The impact of the financial and economic crisis in Asia on Norway's major development partners

Report submitted to the Norwegian Ministry of Foreign Affairs

Hildegunn Kyvik Nordås and
Stig Tenold

R 1999: 1

The impact of the financial and economic crisis in Asia on Norway's major development partners

Report submitted to the Norwegian Ministry of Foreign Affairs

Hildegunn Kyvik Nordås and Stig Tenold

R 1999: 1

Chr. Michelsen Institute *Development Studies and Human Rights*

CMI Reports

This series can be ordered from:
Chr. Michelsen Institute
P.O. Box 6033 Postterminalen,
N-5892 Bergen, Norway
Tel: + 47 55 57 40 00
Fax: + 47 55 57 41 66
E-mail: cmi@amadeus.cmi.no
Web/URL:http//www.cmi.no

Price: NOK 50 + postage

ISSN 0805-505X
ISBN 82-90584-34-2

Indexing terms

Financial crisis
Economic crisis
Asia

Table of contents

Summary*

This paper discusses the events that led to the Asian crisis, the management of the crisis and how it has affected some of Norway's most important development partners, South Africa, Mozambique, Tanzania, Zambia, Uganda, and Bangladesh. The term "The Asian crisis" encapsulates three different, but interrelated, crises, a financial crisis, a currency crisis and an economic crisis.

Four countries have been particularly adversely affected by the economic turmoil; Indonesia, Malaysia, South Korea and Thailand. All of these countries have experienced currency depreciation of at least fifty per cent, a strong reduction in the value of stocks and properties, increasing unemployment rates, and contraction of economic activity. Estimates suggest that the decrease in Gross Domestic Product in 1998 has been approximately 15 per cent for Indonesia, and between 6 and 10 per cent for Malaysia, South Korea, and Thailand. Other countries in Asia have been less severely hit by the problems, but economic growth in the region, which has been the fastest in the world for several years, has been substantially reduced.

Our analysis shows that the effect of the currency and financial crises is negligible for all development partners included in this study, except South Africa. The economic crisis in Asia, which refers to a reduction of Asian demand and economic activity, has some, but limited, implication for Norway's development partners.

The financial and currency crises in Asia led to a reduction of investors' confidence in the development of "emerging market economies," resulting in a massive withdrawal of capital. This affected South Africa, which experienced a higher risk premium in international markets. For the other countries analyzed in this study, however, the increased risk premiums in international capital markets were of relatively little importance. The main reason for this is that the countries are not integrated into the international financial markets as they mainly rely on donor money rather than financing from private sources.

The fast growing economies of Asia have been a significant driving force for the international economic and trade growth in the last decades. The reduction of economic activity in East and Southeast Asia in 1998 thus has important consequences for the international economy. One important effect is the reduction of prices in international commodity markets following the diminishing Asian demand. The net effect is, however, limited for the countries analyzed since they all benefit from the fall in the price of oil.

Our conclusion is that the turmoil in East and Southeast Asia is of relatively little importance to the countries analyzed. Their economies are more exposed to political instability, regional conflicts, weather conditions, and unsound macroeconomic management than to the effects from Asia. However, the development in Asia prior to the crisis, particularly with regard to the amount and utilization of incoming funds and the managing of exchange rates, may be an important lesson for other developing countries.

* The authors thank Stein Tønnesson for useful comments and suggestions.

1 Introduction

This report analyzes the impact of the crises in Asia on six developing countries, South Africa, Mozambique, Tanzania, Zambia, Uganda, and Bangladesh. In order to do so, we first distinguish between three crises: the currency crisis, the financial crisis, and the economic crisis. The three crises are closely related, but it is not the case that one crisis inevitably leads to the others. In South Africa, for example, the currency crisis did not trigger a financial crisis.

The countries included in this study do not have close trade and investment links to Asia, although Malaysia has recently become one of the most important sources of foreign direct investment in South Africa. Furthermore, with the exception of South Africa the countries are not integrated into the world financial markets. The currency and financial crisis therefore has had little direct effect in these countries. The economic crisis has, however, had an impact, albeit so far it has probably been small. Only if the economic crisis eventually spreads to the OECD area, will it take a significant toll on the poor countries included in the study.

On the international level the economic crisis is first and foremost felt in the world commodity markets. In addition, aid flows from Japan have declined as a result of the recession there, and aid flows from multilateral agencies and Japan are to some extent diverted to the crisis-ridden Asian economies. In late 1998 Japan launched a special aid program for the countries most heavily affected by the crisis, and some of the initial funds arranged by the International Monetary Fund (IMF) came from the coffers of the World Bank and the Asian Development Bank.

The paper starts with an analysis of the crises in Asia. The origin of the currency crisis and how it relates to the financial and economic crises are discussed in section 2. It is emphasized that the crisis is neither unique, nor is it the result of an exogenous shock caused by international speculators, as is often claimed. Rather we posit that the crisis had been in the making for some time and was partly due to bad policy. The policy errors relate to what the governments did, but even more to the errors of omission. In particular, gainful liberalization of international capital flows requires a well diversified and developed local financial sector which is capable of managing risk, handle cash flows safely and allocate credit efficiently. It is argued that the countries that had such a financial system in place and in addition managed aggregate demand in order to avoid large, accumulated deficits on the current account escaped the crisis with the least ruptures.

The downturn that the currency crisis triggered was more serious than a correction of the built up imbalances called for. Section 3 maps out the channels through which financial and economic crises spread from one country to another. In addition it discusses the policy measures each country and multilateral institutions such as IMF and the World Bank have at their disposal in order to prevent financial crises from developing into economic crises and to limit the contagion effects. The impact on the selected developing countries in Africa and Asia is discussed in more detail in section 4. Finally section 5 concludes by drawing some lessons from the Asian crisis for development policy in the future.

2 The financial and economic crisis in Asia

The financial crisis goes back to the burst of Japan's bubble property market in the beginning of this decade, while the Asian currency crisis is usually seen as dating back to the collapse of the pegged exchange rate regime in Thailand on July 2 1997. The effect of the Thai devaluation was, however, only "the straw which broke the tigers' back". To get a full understanding of the financial and economic turmoil in the region it is necessary to take into account the development in the preceding years.

For nigh on two decades, a group of countries in East and Southeast Asia had sustained remarkably high rates of economic growth. Through a combination of high savings and investment rates, human capital accumulation, export-promoting policies and a government-initiated focus on rapid industrialization, the countries accomplished an impressive transformation of their economies. The countries are usually classified in two groups – the first generation tigers which are Hong Kong, Singapore, South Korea, and Taiwan, and the second generation tigers which are Indonesia, Malaysia, and Thailand.

2.1 The period preceding the crises

The financial crisis has been particularly severe in four of these countries; Indonesia, Malaysia, South Korea, and Thailand, although all the countries face lower economic growth in 1998 as a result of the regional turmoil. There are some important similarities between the countries which have been hardest hit by the financial crisis:[1]

- Cheap international capital, facilitated by deregulation of national banking systems and the growth of an increasingly integrated international financial sector contributed to a bubble-like development of asset-, equity- and property prices.
- International capital was partly attracted to the region by the high historical rates of return, partly pushed from industrialized countries where interest rates were low. The fixed/ managed exchange-rate regimes of the countries in Asia resulted in a misconception of the actual exchange rate risks, and some of the foreign creditors may have perceived the debt as guaranteed by the government in the various Asian countries.
- Prior to the financial crisis, the asset-, equity- and property bubble burst, resulting in an increase in non-performing loans and a sharp reduction in the value of the collateral of loans extended by financial institutions. This development is on many accounts similar to what happened in Japan and the Western world in the latter part of the 1980s.
- The crisis-ridden countries had opened the capital account on the balance of payment, but the local financial system was not prepared to handle short-term capital flows.
- Policy makers were reluctant to see the fragility of their financial systems and the need for a devaluation of their currencies in light of changing international circumstances, and thus failed to make necessary policy corrections in the period leading up to the crisis.

[1] A more comprehensive and coherent analysis of the background for the financial crisis, where the development in the individual countries is presented in more detail, can be found in Tenold (1998:16-41).

A major problem in Thailand and Malaysia was the large current account deficits financed by large inflows of capital in the period before the financial crisis. A comparison of current account development in various countries in Asia reveals an interesting feature. The countries that had sustained current account deficits in the beginning of the 1990s are those countries which have been hit by the financial crisis.[2]

Table 2.1 Current account development; per cent of GDP.[3]

Country	1990	1991	1992	1993	1994	1995	1996	Avg.
Indonesia	-2,3	-1,6	-1,6	-0,7	-0,6	-1,6	...	-1,4
China	4	4,4	1,3	-2,7	1,3	0,2	0,9	1,3
Malaysia	-2	-8,9	-3,8	-4,8	-6,4	-8,6	-5,2	-5,7
Singapore	8,3	11,2	11,3	7,2	15,9	17,7	15,2	12,4
South Korea	-0,7	-2,8	-1,3	0,3	-1	-1,8	-4,8	-1,7
Taiwan	6,7	6,7	3,8	3	2,6	1,9	5,2	4,3
Thailand	-8,5	-7,7	-5,7	-5,1	-5,6	-8,2	-8	-7

2.2 *Problems in the real economy*

The negative financial development was exacerbated by real economic problems. Exporting sectors suffered from overvalued currencies following the depreciation of the Japanese yen towards the US dollar and European currencies. Since Japan was the most important competitor to the Asian tigers and the tigers had a fixed exchange rate towards the dollar, loss of competitiveness followed. Global overcapacity in important sectors such as the semiconductor and car industries further constrained export growth. Imports continued to grow unabated along with growth in domestic demand, and deteriorating trade balances resulted.

Reduced export growth fuelled speculation that some of the "tigers" were encountering structural difficulties. The apparently vanishing competitive advantage in the production of labor-intensive goods, particularly after the opening of the Chinese economy, would in time force the countries to climb up another rung on the industrial quality ladder. This transformation to exports of more advanced goods necessitated large infrastructure investments and a high degree of human capital formation. In South Korea's case, the trouble was not only fierce competition from low-cost producers. The strong depreciation of the Japanese yen led to an improvement in Japanese competitiveness as well, meaning that South Korean exports were challenged on two fronts.

