Towards a New Strategy for Asian Recovery

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The Asian financial crisis is now moving into its second year, with no clear end to the turmoil in sight.

The three hardest hit economies -- Thailand, Indonesia, and Korea -- have plunged into deep recessions, with widespread bankruptcies, massive layoffs, and sharp rises in poverty. The virus has spread to other emerging markets, and now threatens Russia and South Africa, amongst others.

Japan's own financial weaknesses have been exacerbated by the regional crisis. With its exports to the region falling, its banking system is becoming even more distressed, which, in turn, is threatening to deepen the Asian crisis still further.

The Washington-based strategy to deal with the crisis, mainly through bailout packages designed by the International Monetary Fund, has clearly failed. One just has to compare the IMF's optimism in the latter part of 1997 with the reality today, as shown in Table 1.

Every month or so, the IMF has been forced to downgrade its forecasts for the region. During the first few months of the crisis, the IMF forecast 1998 growth rates of between 2.5 to 3.5 per cent in Thailand, Indonesia, and Korea. Just this week, in fact, the Fund again changed its forecast for Korea, dramatically reducing the projection it made just a few weeks ago. Now, after months of reform efforts, the latest market forecasts suggest that economic output in 1998 will contract by around 5 to 8 per cent in Korea and Thailand, and a whopping 12 to 25 per cent in Indonesia. The IMF's own forecasts are almost as dire.

For even the most sympathetic observer, it is hard to make a case that the IMF has had any success in achieving its basic goal of restoring confidence in the crisis economies.

Their continued downward spiral cannot be attributed to implementation failures by their governments. Thailand and Korea have done essentially everything the IMF has asked them to do. Even Indonesia, which clashed repeatedly with the Fund earlier in the year, and suffered in large part from poor IMF strategy rather than just non-compliance with the IMF programs, has carefully toed the line since signing its third agreement in early April.

The IMF's Mistakes

The IMF's approach, far from reviving confidence, has inadvertently made a bad situation worse. For the Asian crisis economies to begin to move forward, a different approach is needed, based on a new macroeconomic strategy and an aggressive restructuring of corporate and bank balance sheets. Only such a change in direction will restore confidence and growth in the Asian economies.

Without repeating the major debates of the past year, it is worth revisiting some of the most salient points.

The Asian economies entered 1997 facing several important problems, including growing dependency on short-term debt, weak and under-supervised financial systems, slowing export growth, and an overly-cozy relationship between governments and businesses. These problems were probably worst in Thailand, where the regional crisis was triggered following the baht devaluation a year ago.

International creditors soon realized that the amount of short-term debt falling due in Thailand, Indonesia, and Korea was much greater than the amount of foreign exchange available, and the creditors therefore each rushed to be the first to withdraw their funds.

The capital withdrawals quickly turned into a full-fledged financial panic as a result of over-reaction by private investors, policy mistakes by Asian governments, and poorly-designed IMF programmes.

As one good measure of the extent of the panic, estimates by the Institute of International Finance suggest that net private capital flows into Thailand, Korea, Indonesia, Malaysia, and the Philippines turned from US$97 billion of inflows in 1996 to $US12 billion of outflows in 1997 (see Table 2). This abrupt reversal of US$109 billion in capital flows during the last six months of 1997 is equivalent to over 11 per cent of the pre-crisis GDP of these economies.

The rescue packages designed by the IMF did not stop the panic, and along with policy mistakes in each of the individual countries, sometimes added to the panic.

The Fund's original prescription included a combination of high interest rates, budget cuts, abrupt closures of financial institutions, very rapid enforcement of bank capital adequacy standards, and a long list of structural reforms.

The IMF provided each government with several billion dollars up front to help shore up reserves, with the promise of vastly larger sums in the future if reforms were implemented. The objectives of this approach were to arrest the slide in regional currencies, reduce the scale of non-performing loans on bank balance sheets, and to convince foreign investors to stop their withdrawals by showing them that the Asian governments were serious about reforms.

However, the plan largely backfired.

The immense economic contraction that was already underway as a result of the capital

withdrawals was amplified by the Fund's contractionary policies. And foreign creditors became worried that debtor firms would be much less able to repay their loans in such an environment.

In addition, actual official foreign financing turned out to be substantially less than the headline amounts that were announced, so the liquidity squeeze in foreign exchange markets remained. Banks came under extreme stress, and basically stopped making fresh loans. Capital withdrawals accelerated after some IMF programs, and currencies in all of the crisis-ridden countries continued to slide.

