where they really are a major producer, most Asian countries aren't price setters in international markets. Some other examples are in Mexico where we had a similar crisis and U.S. inflation went *up* after the Mexican crisis. U.S. growth also went up, it didn't slow.

I think the stock market crashes are another source of deflationary pressure in some people's views, but if you go back to the 1987 stock market crash, it was actually bigger than what we've seen lately, even in Hong Kong. There again you see that virtually all countries in the world had accelerated growth and had accelerated inflation in 1988 from 1987.

I could tell you the same story about emerging markets, but I'm running out of time, and they're not that big, so I won't. Latin America is going to slow down, but it is still going to grow pretty fast. Africa, the transforming economies of Eastern-Central Europe, the former CIS countries, all are expected to grow faster next year. So the risks of a global collapse are, I think, not that big.

There are risks though, and let me just list them quickly. The major risk created by the Asian crisis concerns Hong Kong and whether the peg will survive, and China, whether they devalue. I think the answer is that the peg survives and China keeps the exchange rate where it is. There is heightened bank risk in Japan, because Japanese banks are the major lenders in Asia, and so the financial risk to Japanese banks is great. There is also a risk, because of the decline in growth in Asia, of social unrest, in some countries more than others. A good point was made in Deputy Prime Minister Panitchpakdi's talk today, that there is a risk that people will use a bad situation as an excuse to close markets or to pursue inflationary policies. I think both low inflation and open markets were major sources of the Asian Miracle. To use the current and expected slowing as a reason to restrict markets, particularly access to financial markets, but even goods and services markets through outright protection, would be a serious mistake, and that's the major risk, I think, in Asia today.

There are a couple of implications that I'd like to at least mention. In 1996, at the ASEAN meetings there was discussion of organizing more formal swap arrangements and financial support arrangements among ASEAN members. That wasn't worked out very well, but I think that in the future, when things settle down, a movement towards that, and indeed perhaps toward a European monetary system arrangement, and maybe even down the line towards a regional currency, will be high on the list of policy makers in Asia. What would keep them from it are (sort of) weak regional institutions. But as regional institutions develop, and as countries have less suspicion and begin to work together more in Asia, I think that's going to become a more important possibility for currency support.

The last thing I want to mention is Steve Cheung's point that it's going to take a few years before this wears off. We think Thailand, for example, will only return to about a 1% growth rate in 1999. So they're still a long way from the 8.5% or 9% they used to have. But, looking ahead, it wasn't bad regulation, it wasn't strong financial markets or competitiveness in the financial sector, that gave us the Asian Miracle. The forces that did that are still here, and I think they will reassert themselves later, perhaps with stronger financial markets and perhaps with some comparative advantage, at least in some regional centers, in some financial services sectors. After the adjustment period I expect things to come back to normal.

Questions, Comments and Responses

Comment, **Saving**: Some people might refer to the state of Texas in the United States, where I live, as a separate country. Texas is, of course, in a fixed exchange rate regime with the other 49 states. In 1985, world oil prices plummeted and the federal government also changed tax treatment of real estate. This combination of events caused real estate and other assets in Texas to be severely overvalued, so a significant adjustment had to occur. We went from being a state with a very large "current account" deficit to a state with a "current account" surplus. Investment simply stopped flowing in. Now, we didn't find the current account surplus to be a good thing.

I'll just give you an idea of how long it took for the necessary asset revaluation to occur in Texas. As you know, we had a banking crisis at exactly the same time, for the same basic reasons. The asset revaluation took until the early 1990s, about five to seven years. All of this excess real estate, all of the buildings as I look around Bangkok, this what Houston looked like in 1986, a lot of cranes sitting around on buildings that weren't finished. Those buildings in Houston are all finished now, they're all filled, and Texas once again has a very large current account deficit. The point is, it's the real things that matter. Texas didn't have an exchange rate crisis because we didn't have an exchange rate, or we had a fixed exchange rate that we couldn't control.