[2] The current account deficits in Indonesia and South Korea were moderate, and can not alone explain the crisis in these countries. The explanation lies partly in the way the current account deficit was financed and weaknesses in the local financial system which in turn constitute the interface between the international and local financial markets. Additionally, the economic crisis in Indonesia is closely intertwined with the country's political crisis. The problems in South Korea were amplified when international investors took a more skeptic view of the debt situation of the country's large industrial conglomerates

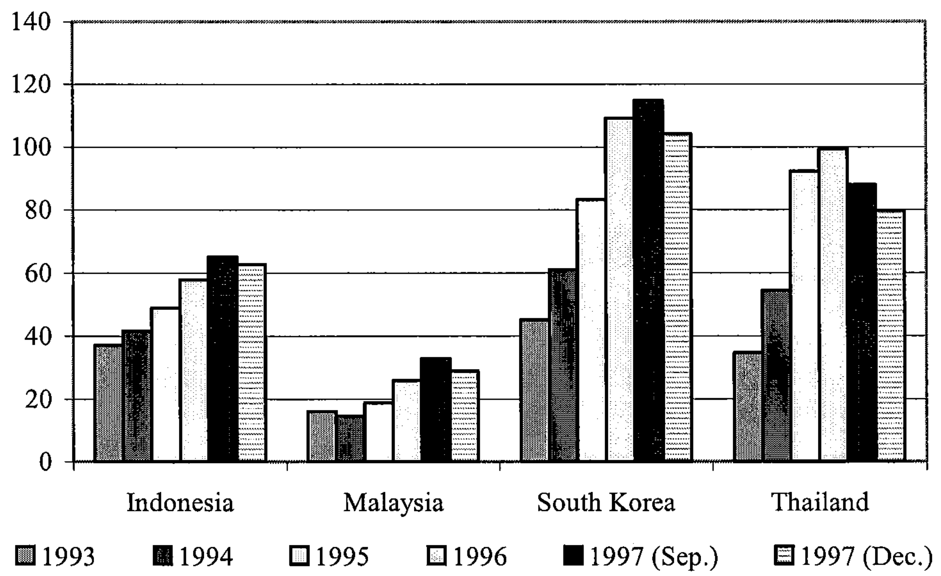
[3] Figures from IMF (1997:142-143) and, in the case of Taiwan, from Corsetti, Pesenti & Roubini (1998:103). The shaded boxes highlight negative figures. Despite the fact that the countries most severely hit by the financial crisis are the countries with the current account deficits, the size of the deficit is seemingly unrelated to the magnitude of the problems in the various countries

Corruption and "crony capitalism" are often presented as one of the main causes of the financial and economic turmoil in Asia. There is little doubt that this aspect of the economic organization has had an adverse effect on economic efficiency and income distribution. However, its role in the current turmoil tends to be overstated. There is no indication that corruption and cronyism increased in the last years, and these factors were a persistent feature of the political and economic regimes even when the countries' growth rates were twice the international average. Rather, we find that what triggered the financial and economic distress was the accumulation of foreign short-term debt in the years preceding the financial crisis. Even though crony capitalism did not trigger the crisis, it contributed to the misallocation of resources that accumulated into structural problems. Furthermore, close ties between Thai politicians and businessmen made it possible to conceal the actual economic standing of several businesses, in particular financing companies with large non-performing portfolios. This may have delayed reforms and made the financial crisis more severe.

2.3 Debt and depreciation

Against a backdrop of high economic growth and financial sector liberalization, banks and other financial institutions in Asia increased their borrowing from foreign sources dramatically. Government-initiated changes made foreign liquidity more easily accessible, and the foreign funds were to a large extent lent to local companies and individuals.

Figure 2.1 Bank and private sector foreign debt, billion dollars.[4]



Accumulation of foreign debt is not necessarily a problem. If the inflow of foreign capital is utilized in sectors which will bring future export earnings, the expected revenue increase may be used to service the foreign debt. Such sustainable deficits

[4] Based on figures depicting debt to BIS-reporting banks from Bank for International Settlements (1996 & 1998b: Table 5A).

characterized the development in several Asian countries until the beginning of the 1990s. However, from the beginning of the 1990s, it appears that the foreign capital to a larger extent funded speculative investments in assets, equity and real estate, as well as an increase in consumption. The reduction of the profitability of investments is illustrated by a sharp decrease in the inverse of the Incremental Capital/ Output Ratio (ICOR) in South Korea and Thailand in the first five years of the 1990s, compared to the last five years of the previous decade.

Table 2.2 Average ICOR (inverse).[5]

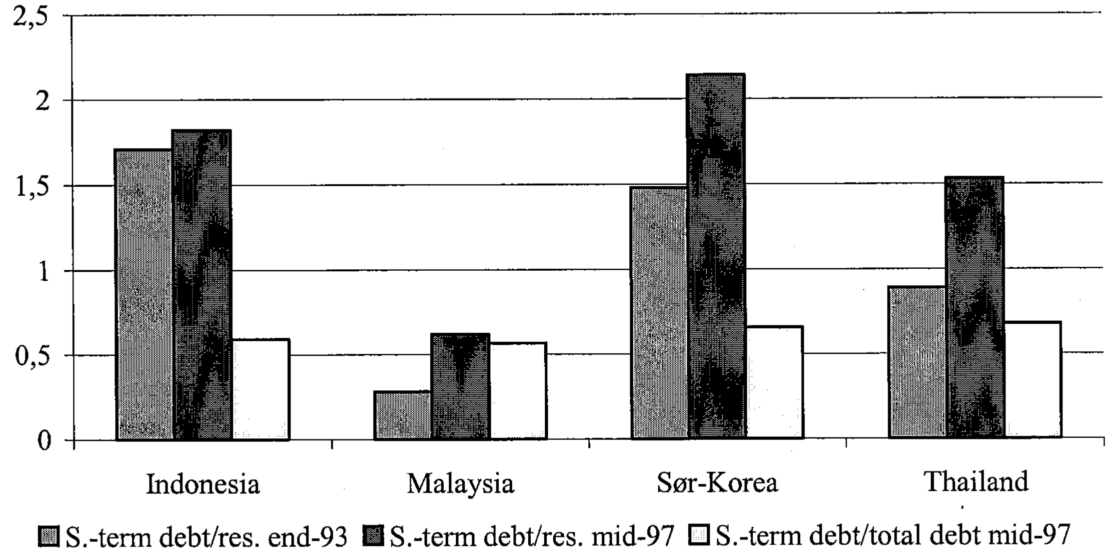
	1986-1990	1991-1996
Indonesia	19,2	22,6
Malaysia	25,1	22,1
South Korea	32,9	20,2
Thailand	32,6	19,6

Three aspects of the high private debt were of particular importance, and are crucial in explaining the financial crisis and the subsequent economic problems:

- The share of non-performing loans (NPL) increased markedly in the wake of the collapse of the asset and real estate bubbles. In the summer of 1998 NPLs constituted as much as 70 per cent of total loans of some Thai banks. Even though this is an extreme example, the share of NPLs increased in the other tiger economies as well. In June 1998, estimates suggest that NPLs constitute 50 per cent of total loans in Indonesia, 30 per cent in South Korea and Thailand, and 25 per cent in Malaysia.[6]
- The loans had not been secured against changes in the exchange rate. This is only a potential problem when the exchange rate is fixed relative to the currency in which the debt is denominated. However, if the national currency depreciates, the amount of local currency needed to pay the creditor increases, thus increasing the debt burden and the possibility of default.
- There was a lack of correspondence between the banks' and finance companies' borrowing and lending. They had typically borrowed short-term money abroad, and lent it to the private sector on a long-term basis. When debtors started to default, the situation became serious relatively quickly.

[5] Figures from Bank for International Settlements (1998a:35). The figures depict the inverse of ICOR, viz the growth of GDP divided by investment/GDP. A reduction implies that the economic growth associated with a given level of investments is reduced. The inverse of ICOR may thus be used as a proxy for the profitability of investments.
[6] It is, however, important to emphasize that the share of non-performing loans has increased as the financial crisis has evolved; figures from July 1997 will therefore be notably lower.

Figure 2.2 Short-term debt relative to reserves and total debt.[7]



The problems in the financial sector and the real economy led to a loss of confidence in future growth in several Asian countries, and as a result of this, their ability to defend the value of their exchange rates was questioned as well. Agents expecting a depreciation reacted by selling the currency, thus creating a currency supply increase which necessitated official intervention to keep the exchange rate at the pegged value. Thailand was the first country which fell victim to large currency sales following fears about depreciation. Joint intervention from the central banks of Thailand and Singapore was necessary to counter a speculative attack in the spring of 1997. However, this and subsequent interventions led to a strong fall in Thai reserves, making the authorities' decision to support the value of the baht even less credible. In the end the amount of foreign exchange reserves was insufficient to counter the speculation, culminating with the end of the Thai fixed exchange rate regime.

The disbanding of the Thai currency peg in July 1997 resulted in an immediate fall in the value of the baht. This had far-reaching implications, as the financial crisis and the currency crisis embodied self-reinforcing effects. When the value of the baht was reduced, the foreign currency nominated debt outstanding increased in terms of local currency. An increase in non-performing loans followed the increased debt burden in private companies. This escalation of the problems in the financial sector led to repercussions on the currency market where increased skepticism about the future development in Thailand triggered further downward pressure on the exchange rate. The Thai authorities were faced with a difficult decision in this period. Whatever they did, there was a danger that the crisis in the financial sector would escalate. They could raise local interest rates and hope that this would counter the currency outflow. The flip side of this was the risk that the share of non-performing loans denominated in local currency would increase. The authorities could alternatively lower interest rates in order to ease the position of the banks and finance companies and at the same

[7] Figures for short-term debt relative to reserves from BIS (1998a:128) and for share of total debt from (1998b). Figures for reserves do not take into account any forward contracts entered into by the central banks. In Thailand, potential losses on forward contracts implied that the real reserves were far smaller than official reserves in mid-97; some sources have suggested a "worst-case" figure of 5 billion dollar, as opposed to the official figure of 27,5 billion dollar.

time stimulate demand. The flip side of this strategy was that the currency outflow could intensify, the exchange rate could further deteriorate and the share of non-performing foreign currency denominated loans would increase. The Thai authorities vacillated between these strategies, and only when the IMF had been called to the scene, and demanded heavy interest rates increases as a condition for giving financial help, did the Thai government follow a consistent strategy.[8]

3 The contagion effect – can it be prevented?

The financial- and currency-problems in Asia in 1997 are on no account unique. Before the turmoil in Asia, the 1990s had already witnessed two major international currency-crises – the *European Monetary System*-crisis in the beginning of the decade and the *peso*-crisis, which spread from Mexico to large parts of Latin America in the middle of the decade. However, in terms of magnitude, depth and extent of contagion the Asian crises are far more dramatic than the other two.