A New Approach

The Fund programs have evolved significantly during the past year, and now include larger fiscal deficits, more realistic financial restructuring plans, and less emphasis on non-financial structural issues. Notably, foreign debts have been restructured or at least rolled over. These measures have finally led to currency stabilization, but not to economic recovery.

After one year, the combination of sustained high interest rates and illiquidity has in fact led to severe economic contraction and a vast overhang of bad debt throughout Asia. Corporations have seen their debt-equity ratios skyrocket from initially high levels as currencies depreciated and interest rates soared. A large number of major firms in each of the economies are now unable to service their debts. Bank loans are simply not being repaid.

The mixture of high interest rates, rising non-performing loans, and IMF pressures for rapid banking recapitalization has left the entire banking sectors of Korea, Thailand, and Indonesia effectively moribund. Only foreign banks and a small number of national banks continue to function normally.

Most banks are simply not lending fresh funds, even for normal trade credits and operating capital. Many firms -- including the majority that were well-managed and profitable under normal circumstances -- are closing down.

The illiquidity crisis has thus evolved into a widespread insolvency crisis, as crushing debt burdens translate into negative net worth. Despite recent stability in currency markets, real economic recovery is still far off.

Under these circumstances, continued high interest rates and the gradual workout of foreign and domestic debts will not solve the problem. As time goes on, more firms will become insolvent and shut their doors, leading to a deepening downward spiral.

Instead, a different approach is needed to move much more quickly to eliminate the overhang of bad debt and get firms back on their feet:

* Expand Liquidity: The first step should be to ensure that there is sufficient liquidity in the banking system to enable firms to continue production even before these firms are able to

restructure their debts.

Exporting firms are the clearest case of the need for expanded provision of liquidity.

One of the sad ironies of the current situation is that exporters, the very firms that should be able to profit most from the massive devaluations, have often been unable to get the credit they need to import raw materials and supplies. Exporters need special facilities to provide immediate lines of credit to enable them to meet their orders and even expand their operations.

* Restructure Debts: Such emergency credit lines, however, will not work by themselves. Even more importantly, new initiatives are also urgently needed for across-the-board workouts of corporate debts.

Bankrupt firms are simply closing their doors now, rather than winning the time to restructure their balance sheets, a process that would give many, if not most, of these firms a new lease on life.

After all, these firms are often highly competitive in international markets. Their problem is not a bad product line or an inefficient production process, but rather an overhang of bad debt which is strangling their operations.

One solution to this problem would be to convert existing corporate debt into equity, so that the bank creditors would become owners of the firms rather than the creditors as now. The reduction of debt would ease the cash flow burdens of the debt, enabling the firms to re-enter the loan markets for working capital and long-term loans.

This kind of debt-to-equity conversion is exactly what would occur in a well-designed bankruptcy system. The problem is that traditional bankruptcy-style procedures are much too slow in the current environment, especially since most financial market participants and court systems have had little previous experiences with bankruptcy-style procedures.

In Thailand, for example, recent estimates suggest that only 4 per cent of expected corporate restructurings have as yet taken place despite a full year of crisis and many months of negotiations over existing debts! Just this week, Indonesia introduced a new bankruptcy law, and is frantically trying to train new judges and open additional courtroom space to handle the expected onslaught of cases. The backlog promises to quickly become huge. Much more dynamic and innovative ways to reduce debts are needed.

The situation in Korea is similar, or possibly even worse, given the very high levels of debt of the chaebols (the large conglomerates). Debt-equity ratios for the largest 30 chaebols average over 500 per cent.

To reduce these extraordinarily high ratios, the government should explore an across-the-board mandated conversion of chaebol debt (owed to banks) into equity, which would make the banks the main owners of the chaebols in the short term. The current owners' shares will immediately

be diluted substantially though not completely.

As part of the procedure, however, the existing owners could receive an option to repurchase the shares from the banks at some premium over current market prices, thereby maintaining incentives to improve the performance of their firms. The banks would be required to sell off these shares in a limited period of time, perhaps two years.

We should emphasize that this strategy is not aimed at rescuing unviable firms. If, after the debt conversion, firms still cannot generate a positive cash flow, then they should probably be liquidated. Firms should not be saved at any cost, but the better firms should be given the opportunity to reestablish their operations without the debt overhang.