I want to relate that I am in agreement with Ammar Siamwalla, it's the real factors that have to be dealt with. Luckily for us in Texas, the state government was effectively unable to do anything, and as a result the economy adjusted and recovered much faster than it would have if they had been able to intervene. Government would have tried to prevent us from having open borders, which would have delayed necessary—if painful—changes. What concerns me now is that individual countries in East Asia are capable of rescinding individual freedoms they have instituted, things that actually made for the Asian Miracle. I'm afraid that if the Asian countries can back off on liberalization and open market policies, then the real and fundamental reason why the miracle occurred will disappear and won't reoccur. Luckily for Texas, we didn't have that option, or we would still be where we were in 1986.

Now, each member of the panel will first have a chance to comment. Then I'll open the floor to questions or comments.

Comment, **Tatom:** I have, I think, two points. One is in reference to the statement that there's almost unanimity on the importance of open markets. That really struck me because I think that's true in this room perhaps and it's true outside of Asia. In contrast though, in Asia there's almost unanimity to find a way to reduce currency speculation and to stabilize exchange rate markets. In the financial industry it's often said that fixed exchange rates and open capital accounts are inconsistent. A lot of economists say this, a lot of my colleagues say it, and what they mean by that is that you have to float, you can't have open capital accounts and maintain fixed exchange rates. But I think this means something different to politicians. They think it means that you have to go back to closed capital accounts, to figure out some way to restrict capital flows to reduce exchange rate speculation. I think that the most serious threat facing Asia today in how they adjust to the situation is the potential of closing markets for financial assets. The threat of protectionism was pointed out earlier by Deputy Prime Minister Panitchpakdi.

One other point regarding currency boards: there was a question from the audience about where to get the money. The statement was made that Thailand is broke, but Thailand is not broke. Thailand has reserves of around $28 billion (U.S.). Even if you netted out forward contracts, they've got way more than enough reserves to support the monetary base and M1. Actually they could get very close to the old 25 baht to the dollar rate. Thailand was stronger than a currency board, they always had reserves that were a large multiple of the monetary base. The problem is that, unlike a currency board, they didn't have any legislative commitment to maintain a peg, so it was easier for them to break the peg. In the end, even a country with a currency board can change its rules. The problem is that you have to be willing to bear the cost of living up to the commitment, and that's what central banks are hardly ever willing to do. That's really the issue, whether or not you want to let interest rates go high enough to maintain the value of the currency and to ride out a speculative attack. That's what Bagehot was talking about. In the end, I think that the costs of maintaining the currency board are actually lower than the costs we're going to see in Asia, certainly in Thailand, of abandoning previous exchange rate regimes. Thailand was the only country with a peg that was known by investors, and they abandoned it, and Thailand will pay the highest price. (Malaysia had a peg to an unspecified basket, that's not really a peg.) That I think is the answer, Thailand could even now go to a currency board. It's an issue of whether they want to pay the cost of the commitment.

Comment, **Siamwalla**: It's a pity that Steve Cheung is not here. But since you raised the issue of the currency board, let me ask my naïve question. For a country like Hong Kong, which has a currency board with 100% support for its currency, what's the point of having a Hong Kong dollar? Why not just use U.S. dollars? Then there is no problem about maintaining a peg, and from the point of view of resource costs, you have to bring in U.S. dollars anyway. So just let the U.S. dollar circulate, close down the central bank, and have Hong Kong as a Texas. Have Thailand as a Texas. Just use the U.S. dollar. What's the point of having a currency?

Comment, **Kawai**: First, fixed exchange rates and open capital accounts are a difficult combination. What's really difficult is that if a country wants to pursue an independent monetary policy, then fixed exchange rates and open capital accounts are inconsistent with each other. In the case of Hong Kong, they have virtually given up the possibility of pursuing an independent monetary policy. That's why they have been able to maintain a fixed exchange rate. Now Hong Kong is a small open economy, so it may make sense to stick to a currency board system. Hong Kong has to take world prices as given, everything is exogenous. Now, Thailand may be still a small open economy, but the economy is growing. Many other East Asian economies are not that small. Also, as the process of economic development goes on and per capita income rises, economic democracy, so to speak, becomes important. Government wants to maintain stable rates of unemployment and economic growth, so they want to pursue somewhat independent monetary policy. Fixing exchange rates in a world of open capital accounts would be an impossible task.