3.1 Regional and international contagion

The change in investors' sentiment in the wake of the *peso*-crisis, which led to the diffusion of Mexico's problems to other Latin American countries, has been dubbed the *tequila*-effect. Likewise, the financial and currency problems spread from Thailand to the other countries in the region. The aptly-named *tom-yum*-effect, worked through a variety of channels, both real and psychological.[9]

There are direct economic reasons for the pressure on other Asian currencies in the wake of the collapse of the Thai fixed exchange rate regime. A depreciated Thai currency implied an increase in the country's competitiveness, and as several of the countries in East and Southeast Asia compete in the same international markets, this was expected to have an adverse effect on the other countries in the region. In addition to this, the relatively high, and increasing, share of intraregional trade meant that these countries would be adversely affected by the reduced growth of the Thai economy. Probably more important than the trade aspect, however, were the other strong economic and financial linkages among the countries of East and Southeast Asia. The industrialized Asian countries had a disproportionately large share of their investments in other countries in the region, including Thailand. They would therefore be relatively harder hit by the financial- and currency crisis in Thailand than countries outside the region. Just like capital from Asian countries had been important in creating the stock market and property bubbles, the owners of this capital would be adversely affected by the fall in asset- and currency values.

The troubles were also spread as a result of changes in market sentiment. The fact that the fast-growing Thai economy had proved to have such large hidden defects came as a surprise, and the other countries in the region were subject to closer scrutiny. This revealed that several of the other "tigers" might also have unsustainable current

[8] The International Monetary Fund and the World Bank still do not agree whether this was the correct response to the problems. World Bank economists, and others who have been skeptical of the IMF's intervention, have claimed that the high interest rates exacerbated the financial problems and resulted in an unnecessarily deep depression.

[9] This contagion is analyzed in more detail in Tenold (1998:34-40).

account deficits, overvalued currencies and declining profitability of investments. Consequently, international investors feared other instances of financial and currency crisis in the region.[10]

This negative attitude was reinforced by a change in the surveillance policies of international investors and rating agencies. Their attention changed from macroeconomic to microeconomic determinants (Wade 1998:12-13). Whereas their focus had previously been on macroeconomic indicators such as debt relative to GDP, export growth, inflation and budget deficits, in which the countries in the region largely came out positive, investors and rating agencies now started to focus on microeconomic indicators and the composition of external debt. Their view of the situation in the Asian countries was far more negative when factors such as the volume of short-term private debt relative to reserves, the currency composition of debt, and the private sectors debt/ equity-ratio were used as basis for evaluation. This led to a major loss of confidence, and a change in the international investors' sentiments towards the countries in East and Southeast Asia.

The contagion and the effects of the changes in market sentiments were amplified by some specific features of the international financial markets. Two such "psychological" aspects were of particular importance. On the one hand, there was the problem of self-fulfilling prophecies. As previously mentioned, when the agents in the financial market expected a Thai devaluation, and acted in a manner consistent with their expectations, the Central Bank had to intervene by selling foreign exchange, leading to an exhaustion of Thai reserves up to the point where a depreciation was inevitable. Thus, by expecting a breaking up of the fixed exchange-rate regimes, the agents in the international financial market managed to provoke exactly that response.[11] In addition, the exchange rate and stock market plunge exhibited a tendency of "overshooting." The fall in the value of currencies and stocks was larger than what was warranted by the general circumstances. One reason for this is that the actions of international investors can be explained by what economists call the fire-sale effect. When a shop burns, the owner is willing to sell his stock at low prices to get rid of it before the flames get it. Likewise, as investors were expecting a strong reduction of values, the fear of being "the last one out" led to overreaction. A result of this herd behavior is that actions which are individually rational have consequences which make them collectively irrational.

The contagion of the crisis may thus be explained both by economic theories and by psychological mechanisms. The turmoil spread fast. As early as three weeks after the Thai authorities had been forced to give up the peg, The Philippines, Malaysia, Indonesia, and Singapore had been forced to change their exchange rate policies. The downward pressure on the currencies of the Philippines, Malaysia and Indonesia can be explained by the fact that these tended to be lumped in the "Newly Industrializing Country"-bracket together with Thailand, and there had been a high degree of

[10] In some instances, e.g. in the case of South Korea, the problem was not necessarily "hidden defects". Rather, well-known factors, such as the conglomerates' high ratio of debt to equity, were suddenly viewed in a more negative manner.

[11] It should, however, be emphasized that there was good reason to expect that the fixed exchange rate would collapse. Otherwise speculation would not have taken this dimension, and the probability that it would succeed would have been much less. We can thus say that speculators brought about an overdue correction of the exchange, in spite of governments' reluctance to do this.

correlation in stock market fluctuations in these countries even before the crisis. Singapore's decision to go from a fixed exchange rate regime to a floating currency can be seen as an attempt to avoid having to use reserves to defend the value of the currency in light of expected speculation.

A second wave of contagion-induced speculation took place in October, when the monetary authorities of Hong Kong had to increase the discount rate to some three hundred per cent to counter the attack on the currency. The value of other Asian currencies continued to fall, but the situation became increasingly more grave in the beginning of December, when South Korea became the focus of attention. Fear about the short-term debts of South Korean companies resulted in an 80 per cent fall in the *won*/ dollar rate during a three week period. The reason for the plummeting currency was partly the regional crisis, partly specific national circumstances. The most serious problem was the extent of leverage in the huge *chaebols*. At the same time, a combination of political and economic factors caused a crash in the value of the *rupiah*, the Indonesian currency.[12] In January 1998 the Indonesian *rupiah* was traded at more than 17000 per dollar; an enormous decrease compared to the steady level of approximately 2300 which had been attained for several years, or the 3500 *rupiah* per dollar which had been recorded as late as October 1997.

As the financial crisis in Asia escalated, consequences were felt even outside the region. One effect of the financial problems of the newly industrialized countries in Asia, was increased skepticism to "emerging market economies" in general, mainly based on the fact that these countries frequently have underdeveloped financial sectors. Whereas the risk premium on emerging market debt had been reduced in previous years, the spreads on international bonds widened considerably in the latter part of 1997 (BIS 1998a:125). In June 1997 the average spread was 130 basis points, but this had increased to 375 basis points six months later.[13] The increase in risk premium was higher for Asian countries than for countries in Latin America, reflecting the loss of confidence in Asian development and illustrating Asian countries' problems of acquiring international financial resources.

In the first half of 1998 conditions in the international securities market had stabilized, but in late summer there was a deterioration of investor confidence following the financial problems in Russia and Latin America, and the difficulties of a large American hedge-fund. The main results of the loss of confidence were increased volatility, an enormous increase in the yield of emerging market securities and a market in which only the most highly rated agents were able to attract resources.[14]

[12] In the early part of the autumn the Indonesian authorities had been praised for the policies which they had introduced to tackle the crisis. However a major loss of confidence in both the government and the *rupiah* in the last part of 1997 and the beginning of 1998, amid fears of civil war and national debt default, can explain why Indonesia has become the hardest hit country. Additionally, the flight of "ethnic Chinese capital" was probably of great importance, but it is difficult to get reliable statistics which can confirm this proposition.

[13] For comparison the difference between Norwegian and German interest rate in early December 1998 was 425 basis points.

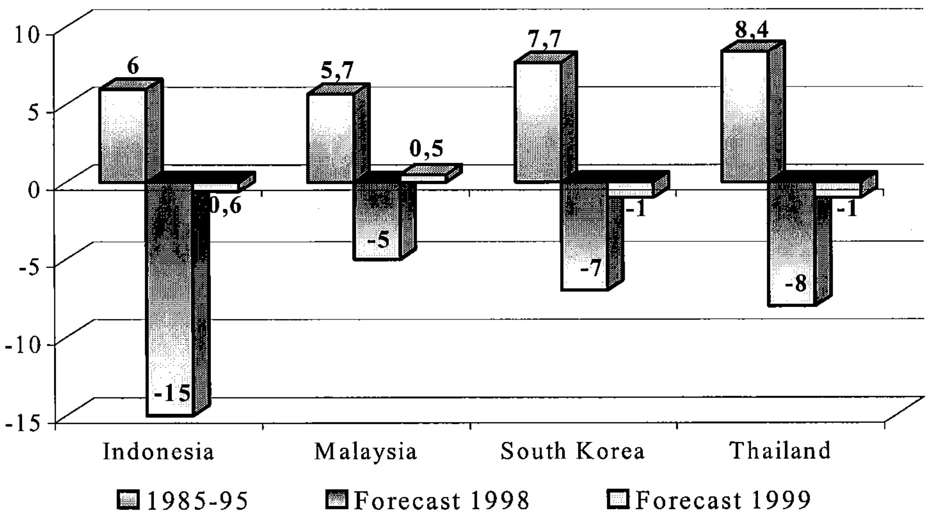
[14] Emerging markets issuances declined by more than 50 per cent, and the spread on some bonds, eg dollar-denominated Russian bonds, increased to more than 6000 points, an all-time-high for an emerging market instrument. Asian, and particularly Latin American bonds, were subject to a multiplication of spreads as well, and the average spread on emerging market papers reached the same level as that recorded at the height of the Mexican *peso*-crisis.

This flight to quality can be seen as a result of international investors' changed perception of the risk inherent in emerging market bonds, and a wish to reduce the portfolio risk which had increased following the turmoil in Asia. Even though the problems of Eastern European and Latin American countries had a very important national dimension, there is little doubt that the outcome has been amplified by the negative experiences in Asia.