* Recapitalise Banks: Since most Korean banks are also bankrupt (with or without the debt-equity conversions), some will have to be closed or merged, but for others the Korean government will have to inject new capital into the failed banks. The same would apply in the other crisis countries.

Government intervention would presumably be in the form of new bank equity which would give the regulatory agencies special control and supervision over the banks. As with the chaebols, the existing bank owners might retain a small portion of overall ownership, with the option to repurchase equity shares issued to the government.

During this period of balance sheet restructuring, the government would protect depositors and maintain banking services. The injection of new capital would allow new lending to begin again. Over time, the government would sell off its shares in the banks, to foreign and domestic investors, including the current owners.

Corporate debt restructuring and bank recapitalization should proceed in tandem. Neither step can await the completion of the other. For example, bank recapitalization needs to begin urgently so that lending can resume quickly for exporters and firms without a large debt burden. However, the process of bank recapitalization cannot be completed until corporate debts are restructured, and the banks convert some corporate debt into equity.

These highly unusual steps would carry real risks, not the least of which would be the possibility of stronger government influence over the economy and delays in the process of eventual privatization. But they would also go a long way towards making both enterprises and financial institutions viable, and they would facilitate a much more rapid return to bank lending on a normal market basis.

On balance, the risks seem worth taking in order to halt the precipitous slide in economic activity and social dislocation. Case-by-case financial restructuring could leave the region in financial turmoil for years to come.

* Readjust Macroeconomic Policies: In the context of the adjustment process as just outlined, a

shift in macroeconomic policies would also be possible.

The key is to reduce interest rates and expand domestic credit. Yes, this will probably entail some further depreciation in the region's currencies, at least in the short run. But that would be a relatively small price to pay for re-starting economic activity.

In any event, the impact on exchange rates is likely to be fairly small. Over time, as economic activity picks up and foreign lenders re-enter the markets, exchange rates will again appreciate in real terms.

Korea, for example, has recently reduced interest rates without causing the currency to depreciate again. Even so, there is a strong case for even lower interest rates in Korea. It has a huge trade surplus; inflation has been slightly negative since March; unemployment is soaring; and the currency is appreciating.

There is simply no reason to persist with punishingly high interest rates.

Japan

Asia's prospects for a speedy turnaround depend also on developments within Japan. Japan's basic problem is weak domestic demand, resulting from a collapse of bank lending, and the fall of exports to the rest of Asia. The Japanese banking crisis, in turn, reflects the vast overhang of bad debts in the Japanese banking system.

As in the rest of Asia, Japan needs a drastic, across-the-board solution to the bad bank loans (for example, their repurchase by the government in exchange for public debt), and an expansion of monetary policy. Part of that monetary expansion could come in the form of greatly expanded grants and credits to the other crisis countries of Asia.

The yen is likely to depreciate further in our view. The rest of Asia is reluctant to see that happen, but we believe that it will occur as a natural part of Japan's path to recovery, and that Japan's recovery is strongly in the best interests of the rest of Asia.

Asia's turnaround then depends on three steps: accelerated conversions of corporate debt to equity; accelerated recapitalization of Asia's banking sector; and easier monetary policy. These steps carry risks, but the current policies are even riskier.

Not every goal can be achieved: the yen is likely to depreciate further, for example; the Chinese yuan is also likely to depreciate at some point in the future; and Hong Kong will suffer more from its fixed peg to the dollar.

Nevertheless, the balance of evidence suggests that a new direction in Asia is needed.

1998 GDP Growth Rate Forecasts for Indonesia, Korea, and Thailand

Country and Forecast Source	Date	Growth Forecast (%)
Indonesia		
IMF, first program	October 1997	3.0
second program	January 1998	0.0
third program	April 1998	-5.0
fourth program	July 1998	-10.0
Market forecast	July 1998	-12.0 to -25.0
Korea		
IMF, first program	December 1997	2.5
third program	February 1998	1.0
World Economic Outlook	April 1998	-0.8
Article IV Consultation	June 1998	-1.0 to -2.0
revised projection	July 1998	-5.0
Market Forecast	July 1998	-5.0 to -7.0
Thailand		
IMF, first program	August 1997	3.5
second program	November 1997	0.0 to 1.0
third program	February 1998	-3.0 to -3.5
World Economic Outlook	April 1998	-6.0
Article IV Consultation	June 1998	-4.0 to -5.5
Market forecast	July 1998	-5.0 to -8.0