In the face of the current financial crisis, some East Asian economies may be hesitant about further opening of their financial markets to the rest of the world. However, if you look at Thailand, Indonesia, and Korea, they are actually opening up the capital market, the financial market, because commercial banks and financial institutions need increased capitalization. They are actually encouraging foreign capital to come in and acquire equity in commercial banks and financial institutions. Korea also has relaxed its restrictions over stock market investment by foreign investors, increasing the maximum cap on foreign money to, I believe, 50%. They have gradually increased the cap. Thailand, Indonesia, and Korea lack foreign capital, so they are now very aggressive in opening up their capital markets.

I have a very strong view about the possible exchange rate arrangement in East Asia, particularly in the ASEAN region. There was discussion of the ASEAN countries eventually forming a monetary union, starting with a loose swap arrangement, a joint intervention arrangement, and maybe in 10 or 20 years there is a more closely coordinated monetary area. Given the diversity of their trade relationship with the rest of the world, the United States, Europe, and Japan, these countries simply cannot afford to stabilize their exchange rates against one particular currency. I am not suggesting that they should fix their exchange rates against a basket of currencies, but they should adopt a loose currency basket system where the bands of exchange rate fluctuations may be fairly large. ASEAN countries would adopt similar currency baskets so that intraregional exchange rate variations would not be that large.

Comment, **Nasution**: I have mixed feelings about the currency board. I think it not only implies a fixed exchange rate, but also it constrains the monetary base to operate like the gold standard. The money supply should be contracted under this board, but there is no possibility to sterilize the reserve outflow in order to preserve internal balance or the level of the domestic interest rate. Well, if you impose this on Thailand, which is a medium sized country, or on a large country like Indonesia, I think you have very severe domestic problems, a recession, you see? You have to see that the size of the country matters. In a country like Hong Kong, which is a small open economy, the percent of export and import of GDP is over 100%, maybe 200%. While in a country like Indonesia or Thailand, it is only 20% to 30%. So a big chunk of the GDP is from the non-traded goods sector, and there is an adjustment problem.

On the other hand, I see the importance of the currency board as an instrument to impose discipline, because by definition a currency board precludes the central bank from operating as a lender of last resort. In a country like Indonesia you see that first there is no deposit insurance, second there is abuse of financial support from the central bank, third there is a lot of corruption, malfeasance, and things like that. So maybe you need a currency board in the short run, but in the medium run you need to be flexible, and have to remove this currency board. Why should you effectively leave managing a country like Indonesia to the Federal Reserve Bank of the U.S. in Washington, D.C.? We need to have the discipline, but the currency board is not the only means to impose discipline. Whatever you do, you have to be flexible, more pragmatic.

Saving: Now, I know there are some questions, and what I'd like you to do is to state your name and affiliation and then you can ask a question of any member of the panel.

Comment, **David Western**, Curtin Business School, Perth, Australia: The China card has been on the news the last week, and concern over currency in Asia has been linked to the threat of China devaluing its currency. With Chinese wage rates being 20 and 30 cents (U.S.) per hour, and Korean manufacturing being at $7–8 an hour and so on, you can see why these countries must be concerned about the level of their real exchange rates compared to China, because the Chinese real exchange rate is very, very low. The China card hasn't been mentioned by the panel, but it relates directly to how far other currencies might fall.

Response, **Tatom**: I said I didn't think China would devalue. They are running a pretty large surplus and I don't see why they would want to devalue. Another thing is that we tend to use effective exchange rates instead of CPI-adjusted exchange rates, or bilateral exchange rates, and if we use these instead, then China's currency is not really over valued by any stretch. Also, people tend to talk about competitive devaluations. That's not a feature of Asia. If you look at most Asian countries, they are not competitively devaluing. Certainly not Taiwan, Singapore, Hong Kong, China, Vietnam, go on down the list, Pakistan, India. They are not competitively devaluing now, and they didn't competitively devalue when China devalued in 1992. So, I don't think that's really a feature of the story. That's more of a European story. Europeans like to talk about competitive devaluation. It's their biggest fear, but it doesn't really happen there either.