3.2 *From financial crisis to economic crisis*

The financial and currency crises have had dire consequences for economic activity, particularly in the countries which have been hardest hit by depreciation and financial sector problems. Whereas economic growth in Thailand and South Korea was among the highest in the world during the period 1990-1996, it is expected that these economies will contract some 7 to 8 per cent in 1998. Perspectives are looking even bleaker for Indonesia where contraction was running at 14 percent in the 4th quarter of 1998. Malaysia, which has chosen to manage without technical and financial assistance from the IMF and in September 1998 introduced exchange controls, has not fared any better than its neighbors. Output contracted by 8.6 percent in the third quarter of 1998 compared to the same quarter the year before.[15]

Figure 3.1. Annual economic growth, 1985-1999.[16]



The financial and currency situation influences the economic activity in a variety of ways. The fall in the value of the local currencies, together with plummeting asset and property values, has resulted in a strong reduction of real income and wealth in East and Southeast Asia. An important effect of this is that consumption and investments have been reduced, which again has hampered aggregate demand and economic activity. This reduction has been exacerbated by a strong outflow of foreign capital.

[15] Source of these figures is The Economist 13.-19. February 1999, which reports the most recent official statistics.

[16] Forecasts are average estimates based on mid-1998 data from the World Bank, the International Monetary Fund, and Goldman Sachs. Compared to the most recent figures, the forecasts seem to be on the optimistic side for Indonesia and Malaysia and perhaps on the pessimistic side for Thailand.

Whereas the net private capital inflow to the Philippines, Indonesia, Malaysia, South Korea and Thailand amounted to 93 billion dollars in 1996, the corresponding figure for 1997 was an *outflow* of some twelve billion dollars. This amounts to a change in net capital inflow of 105 billion dollars, or ten per cent of GDP in the countries affected. This enormous reversal of liquidity has been made all the more serious by the fact that the outflow was concentrated in the latter part of 1997.

Investments may have been further dampened by the interest rate increases which the IMF set as a condition for giving financial assistance. However, short term interest rates have come down to between 6 and 7 percent in South Korea and Malaysia and slightly below 6 percent in Thailand, and are not the major cause of low investment rates any more, except in Indonesia where interest rates are still very high. Bleak market growth prospects have made companies reluctant to invest, and the reduction of liquidity has made some companies, though willing, unable to invest.

Under normal circumstances, a fall in the value of a country's currency boosts competitiveness and exports. However, in several Asian countries the contraction of liquidity was so severe that it was impossible to get export credits and other kinds of working capital even for companies without financial problems. Thus, the depressed situation in the financial sector contributed to a transmission of the problems to well-managed companies, and the potential for increased exports could not be realized due to the constrained liquidity of the financial sector.[17] Despite the fact that exports did not increase as expected, the countries are now running current account surpluses due to a dramatic reduction of imports.

3.3 Limiting contagion and avoiding financial crises

The financial and currency crises in Asia, and their effects on other emerging markets, have led to increased focus on what has come to be called "the international financial architecture," a term attributed to the US Treasury Secretary Robert Rubin. One aspect which has received particular attention is the question of short-term capital flows and capital control. Advocates of capital control claim that the strong capital outflow and subsequent contagion could have been avoided by the introduction of simple capital control measures. Others disapprove and claim that the short-term benefits of capital controls, including increased stability, will be outweighed by long-term deficiencies, including higher borrowing rates, administrative difficulties and costs, delayed restructuring, and competitive distortions.

It is probably the case that once confidence in an economy is gone, capital controls can do little to stem the outflow of capital. Nevertheless, free flows of capital on capital account transactions require a sound and diversified local financial sector, and the capacity to enforce regulations in accordance with international standards such as the recommendations of the Basle Committee. In the absence of such a system, free flow of capital can increase volatility and do a lot of harm. Therefore, financial sector reform and strengthening of the regulatory framework need to go hand in hand with liberalization of international capital flows. This is also reflected in the prominent role

[17] Another reason for the lack of export growth was the fact that several countries competing in the same international markets had their competitiveness improved by currency depreciation at roughly the same time, sterilizing some of the effects of their depreciation.

of the financial sector in the programs which were established in Asia in cooperation with the International Monetary Fund (IMF). Such programs are more directed towards preventing similar crisis to occur in future, than to alleviate the present crisis and limit contagion. Nevertheless, the reforms may also contribute to the restoration of confidence in the present situation, which indeed is an important step towards stabilizing the situation.

In these crisis-ridden countries there is little doubt that deregulation, little experience with the mechanisms of the international capital market, and erroneous perceptions of exchange rate risk contributed to the crisis and the contagion effect. After extensive financial sector difficulties and heavy currency depreciation, Indonesia, Thailand, and South Korea approached the IMF in order to arrange measures which could alleviate the crises and help the countries regain investor confidence. The assistance from the IMF was two-fold. On the one hand the countries were given financial assistance; the IMF brokered rescue packages, consisting of capital from multilateral organizations and other countries. The packages to Indonesia, Thailand and South Korea have a combined value of more than 100 billion dollar. The technical assistance has met with some resistance, particularly in Indonesia and South Korea, but all three countries are now implementing the programs which have been designed in cooperation with the IMF. The greater willingness to implement these programs is a result of political changes at the national level, as well as greater flexibility on IMF's part. The programs were initially heavily criticized particularly for their failure to recognize the depth of the economic crisis and its social consequences. They were therefore modified and the austerity measures were relaxed somewhat.

Morris Goldstein (1998), of the American "think-tank" *Institute for International Economics*, has suggested five issues which should be emphasized in connection with reforms aimed at alleviating the shortcomings of the international financial system:

- Reducing moral hazard and making private debt rescheduling more orderly and more flexible;
- Strengthening prudential standards in developing countries and making it more attractive for countries to implement these standards sooner;
- Improving transparency and disclosure in financial markets;
- Giving IMF surveillance more punch;
- Shoring up risk management in global financial institutions.

These changes will not constitute a fundamental reform of the international financial system, but can be seen as a way of increasing transparency and reducing risks without changing the system. More radical commentators have suggested the introduction of a tax on capital transactions, often called a Tobin-tax, as a means of increasing the stability of international financial markets, or introduction of other types of control on short-term transactions.

3.4 Political implications

The financial and economic turmoil in East and Southeast Asia has resulted in political changes in all the countries affected by the crises. A good analysis of the political economy and political implications of the turmoil is given in Tønnesson

(1998). However, it may be fruitful to give a brief introduction to the political development in the countries most adversely affected by the crises:

- Thailand was not only the first country to be hit by the financial crisis, it was also the first country where there was major political change. In the autumn of 1997 General Chavalit was forced to resign, and his government, by many viewed as corrupt and responsible for the current problems, was replaced by a coalition government led by Chuan Leekpai. This government has subsequently proved to be extremely willing to conform to the demands of the IMF. However, in the autumn of 1998 lacking support in the parliament forced the government to postpone some basic legislation, including a new bankruptcy law which would have facilitated the restructuring of the economy.
- In South Korea a former dissident, Kim Dae-Jung, won the presidential election rather surprisingly, partly because the voters preferred a leader who could not be linked to the adverse development.
- In Indonesia the political and economic development can not be separated in an analytical context. The loss of confidence which the country fell victim to was based as much on political and ethnic as economic factors. It remains to be seen whether the apparent "shift of power" from former President Suharto to the current President Habibie, one of his proteges, is anything more than window dressing.
- The situation in Malaysia is also difficult to assess, as the Umno are still in power, as they have been since the 1950s. However, the crown-prince of the party, former deputy prime minister and finance minister Anwar Ibrahim, was ousted from the government in early September 1998 and later arrested. Despite the complexity of this case, which currently lingers in the Malaysian judiciary, there is little doubt about the fact that there were serious policy differences between Mr. Anwar Ibrahim and the Prime Minister, Mahathir Mohammad, in the period leading up to the exclusion. The crisis has led to a strengthened position for two established opposition parties.

It is difficult to foresee the long term impact of these political changes, partly because it is not yet clear whether several of the changes are real reforms, or whether they are "window dressing" designed to silence an increasingly vocal opposition. Tønnesson (1998) notes that crises are often followed by reforms, but that insufficient reforms may lead to new crises. He emphasizes the fact that the crises, in a regional security perspective, have led to a shift of power from the non-Chinese to the Chinese states and an affirmation of the United States, power in economic questions.

4 The effect of the crises on selected development partners

The countries included in this study, South Africa, Mozambique, Tanzania, Zambia, Uganda and Bangladesh are no strangers to crises. Mozambique, Tanzania and Zambia have had more or less permanent balance of payment problems since the 1980s. Economic development in these countries is held back by local bottlenecks such as weak institutions and lack of infrastructure. Furthermore, the share of rain-fed agriculture in GDP is so large that variations in income over time largely reflects variations in weather conditions. These countries have simply not entered a stage of development characterized by sustained economic growth. In fact, GDP per capita is about the same now as it was in the 1960s, and transactions with outside markets are largely confined to trade in basic goods, aid transfers and remittances from workers abroad. Furthermore, the financial sector is in such a state that the market for long-term credit is all but non-existent. In such a situation the consumption and production decisions can often not be separated, and investment for future capacity extensions is funded from retained profits.

Our analysis shows that economic and social development in Mozambique, Tanzania, Uganda and Zambia are determined by local conditions and aid flows while the Asian crisis has only a marginal impact. To illustrate the point, the Budget Speech made by the Minister of State President's Office in Tanzania in June 1998 mentioned weather conditions in most sections of the speech, while the Asian crisis was not mentioned with one single word. Mozambique is in the midst of a strong, donor-supported recovery after decades of war. Its development is fragile and dependent on aid and good relations to South Africa for still many years to come. Bangladesh does not have strong trade linkages to South East Asia in spite of its location. Neither is it integrated into international financial markets. South Africa is about to reenter the global economy and is the only country in this sample that is significantly affected by the currency crisis in Asia. In addition the development in South Africa has an impact on its SADC partners and perhaps to a marginal extent also on Uganda.[18] Therefore, the impact of the Asian crisis on South Africa is discussed at some more length than the other countries.

We start the analysis by looking at each of the three types of crises, the channels through which they might affect the countries in our study, and rough estimates of the magnitude of the impact. It is shown that the direct impact is small. We then go on to look at each country in more detail in order to explain why the impact is relatively small.[19]

4.1 The currency and financial crises

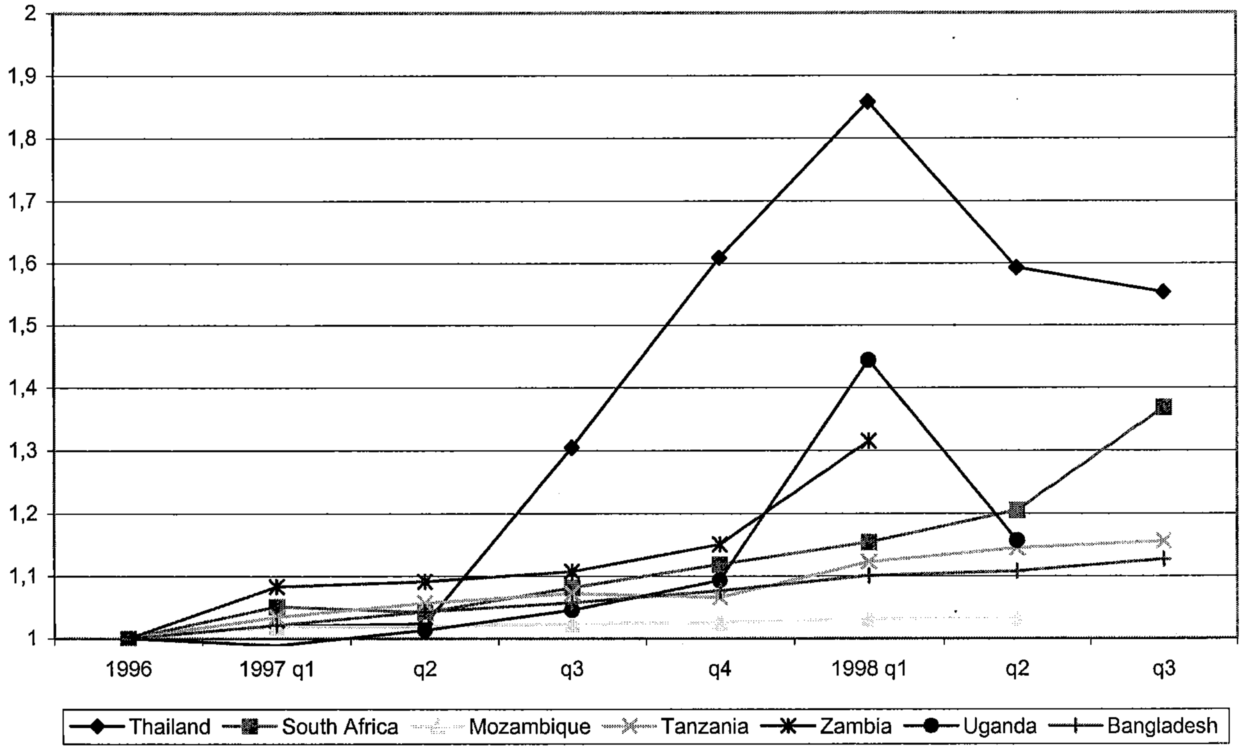
With the exception of South Africa, the countries in this study receive very little inflows of private portfolio investments, or private, foreign loans. By the end of 1996, the six countries' combined external debt to private creditors was about 18 percent of Thailand's debt, and of this, South Africa accounted for more than 90 percent (BIS 1998). Moreover, out of the six countries in the sample, only South

[18] SADC is the Southern Africa Development Community, a regional trade block which aspires to become a common market, but has a long way to go before that becomes a reality.

[19] There appears to be some symmetry in the situation in the sense that unprecedented growth in the East Asian countries did not spill over to the least developed countries in Africa and neither did the financial and economic crises.

Africa has a currency that is convertible on international markets. Therefore, the exchange rate of the currencies of these countries are determined by local demand for and supply of foreign exchange. These are in turn mainly determined by trade and aid flows, and to some extent other transfers such as remittances from workers abroad. Financial turmoil far afield has little impact on this market. As expected, none of the countries in question has had a currency crisis anywhere near the Thai baht crisis, which in turn is the mildest of the currency crises in the four countries discussed in section 2. Figure 4.1 depicts the exchange rate indices for the six countries compared to Thailand, and 1996 is chosen as the base year.

Figure 4.1 Exchange rate indices



Source: IMF 1998

The financial crisis in Asia has led to higher risk premiums and consequently higher interest rates in emerging economies. High interest rates discourage outflows of footloose capital, but also dampens investment and economic growth. However, in the countries included in this study, there is little footloose capital ready to flee as confidence in emerging markets decline. Even in South Africa, foreign portfolio investment has been moderate and capital control has prevented large amounts of local savings from fleeing the country. Nevertheless, the South African reserve bank had to raise the discount rate sharply from 15 percent in April 1998 to 18 percent in

May and further to 20 percent in June 1998.[20] The other countries included in this study mostly borrow internationally on IDA terms, and neither local nor external interest rates are affected by the turmoil in international financial markets.

A possible effect in the medium term of the financial turmoil in Asia is a reduction of funds from multilateral donor agencies such as the IMF and the World Bank. Since the total amount of development aid is limited, an increase in multilateral aid flows to crisis-ridden Asian and Latin American countries reduces funds available to other areas. It is, however, doubtful that this will hurt the least developed countries. In the longer run, if the Asian crisis leads to a more cautious attitude to emerging markets, the poor developing countries' access to global financial markets may be delayed.

4.2 The economic crisis

The economic crisis can be traced in all the countries included in the study, albeit to a different extent. The most important channels for the spreading of the crisis are trade, including changing terms of trade, aid, and remittances from workers abroad. Table 4.1 presents key figures that illustrate the linkages of the countries in our study to the Asian economies and exposure to the world markets.

Table 4.1 Basic indicators

	South Africa	Mozambique	Tanzania	Zambia	Uganda	Bangladesh
Growth 1990-97	1.5	6.9	2.9	-0.5	7.2	4.5
Growth 97	1.7	7.9	3.3	3.5	5.2	5.9
Interest rate	16	Na	16.2	17.7	14	8
Current account/GDP	-1.5	-29	-7.9	-6	-4	-3.1
Exports/GDP	28	26	22	30	11	16
Ow to Asia	12	11	28	30	3	8
Imports/GDP	26.8	70	33	21	26	24
Ow oil	9	11	16	13	7	6
Net current transfers	-143	283	317.5	Na	620	1909
Development aid	361 (0.3)	923 (72)	894 (30)	614 (19)	684 (12)	1255 (4.5)
Foreign debt	23 389	5781 (443)	6380 (100)	Na	3564 (64)	16569 (63)
Long-term	14284	5299	Na	Na	3054	15713
Short-term	9105	281	Na	na	93	186
Gross reserves	6000	517	622	239	633	1609
Foreign direct investment	1705	35	250	70	250	145

Growth is given as percentage change over the previous year. The interest rate is the nominal discount rate. Current account, exports and imports are given as percentages of GDP, current transfers in millions of dollars, development aid (ODA) as mill. USD and percentage of GDP in brackets, foreign debt, reserves and FDI are given in millions of USD (percentage of GDP in brackets) . Figures are from 1995 on development aid, otherwise from 1996 or 1997.
Sources; IMF, World Bank, EIU, Bank of Tanzania, South African Reserve Bank

[20] This reversed the gradual loosening of monetary policy which had been implemented from the fourth quarter of 1997. Tight monetary policy was introduced in order to defend the exchange rate of the rand during the currency crisis in 1996.

Note Mozambique's precarious external position. The current account deficit is funded by development aid, and to some extent foreign investment, mainly from South Africa. Note also that in spite of its location, Bangladeshi exports to Asia are relatively small.

4.2.1 Trade and terms of trade

Starting with trade, there is a direct impact of the economic crisis in Asia stemming from lower demand for industrial raw materials in the crisis-ridden countries and improved competitiveness of Asian exports due to currency devaluation. Obviously, the countries with the closest trade links with Asia and the countries that compete directly with Asian goods in the world market, or in their own home markets are those most affected. In our sample Zambia, Tanzania and South Africa have the largest share of their exports going to Asia. Their major exports are agricultural raw materials, metals and minerals. South Africa and Bangladesh are the only countries in the sample with an industrial sector that competes directly with Asian goods in their own home market and in the most important export markets which are the SADC region for South Africa and the OECD markets for Bangladesh.

In spite of the sharp decline in the exchange rate of the crisis-stricken Asian economies, they have apparently not been able to exploit the improvement in competitiveness. Exports increased by only 9 percent in dollar terms in South Korea and 1 percent in Indonesia between the first quarters of 1997 and 1998 (IMF 1998), while exports declined in dollar terms to the tune of 2.5 percent in Thailand during the same period of time. For comparison, Mexican exports increased by 24 percent from 1994 to 1995 following the Mexican currency crisis. This difference in adjustment to the currency crisis has at least three reasons. First, the import content of Asian exports is high so that the improvement in competitiveness is smaller than the depreciation of the exchange rates suggests. Second, a potential increase in exports is constrained by a liquidity squeeze or credit crunch. Third, while Mexico's major export market was a booming US economy in 1994, the major export market of the Asian countries is a depressed Japan. Therefore, the major impact of the Asian crisis on international trade as yet is the decline in imports to Asia.