Response, **Siamwalla**: Just to emphasize a point that has already been made, actually in 1993 we devalued after the Chinese. Nobody has found out why there was a really rather drastic fall in export growth, from 20% to zero, within one month. One explanation is the Chinese devaluation. I have been told, although I haven't been able to pin this down, that in the early part of the 1960s there was a VAT-related policy that induced a lot of exporters from China to ship in a hurry, and our exports fell drastically. That was the trigger for the herd to follow.

Comment, **Anan Lewchalermwong**, Retired Professor, School of Development Economics, Bangkok: Hong Kong has got fixed exchange rates and it has China as a backer. The U.S. has backed Mexico. *The Economist* has written about the fall of Thailand, but who is going to rescue us, who is going to back us? If you can, answer my question. The exchange rate has now fallen so low, you see, and yet the condition hasn't improved. Don't listen to the politicians.

Exchange rate depreciation doesn't solve the problem, even when it comes down to 100 baht per dollar. You only talk in terms of money, money, always money. Money policy doesn't solve the problem, Thai monetary policy alone will never solve Thailand's problem. Thailand's real problem is stagnation I tell you, and I will give you the solution to Thailand's problem.

You say that the Thai current account deficit is 8% of GDP, but it does not matter, because Singapore's deficit is 10% of GDP. Thailand's situation is totally different because Singapore has got strength in its economy. The baht exchange rate has fallen very low because the Thai economy is very bad, that's the reason. Exchange rates are high or low depending on the economy. This is the explanation. So, when you talk about exchange rates, never forget about the real sector, never talk about only the money sector, please.

Comment, **Michael Intriligator**, University of California, Los Angeles: I would like to ask the panel to take a longer term view, going beyond the current crisis and looking at the long term implications. To put it another way, how are we going to prevent future crises like this in other parts of the world? It could start anywhere in the world—Central Africa, south Asia, many places. I would like to propose a five point agenda and am interested in your reactions.

First, the IMF has to be rethought, or they have to do some rethinking at the IMF. They have to act fast and they have to be supported. They can't just delay and negotiate and so forth, they have to move in very quickly when there's a break. They have to change their whole modality because, as I see it, their method of operation stems from the time when they were fighting structural inflation in Latin America. They developed a certain policy package and they keep using the same package over and over and over again, even when the problems are not structural inflation. This is what many refer to as "one size fits all," when the IMF should be custom tailoring policy to the particular issues that are of concern. I agree with Jeff Sachs that what the IMF is doing in East Asia is going to make the problems worse, not better. That's the opposite of what the IMF was set up to do, it seems to me.

The second point is that you can't rely just on the IMF, they don't have the resources and you have be broader than that, to bring in the G-8, or the G-7 Plus. I don't mean the G-7 and Russia, I mean the G-7 and China. Those are the countries that have the wherewithal to help countries that are in crisis.

Related to this, I think there should be some regional support mechanisms, not integration or common currency. In this instance, ASEAN should have played a mutual support role, rather than neighboring countries standing aloof one from the other. They're falling down individually when they could be stabilizing as a group.

The fourth point is the importance of financial institutions. We've heard that half of the important financial institutions have been lost. If prices are low, they should attract more trade, but they've lost the financial institutions that they need to finance the trade, so the advantage of cheaper export goods is lost completely. The upshot is that they should be supporting, rather than destroying, these financial institutions. Again, it requires a rethinking on the part of the IMF.

Finally, and maybe most controversially, 25 years ago James Tobin proposed something called a Tobin Tax. He suggested there should be a very small tax on international currency transactions as a way of moderating destabilizing speculation. The main argument against Milton Friedman's floating rates was the possibility of destabilizing speculation. The evolution of institutions has only made the possibility of the destabilizing speculation much more powerful, and I think we've seen that in this current crisis. Maybe now is the time to think seriously about imposing a sort of Tobin Tax to reduce destabilizing financial speculation.

I'd be interested in your reaction to these five points and any other suggestions for preventing the next such crisis.

Response, **Kawai**: I agree with Professor Intriligator's statement about the IMF. The East Asian currency crisis was essentially a private capital driven crisis, it was not driven by the government sector as was the Mexican peso crisis. There, government debt was a big problem and the government had difficulty in rolling over U.S. dollar denominated debt. Today we are talking about private sector capital flow problems, and you cannot simply use the same prescription applied earlier to many of the Latin American countries, in particular fiscal policy. There is no need to address the question of fiscal balance because that has not been the source of the economic crisis in East Asia. The IMF now realizes that fiscal policy requirements have been too tough.

I am not quite sure that we should criticize tight monetary policy, because exchange rates are going down, down, and down, and to stop this you have to have the right monetary policy. The essential credit crunch problem in Thailand is not really the result of tight monetary policy. There is some dilemma created by the need, or perceived need, to strengthen financial institutions.

We do need some regional support mechanism. The central bankers group and APEC finance ministers meetings are now trying to introduce the so-called regional surveillance system where countries in the region exchange information and also put peer pressure on neighboring countries. East Asian countries may be quite sensitive to criticisms from outside the region, but if Thailand is told by Indonesia to do certain things, that sort of intra-regional suggestion may be better accepted. A regional financial cooperative joint support mechanism has been emerging, and I think it is going to play an important role.

Many financial institutions are weakened, so there is no question that we should strengthen financial institutions. You have to increase capitalization of banks and you have to get rid of bad loans from the financial institutions, and the definitions of bad loans have been moving toward the international standard of three months with no interest payments. In Thailand loans used to be classified as bad if interest payments were not made for 12 months. Thailand has just shifted the standard to six months, which means that banks and financial institutions have to hold bigger loan loss reserves and really tighten credit. This threatened even the export oriented sectors. Providing export financing has been a problem in the last two or three months in Thailand, while export growth is really the only source of recovery in the case of Thailand, and also in the case of Korea and in Indonesia. We have to solve this dilemma. Various mechanisms have been proposed and some have been implemented. This currency depreciation has just begun to do its job. As exports grow sufficiently, market confidence will come back and I would say there should be a bottom to the Thai baht. I don't know what the bottom is. It might not be 100. As external account performance gets better and the rate of economic growth bottoms out, there should be sufficient confidence in the currency.

Regarding a Tobin Tax, even if all the markets in the world cooperatively decided to introduce the Tobin tax, I could say it would still be extremely unproductive. To be effective the tax rate would have to be very high, which would be counter productive to long term capital flows. There are many economies where stock transactions are taxed and we still observe bubbles and the collapse of bubbles. In Japan we have been arguing that those taxes have to be abolished.

There are an increasing number of countries, like Chile and the Philippines, that are trying to limit short term inflows of capital via financial institutions, by imposing liquidity requirements. Certain portions of capital inflows must be invested in domestic liquid assets. That sort of system may be more effective at maintaining the soundness of the banking system and financial market in emergency times.

Response, **Nasution**: From our perspective, we need the money and advice that we get from the IMF and international organizations to restore our link to international markets. Well, if you are just talking about money, then I think Brunei has much more money than the IMF, but Brunei provides no advice. For advice, I think you have to build up an internal capability, you cannot leave your fate to foreigners. Look at the history. Back in the 1970s, Indonesia and Korea signed the IMF standby arrangement, even though we didn't need the money at that time, because that was the only way to get cheap foreign advice. So at the time, Indonesia and Korea were effectively ruled by highly educated economists that we call technocrats.

On regional financial cooperation as emphasized by Professor Kawai, well, I don't think it will work because you have different needs and different financial structures. In Indonesia, at least, a big portion of the financial assets are denominated in foreign currency. In Japan I think the share of financial assets denominated in U.S. dollars is not that big. In a country like Indonesia or Thailand, a lot of people hold their financial assets in foreign money. In Australia and OECD countries most financial assets are in long term assets, while in Indonesia and Thailand our time horizon is very short. So be careful about proposals for regional linkages.

Comment, **Gordon Tullock**, University of Arizona, Tucson: Firstly, with respect to David Western's point, there's a book in your library by a dead white male named David Ricardo. Get it out and look under Portugal and your concern about wage differentials will be resolved immediately. If this still bothers you, consider what happened when the United States and Mexico cut their tariffs.

The other thing has to do with pessimism. Thailand is a very strong country. They have a lot of assets, a lot of hard working, skilled people. What they have is a messed up monetary system. Money can be very helpful, but it can be very injurious. I would be willing to bet, however, that instead of trying to strengthen the system, that repealing three quarters of the laws dealing with money would be a far better way of getting the economy back on track.