When the credit crunch eventually eases in Asia, Bangladesh and South Africa are the countries among those included in this study which are most affected by increased competition. Bangladesh will face increased competition in the world market for its textile exports, while South Africa will face increased competition in its own home market and the SADC region. Both South Africa and the SADC as a whole are in a process of scaling down import protection. The trade liberalization policy was designed to allow for gradual adjustment to increased competition. However, a combination of the sharp depreciation of the Asian currencies towards the US dollar and the South African policy of defending the exchange rate of the rand towards the dollar could lead to "shock therapy" for local industries rather than the gradual approach envisaged a few years ago.[21]

A rough estimate of the direct impact of a slowdown in import demand in Asia for the six countries is shown in table 4.2. The figures include all Asia, and between the

[21] Even the gradual approach envisaged by the government led to massive protests both from the business community and the trade unions in South Africa.

second quarter of 1997 and the second quarter of 1998, imports to Asia declined by about 15 percent in dollar terms.[22] Another effect of the crisis in Asia is a change in terms of trade. Since the countries in our study's main exports are commodities, they are largely affected by changes in commodity prices. The world market commodity prices have declined by about 20 percent in dollar terms on average from November 1997 to November 1998. This average conceals large differences among commodities. Coffee, for example, has seen a smaller decline than average, and coffee is the most important exports of Tanzania and Uganda. Oil, on the other hand, has seen a year on year drop in world market prices of 43 percent. How much of the changes in commodity prices can be attributed to the Asian crisis is difficult to say. 1998 has seen extreme weather conditions, increased supply of oil, and an escalating economic crisis in Russia, which also have contributed. Besides, the declining trend started in 1996, before the Asian crisis. It is therefore beyond the scope of this study to come up with precise numbers on the linkage between terms of trade, the Asian economic crisis and income in the six countries included in our study. All the countries in our study are net importers of oil. Estimates of the savings due to lower oil prices and the direct effect of a decline in import demand in Asia are given in table 4.2. The figures are given as percentages of GDP.

Table 4.2 Impact on GDP of reduced export demand in Asia and lower oil prices

	South Africa	Mozambique	Tanzania	Zambia	Uganda	Bangladesh
Exports	- 0.5	- 0.4	- 0.9	- 1.4	-0.05	-0.2
Oil	1.0	3.3	2.3	1.2	0.8	0.6

The table indicates that the drop in import demand in Asia shaves half of a percentage point off GDP in South Africa, while the decline in oil prices saves South Africa one percentage point of GDP in imports of oil. The full impact of changing terms of trade and indirect effects due to changes in import demand in the rest of the world are not taken into account here. Nevertheless, table 4.2 suggests that the net impact of the economic crisis in Asia on the countries included in the table is small. In Mozambique, the gain from lower oil prices are so much higher than the loss of export revenue due to lower import demand in Asia, that the net effect is probably positive. For the other countries in the sample, the gain from lower oil prices is probably not sufficient to counterbalance lower import demand (included in the table) and deteriorating terms of trade (not included in the table), and the net effect is likely to be negative. Zambia appears to be the country most adversely affected through the trade channel.

A second round of more indirect trade-effects of the Asian economic crisis on poor countries could occur if lower demand in Asia takes its toll on OECD exporting industries. An indication of this happening came when Boeing, the largest manufacturer of airplanes in the world announced layoffs of workers due to the Asian crisis. The fact that individual export-oriented companies have to scale back production does not necessarily affect total demand in the OECD significantly, however. In fact, OECD growth appears to have been little affected by the Asian crisis. An expected downturn in the US economy is more related to normal business

[22] Reliable figures for each individual Asian country are not available. Estimates of the direct impact of the Asian crisis through the trade channel are made by the authors based on figures in table 4.1.

cycle fluctuations and a stock market bubble that might burst, than to the Asian crisis. Nevertheless, a cyclical downturn in the US on top of the Asian crisis may increase the probability that the economic problems in Latin America, particularly Brazil, turn into a serious crisis and then affects poor developing countries through the trade channel.[23]

4.2.2 Foreign investment

The downturn in commodity prices and loss of confidence in emerging markets coincided with liberalization of investment policy and privatization in countries such as Zambia, Tanzania and Uganda. The expected inflow of foreign investment to these countries following liberalization may be postponed due to the Asian crisis. On the other hand, if depressed prices are perceived to be temporary, commodity-based companies that are listed on the stock exchange have become a bargain for foreign investors. Allowing foreign acquisitions of commodity-based companies under such circumstances may create political problems for the liberalization process.

Low commodity prices have led to restructuring in multinational commodity-based firms. There is at present a wave of mergers and acquisitions, particularly in the petroleum sector. In such a situation it may be difficult for smaller, national, independent commodity-based companies to survive. Two of the major commodity-based companies in South Africa have adjusted to this reality by moving the primary listing to the London Stock Exchange (Gencor and Anglo American).[24] Both the South African multinationals are big enough to enter the FTSE 100. They now have to follow FTSE accounting and disclosure standards which in turn reduce the risk premium on the capital they raise in OECD credit markets. The London listing thus facilitates the companies' further expansion in the world markets while focusing on their core businesses.

The exodus of South African multinationals had probably taken place even without the Asian crisis, and should be seen as part of the ongoing globalization process. The companies may by this move become vehicles for international capital flows, the transfer of technology, and integration into the world markets that will benefit South Africa in the long run. This is indeed the way South African authorities see it, and they did not oppose Gencor and Anglo American's move.

We have now seen that the Asian currency and financial crisis has had no discernible impact on Mozambique, Tanzania, Zambia, Uganda and Bangladesh, while it has contributed to higher interest rates and slower economic growth in South Africa. The *economic* crisis in Asia, on the other hand, has had a negative impact on exports in all the countries concerned. The economic crisis has also contributed to changes in terms of trade, but whether positive or negative for each individual country remains to be seen. For Mozambique, the net impact of the economic crisis in Asia may well be

[23] Brazil recently accepted a rescue package from the IMF in order to prevent further capital outflows and a devaluation of the currency. This package only postponed the currency crisis which materialized in mid January 1999. Economic growth slowed down to –0.1 percent in the third quarter of 1998, while industrial production declined by 6 percent in September compared to September 1997. Brazil is at the moment in recession and has to take bold measures in order to shore up its public finances.

[24] Gencor was split up and a new company, Billiton, was formed from previous divisions of Gencor and listed in London. Anglo American, the largest company in South Africa, is currently in the process of listing in London. In addition South African Breweries, one of the largest breweries in the world, has listed in London, and Old Mutual, an insurance company, plan to do the same.

positive, while for the other countries in the sample, the impact is probably slightly negative. The next section takes a closer look at each country in the sample and analyzes the fundamentals that determine to what extent the countries are influenced by turmoil in the world economy.

4.3 Fundamentals in individual countries

4.3.1 South Africa

South Africa has had a sound and relatively sophisticated financial system for decades. The Reserve Bank (the country's central bank) was established in 1921 and has a relatively high autonomy in running the monetary policy of the country. Its major policy objective is to protect the value of the South African currency; e.g. an exchange rate target. Nevertheless, South Africa has a floating exchange rate, and the Reserve Bank's major task is to avoid short-term volatility (Stals 1998). South Africa's bank regulation and supervision are based entirely on the recommendations of the Basle Committee (Stals 1998).

In the context of the Asian crisis, the financial sector's level of development constitutes a very important difference between South Africa and Asia. The Asian tigers started out on their unprecedented growth path with a weak financial sector and regulatory framework. Furthermore the financial sector, its regulatory framework and the institutions that were supposed to enforce regulations were not significantly improved during the period of rapid growth. In contrast, South Africa was founded on an, at the time, strong and sophisticated financial sector. The mining houses that established the modern South African economy were, and still are, in essence financial companies. During the decade of stagnation in the South African economy preceding the 1994 elections, the financial sector was largely kept intact. Thus, while the financial sector and regulatory framework were lagging behind the general economic development in Asia, it was ahead of the general economic development in South Africa.

This difference probably explains why the currency crisis that struck in South Africa in 1996 and again in 1998 did not trigger a financial crisis. In addition, South Africa was no stranger to currency crises and capital flight and had gained experience in handling such situations. As sanctions against South Africa were stepped up during the early 1980s, both short- and long-term capital fled the country during a relatively short period of time. South Africa had little access to international financial markets during the sanctions era. Moreover, it had to repay much of its outstanding debt faster than the initial borrowing conditions indicated. South Africa therefore had to run a surplus on its current account on the balance of payment and never had much opportunity to build up reserves. The South African balance of payment situation thus resembled the development the Asian countries have gone through, but for very different reasons, and with different consequences.

After sanctions were lifted in 1993, the credit constraint on South Africa was eased substantially, and the current account turned into deficit from 1994 onwards. The South African authorities took a very cautious stand on the reintegration into the world financial markets. They were aware of the large distortions that had developed during the sanctions period. Therefore, exchange controls were lifted only gradually. Controls were first removed on transactions on the current account of the balance of payment (e.g. transactions related to trade and transfers). The second major step was to lift control on foreign residents' transactions on the capital account. The remaining control for the time being is on South African citizens' transactions on the capital account of the balance of payment. Apparently, local citizens are seen as a greater danger to financial stability than foreigners. In South Africa this is partly because South African migrants' savings in South Africa exceed South Africa's foreign reserves. Again the balance of payment situation resembled the Asian case, but while South Africa took precautions to stem the outflow, Asia did not.

South Africa experienced a currency crisis in 1996 when the currency depreciated by about 20 percent. The market had just recovered from the 1996 crisis, and monetary policy had started to ease when the contagion effect of the Asian crisis struck. The policy response in both cases was a tightening of monetary policy i.e. an increase in interest rates in order to defend the exchange rate. The interest rate hikes were nevertheless nowhere near the first response in Asia. Because of the much sounder financial situation, the dose of austerity measures needed to stabilize the situation and restore confidence was much smaller in South Africa. As the economic fundamentals such as the sound financial sector, moderate levels of debt and a reasonable internal and external balance again came to the fore, the exchange rate reclaimed much of lost territories. Furthermore, after having been put on Moody's watch list for possible downgrading, South African bonds eventually maintained their rating.[25]

The South African economy has nevertheless stagnated over the past year. The slowdown and stagnation have undoubtedly been worsened by the contagion effect of the Asian crisis, but South Africa's major problem is that the economy never really took off after the first euphoria following the multiparty elections. The economy still suffers from structural problems inherited from the apartheid years, where the most serious problem is the substantial mismatch between the skill- and productivity level on the one hand and the wage levels and industrial structure on the other (Nordås 1996). This state of affairs renders South African companies uncompetitive in international markets and constitutes an obstacle to growth. The policy strategy that was designed in order to foster competitiveness, stimulate growth, foreign investment and exports, was a gradual easing of monetary policy, liberalization of trade and international capital flows and a tight fiscal policy. The currency crisis jeopardized this strategy. Monetary policy could not be eased, due to higher import inflation, while the other policy measures remain in place leaving the overall policy stance very tight. Thus, the Asian crisis did not cause South Africa's economic problems, but it has limited South Africa's ability to address the problems through the easing of macroeconomic policy.

The South African experience underscores the points made in section 2, namely that a currency crisis does not have to develop into a financial and economic crisis if the fundamentals both at the macro and the firm level are sound in the first place.

[25] Moody's is a credit rating agency which has given South Africa the lowest investment grade. Standard and Poor, another credit rating agency, has only given South Africa a credit rating.

4.3.2 *Mozambique*

Mozambique started its recovery in 1993 after a prolonged war. Growth has continued unabated so far in 1998, mainly driven by domestic dynamics, foreign investment in mega-projects and substantial transfers of foreign aid. Mozambique has very close economic relations with South Africa. It is the most important trading partner, source of foreign investment and source of remittances from workers abroad. South African companies have featured prominently in new investment and development initiatives such as the Maputo corridor, and a huge aluminium smelting plant is being built. The potential impact on Mozambique of the Asian crisis is therefore mostly an indirect impact through links to South Africa.

Mozambique's encouraging development since 1993 has gained momentum and the flow of foreign funds from donors and South African investors has continued unabated in spite of turmoil in international markets and the stagnation in South Africa. Mozambique's great potential as a tourist destination, source of energy to regional markets, notably South Africa, and the country's enabling policy environment have overshadowed the general negative sentiment about developing and emerging markets. Thus, as long as South Africa avoids a credit crunch, which it most likely will, the investment inflows will probably continue.

The dominance of foreign inflows as a source of development funding in Mozambique is, however a cause for concern. There is the danger that Mozambique will experience the same as Latin-America and South East Asia has experienced before. Rapid growth fuelled by large inflows of foreign funding, a huge current account deficit, rapid accumulation of debt, even though it is on concessionary terms, constitute the ingredients of a looming crisis. Since the debt is denominated in hard foreign currencies, there is a danger that it can not be serviced when the economy inevitably reaches a stage where the recovery and catching up phase has run out of steam. Hopefully both local authorities and donors will pause to ensure that an "Icarus" scenario is avoided.[26]

To summarize, Mozambique is probably the country in our sample least affected by the Asian crisis, since its development is overwhelmingly driven by local dynamics and flows of donor money. Mozambique may, however, draw the lesson from the Asian crisis that capital inflows, from whichever source, should be scaled to the country's absorption capacity in order to avoid serious setbacks further down the line.

4.3.3 *Tanzania*

Tanzania has a floating exchange rate regime, but the currency is not convertible outside the East African Community (Tanzania, Kenya and Uganda). The exchange rate is therefore mainly determined by the supply and demand of foreign exchange in the local market, which in turn depend on trade flows and transfers and loans from donors and others.

Tanzania's exposure to the world market is somewhat higher than the average for low-income countries (see table 4.1 above). The main exports are agricultural-based commodities and minerals. Anecdotal evidence indicates that the mining sector has

[26] Icarus flew so high that he got his wings burnt by the sun and crashed to the earth.

been booming for several years, and it is widely believed that the sector is not fully captured by official statistics. If so, this can explain that the Tanzanian shilling was fairly stable in nominal terms and appreciated in real terms over the past year (Bank of Tanzania 1998) in spite of a recorded worsening of the trade balance to the tune of 88 percent during the first quarter of 1998 compared to the same period in 1997.

The increased balance of trade deficit in 1998 had little to do with the Asian crisis. The reason was rather a dramatic decline in export volumes due to bad weather conditions in 1997 on the one hand and a sharp increase in imports on the other hand (Bank of Tanzania 1998, Republic of Tanzania 1998).

Tanzania's outstanding foreign debt constitutes about 100 percent of GDP, but most of it is public sector borrowing on concessionary terms. Only 3.9 percent of total debt were owed by the private sector (Bank of Tanzania 1998). This reflects the fact that Tanzanian private companies have very little access to international financial markets and are consequently little affected by turbulence in the international financial market. International credit to Tanzania has declined during the period June 1997 –June 1998, and is back to the level of the early 1990s. The decline is, however, a result of donors' impatience with the slow pace of reforms in Tanzania. Finally, FDI has actually increased substantially over the past few years due to the combined effects of liberalization of external and internal markets and the lifting of sanctions against South Africa, which is by far the largest foreign investor in Tanzania. At present, South African companies dominate the breweries sector, the financial sector and the mining sector in Tanzania.

4.3.4 Zambia

Zambia is the country besides South Africa in our study which is most affected by the Asian economic crisis. Zambia is affected directly through the copper market where depressed demand and prices have resulted in a decline in export revenue. However, Zambia is probably also the Southern African country that has been hit hardest by the El Nino weather conditions. It is therefore difficult to isolate the effect of the Asian crisis on Zambia.

The decline in copper prices has rendered the copper mines less attractive to private investors, and may be one factor that has led to the slow progress in the planned privatization proceedings. Politicking is, however probably even more important and the issue is souring the relations between the Zambian government and donors (EIU 1998).

Zambia recently finalized trade negotiations with the Southern African Customs Union (SACU). The agreement needs to be ratified by the member countries of SACU, which may take some time. Nevertheless, Zambia is posed to benefit from free access to the SACU, particularly the South African market. In the short run, however, the depreciation of the South African rand and lower demand in South Africa, partly as a result of the Asian crisis, will postpone the benefits from the trade agreement.

The Zambian economy would be in deep trouble even in the absence of the Asian crisis or bad weather conditions. It is affected by the conflicts in the region, a situation that scares off foreign investors. Political conditions and lack of willingness or ability to implement reforms have led to a sharp decline in donor funding, which has probably contributed to the deteriorating exchange rate at least to the same extent as the Asian crisis. Finally the the ZCCM-operated copper mines are in dire straits and output has declined dramatically due to lack of investment and neglect of maintenance for a long period of time.

4.3.5 Uganda

The Ugandan economy was devastated after wars and decades of mismanagement when a recovery program was introduced and supported by the IMF in 1986. With a few setbacks, the economy has recovered steadily, and economic growth has averaged 7.2 percent during the period 1990-1997. This is close to the emerging market growth rates and an outstanding performance in an African context. The country is, however, still a low-income, rural economy with a very small industrial base. Its degree of integration with the world economy is even smaller than the average for low-income countries as table 4.1 shows.

Recovery has depended strongly on donor funding of imports - the share of imports that is funded by export earnings has in fact declined steadily during the recovery process. In this respect Uganda's development is similar to that of Mozambique, and the same warnings apply to the future development of Uganda. Thus, if growth slows down or the currency depreciates significantly, the accumulated debt, which has tripled from USD 1.2 bill. in 1986 to about USD 3.6 bill. in 1998, or close to 60 percent of GDP, increasingly becomes a drain on the Ugandan economy. The debt burden is in fact already unsustainable and Uganda has benefited under the World Bank's heavily indebted poor country initiative.

Threats to the Ugandan economic development in near future comes from escalating conflicts in Congo, where Ugandan forces are involved, and the activities of rebel forces within Uganda rather than the Asian crisis. This situation represents a drain on local economic resources, it disrupts regional trade and it scares off foreign investors.

4.3.6 Bangladesh

Bangladesh has had an average growth rate of 4.5 percent during the 1990s, with higher growth rates the last couple of years. This has been achieved with a reasonably sound balance of payment position and reasonably stable prices, but the government budget deficit has been high as a share of GDP and the investment rate has been low. Further improvement in the economic situation is held back by political instability and bottlenecks in infrastructure, particularly shortages of electricity, which in turn is a result of the low investment rate.

This year, parts of the country have been devastated by floods during the same period of time as the Asian economic crisis struck. Therefore, it is difficult to isolate the impact of the Asian crisis. What appears to be the case, however, is that the crisis has had little effect. Bangladesh has low levels of short-term foreign debt, and it has exchange controls. The exchange rate regime is a crawling peg exchange rate which allows it to adapt to changes in terms of trade and competitiveness. Nevertheless, it has not kept up with the sharp depreciation of the East Asian currencies and

Bangladeshi manufacturing industries potentially face increased competition, particularly in the textile industry. However, as mentioned above, East Asian industries have not been able to exploit their improved competitiveness due to credit constraints. Hence Bangladeshi manufacturing output has continued to grow during 1997 and 1998 to the tune of about 8 percent in real terms (EIU 1998).

Bangladesh's major export markets are the United States and Europe, which still show considerable growth. The Asian economic crisis will consequently not affect Bangladeshi exports much unless it leads to a sharp decline in growth performance in the OECD.

FDI flows to Bangladesh has slowed down in 1998, and this is attributed to the Asian crisis (EIU 1998). However, political instability and hurdles over exploration rights and FDI in the energy sector probably contributed as well. Finally, remittances from workers abroad constitute a large share of total transfers on the current account of the balance of payment. Bangladeshi workers are employed in the Middle East and South East Asia to a large extent. As the Asian economic crisis deepens and oil prices reach new lows, foreign workers are the first to go both in Asia and in the Middle East. Remittances from workers abroad may slow down significantly as a result. So far, however, there are few signs of a decline in remittances.

5 Conclusions and lessons from the Asian experience

Both the recent financial crisis in Asia and the more or less permanent balance of payments and debt crises in Africa south of the Sahara illustrate the dangers of encouraging more inflows of foreign funds than what can be productively employed in the local economy. How much resources can be productively employed in turn, depends on the extent and quality of local institutions, infrastructure and human capital. These assets are complementary to foreign capital, and the return on the latter depends on the quantity and quality of the former. Thus, when human capital accumulation, a regulatory framework and macroeconomic policy, failed to keep pace with capital flows, the economy was destabilized and vulnerable to external shocks and changes in sentiment.