Comment, **George Murphy**, University of California at Los Angeles: What I've been pondering is this. When you have a combination of very high rates of growth and very high savings rates and you also have banking systems which were accustomed to quite different situations, then the banks simply have to learn. There is a learning problem in adjusting portfolios appropriately for levels of risk.

Response, **Siamwalla**: I have been thinking about that for a long time and I think that in some sense the high rate of growth has been counterproductive for us, because in the ponzi scheme that we are pleased to call our commercial banks, the high rates of growth cover up real and deep problems. That's why when we stumble, we really stumble big time. We have to go through this painful adjustment, hold all this fiscal surplus as we now have to fill up that gap, and all this is to make up for mismanagement in our financial system. It is because with an 8% rate of growth you really can cover up a lot. This is why financial management is weak throughout the region, growth masked weak management.

The last crisis was in the early 1980s. In the old days, domestic savings created a constraint. The current crisis was fueled by foreign money. The open capital market increased the foreign exchange risk

Response, **Tatom**: The capital flows were huge and a lot of learning was needed. I think that government regulation failed. Finance was the problem.

Question/Comment, **Garry Jacobs**, International Center for Peace and Development, Napa, California: Is there really no power of self determination to address this more aggressively? Fundamentals are out of alignment and there was excessive short term borrowing. Is 55 baht per U.S. dollar a realignment to real fundamentals? This is not likely. There has been a loss of confidence and the underlying reality is the economy. Look beyond the appearance to the reality. If we could distinguish fundamentals from confidence, along with commitments from professionals to look at realities, we could realistically assess the level of the baht.

Postscript

Jane V. Hall, California State University, Fullerton: These presentations and the subsequent dialogue frame the East Asian economic turmoil as a painful, but temporary, series of adjustments to massive inflows of private capital that could not be efficiently directed by financial institutions which were not adept at risk management and operated in a lax regulatory environment. Some currencies, notably those of Thailand, South Korea, and Indonesia, had already responded to the building crisis with severe depreciations, raising the issue of how best to maintain currency stability. The IMF, criticized for a "one-size-fits-all" approach, offered rescue packages—with conditions—and advice.

It is interesting to look at what has happened since January 16, because world events since then are in agreement with the prognostications contained herein.

The February IMF review with the program for Thailand led to agreement for a smaller budget surplus, or even a small deficit, in recognition that Thailand had met most IMF targets and that Thailand is committed to "stay the course," and needs to increase spending on social programs. This is an outcome that Deputy Prime Minister Panitchpakdi expressed hope for and that indicates the IMF is indeed becoming more flexible and learning to custom-tailor policies. Many panelists and members of the audience noted the importance of broader support than can be provided by the IMF. The G-7 will meet in May to address the East Asian situation, among other matters.

President Suharto in mid-February announced a plan to move Indonesia to a currency board, pegging the rupiah to the U.S. dollar. While this was cited by Professor Cheung as an *ex ante* means to *avoid* rapid depreciation and maintain confidence, most panelists noted that imposing a currency board *ex post* in the middle of a crisis would likely only make things worse and would be extremely painful. In fact, the IMF immediately indicated that it would withdraw its $43 billion rescue package from Indonesia if Suharto proceeded. Suharto's response was to fire the head of the central bank who opposed imposition of a currency board. The rupiah again fell precipitously. Bagehot's publishing legacy, *The Economist*, noting spreading unrest in Indonesia, recently noted the growing risk of political turmoil as food prices and unemployment rise in the region.

Echoing Professor Saving and others on the panel, the Chair of the U.S. Federal Reserve Board and the President of the Board of Trade in Britain have both called for the continuing liberalization of trade and investment as the world continues to seek the advantages of free markets. President Becket suggested maintaining faith in the long-term picture. Chairman Greenspan noted that the IMF's role in stabilizing East Asian economies is important to encourage the continuing movement toward U.S.-style markets. Deputy Prime Minister Panitchpakdi also highlighted the importance and the power of markets, cautioning that liberalization—to which Thailand remains committed—reduces the potency of government intervention.