The policy responses to a crisis are usually directed towards two interdependent objectives, namely the restoration of confidence and the restoration of economic fundamentals. However, the policy response appropriate for shoring up confidence in order to prevent a crisis from escalating, are not necessarily the same as the policy responses appropriate to restore fundamentals when the situation has turned into a full-blown economic crisis. To illustrate the point, if a vehicle is accelerating towards a cliff, the appropriate measure is to step on the breaks. Once the vehicle is over the cliff, the appropriate measure is rather to try to keep steerage way and opt for a soft landing. Sometimes it is difficult to know exactly when the vehicle is over the cliff. In the Asian case, the brakes were tried first. This had proven successful in previous crises such as the Mexican crisis in 1994 and in South Africa in 1996. In the Asian case, it was realized after a while that the economy was already over the cliff and a looser macroeconomic policy was tried. The situation now appears to be stabilizing in Asia, but it is too early to draw any conclusions regarding which crisis management strategies worked and which did not .

The lessons of relevance to the developing countries included in our study and donors that can be drawn from the crisis are the following:

- Large current account deficits over an extended period of time are not compatible with sustainable economic development;
- Fixed nominal exchange rates over a long period of time cause trouble when the rate of productivity growth and the rate of inflation differ between the countries which have fixed rates towards each other;
- Institutional development needs to go hand in hand with economic development. A sound financial sector and regulatory framework around it are of particular importance;
- It is much easier to prevent than to handle a crisis;
- International financial institutions proved incapable of preventing or even predicting the crisis.

The high-performing Asian economies have been held out as an example of successful development by multilateral development agencies, scholars and others. Their success has been attributed to export-orientation and openness, high savings rates and a relatively high level of human capital, while institutional weaknesses have largely been overlooked. Hopefully, the Asian crisis will lead to increased focus on institutional development, particularly in the interface between local and international financial markets. And hopefully openness to international trade and investment is still seen as a key to economic development as long as it is combined with sound macroeconomic management and sound business management. In practice this means that the leverage in private businesses, the government deficit and the current account balance (net of aid transfers) should be kept at sustainable levels and that exchange rates should under normal circumstances be flexible enough to adjust to external shocks in order to ensure that the exchange rate is not allowed to drift way out of equilibrium.[27]

[27] During periods of hyperinflation, there is a case for fixing the exchange rate in order to stabilize the economy. Brazil is a good example that this has worked, and also a good example that the exchange rate should be allowed to adjust once stability has been achieved.

Appendix

Currency crisis →financial crisis → economic crisis

A recent IMF study by Agenor and Aizenman (1998) explains the contagion effect by imperfections both in the local and the international financial markets. The typical situation in many of the Asian market economies is that local banks borrow on the international capital market at a premium reflecting the country risk, and lend to local customers at a premium reflecting the risk of default and the cost of enforcing the lending contract.[28] The local customer is typically a firm that borrows for both investment and working capital. The profits and the productivity of firms depend on a number of factors, some of which are volatile and beyond the control of the local firm. Increased volatility in any such variable may increase the probability of default on loans, since increased volatility implies that a very bad state of nature may last for long enough that the firm can not recover its costs. Examples of increased volatility that may have such an effect is the switch from a fixed exchange rate regime to a floating exchange rate regime, which happened in Thailand in July 1997. This financial market event may trigger the following adjustment process:

- The value of the foreign debt in terms of the local currency increases;
- Local banks increase their lending rates to local firms because of an increased risk of default;
- Local firms' operational costs increase further, and production is scaled back and workers laid off;
- Local banks may incur losses that affect their ability to service foreign loans;
- The risk premium local banks pay on the international capital market increases;
- This triggers a third round of increases in local interest rates;
- The increased risk premium in international capital markets does not only apply to the bank that is actually in danger of defaulting, but also other banks perceived to be in much of the same situation in the country first affected and in similar countries.

Agenor and Aizenman (1998) show how the degree of integration with the international capital market affects the real effects of increased volatility. Countries with a small degree of integration and high risk of default at the outset, pay a high, perhaps even prohibitive risk premium and are not much affected by a higher degree of volatility. In our study, Mozambique, Tanzania, Zambia, Uganda and Bangladesh fall into this category. Conversely, countries with a high degree of integration into international capital markets are perceived to have a risk of default close to zero. If they are perceived as having zero or very low risk of default even after the increase in volatility, their risk premium is still low or nil and increased volatility in the financial markets has little effect on the real economy. Countries most affected by increased volatility are those on the verge of being fully integrated into the international financial markets. They pay a risk premium small enough to sustain significant capital flows under normal circumstances. Increased volatility in these cases may increase the probability of default significantly and hence the risk premium. The impact on the real economy follows from higher costs of borrowing and higher costs of enforcing lending contracts. The latter effect stems from the fact that it is more difficult to distinguish good investment projects from bad ones in a volatile market.

[28] Indonesian companies borrowed directly in the world financial markets to a significant extent.

Literature

Agenor, P.R., 1997, "Borrowing risk and the tequila effect," IMF working paper 97/86, July, Washington: IMF.

Agenor, P.R. and J. Aizenman, 1998, "Contagion and Volatility with imperfect credit markets," *IMF staff papers,* vol. 45, no. 2, June, pp. 207-235.

Bank for International Settlements, 1996, *International Banking and Financial Market Developments*, Basle: Bank for International Settlements.

Bank for International Settlements, 1998a, *68th Annual Report – 1st April 1997 – 31st March 1998.* Basle: Bank for International Settlements.

Bank for International Settlements, 1998b, *International Banking and Financial Market Developments*, Basle: Bank for International Settlements

Bank of Tanzania, *Economic Bulletin*, various issues.

Corsetti, Giancarlo, Paolo Pesenti & Nouriel Roubini (1998) "What caused the Asian currency and financial crisis?" manuscript.

The Economist, 13th -19th February 1999.

Economist Intelligence Unit, 1998, Country Report 3rd quarter 1998, Bangladesh

Economist Intelligence Unit, 1998, Country Profile Mozambique 1998/99

Economist Intelligence Unit, 1998, Country Report 3rd quarter 1998, Mozambique, Malwi

Economist Intelligence Unit, 1998, Country Report 3rd quarter 1998, South Africa.

Economist Intelligence Unit, 1998, Country Profile Uganda 1998/99

Economist Intelligence Unit, 1998, Country Report 4th quarter 1998, Uganda, Rwanda, Burundi.

Economist Intelligence Unit, 1998, Country Report 3rd quarter 1998, Zambia, Democratic Republic of Congo.

IMF, *International Financial Statistics,* various issues.

IMF, 1998, *Direction of Trade Statistics Yearbook, 1998,* Washington D.C., IMF

Nordås, H.K., 1996, "South African manufacturing industries – catching up or falling behind?" *Journal of Development Studies,* vol. 32, no. 5, pp. 715-733

OECD, 1998, *Economic Outlook* June 1998. Paris: OECD.

Republic of Tanzania, 1998, "Speech of the minister of state president's office (planning) hon. N.W. Malocho (MP) presenting to the National Assembly the Economic Survey for 1997 and the Rolling Plan and Forward Budget for 1988/99-2000/01.

Stals, 1998, "The integration of the South African financial system in the global financial markets," in South African Reserve Bank, Quarterly Bulletin, June 1998.

Tenold, S., 1998, "Fra tigersprang til mageplask – Bakgrunnen for de økonomiske problemene i Øst- og Sørøst-Asia", *NUPI-report 236,* Oslo: Norwegian Institute of International Affairs.

Tønnesson, Stein, 1998, "Asia-krisens politikk", *Internasjonal Politikk* 56 (3):361-392.

Wade, Robert, 1998, "The Asian Debt-and-Development Crisis of 1997-?: Causes and Consequences", *World Development* August 1998

World Bank, 1998, *World development Report Knowledge for Development,* Oxford: Oxford University Press

R 1998: 1	JUL-LARSEN, Eyolf (ed.), Florence Bukali da Graca, Jesper Raakjær Nielsen, Paul van Zwieten Research and fisheries management; the uneasy relationship review of the Zambia-Zimbabwe SADC fisheries project. Bergen, 1998 (Price NOK 125 + postage)
R 1998: 2	SURKHE, Astri et al. Humanitarian assistance and conflict. Report prepared for the Norwegian Ministry of Foreign Affairs. Bergen, 1998. (Price NOK 90 + postage)
R 1998: 3	TJORE, Gro Protective strategies in the 1990s: A review of the policy discourses in UNHCR and the executive committee. Bergen, 1998. (Price NOK 90 + postage)
R 1998: 4	DIA, Mona Boikott til hvilken pris? Barns situasjon i Irak og Burundi. Rapport for Redd Barna. Bergen, 1998 (Price NOK 90 + postage)
R 1998: 5	NORDÅS, Hildegunn Kyvik Macmood, a macroeconomic model for the Tanzanian economy. Bergen, 1998 (Price NOK 50 + postage)
R 1998: 6	NORDÅS, Hildegunn Kyvik Criteria for general budget support and general sector support. Report commissioned by the Norwegian Ministry of Foreign Affairs. Bergen, 1998 (Price NOK 50 + postage)
R 1998: 7	BJERKELAND, Kristin M. Korrupsjon. En studie av skatteadministrasjonen i Tanzania. Bergen, 1998, 102 pp. (Price NOK 90 + postage)

A complete list of publications and Annual Report available free of charge

For priced publications:

Surface mail (B-economique) free with prepaid orders. For airmail (A-prioritaire) outside the Nordic countries add 20 %

Four easy ways to pay:

Cheque, issued in Norwegian kroner
Post office giro, paid by International Giro: 0808 5352661
SWIFT: DNBANOBB, Den norske Bank no: 5201.05.42308
Credit card: VISA only

Order from:

Chr. Michelsen Institute
P.O. Box 6033 Postterminalen, N-5892 Bergen, Norway
Fax: + 47 55 57 41 66 Phone: + 47 55 57 40 00 E-mail: cmi@amadeus.cmi.no

Summary

This report first describes the currency, financial and economic crises in Asia and analyses how the crises evolved. The second part analyses how the three types of crises affect selected Norwegian development partners in Africa and Asia. It is suggested that the currency crisis had very little impact in the poorest developing partners that are not integrated into the world financial system. The currency crisis did, however, spread to South Africa. As a result the easing of monetary policy that was under way was reversed. The economic crisis on the other hand, has had a more significant impact, both in terms of export demand facing the countries in question and the prices they obtain on their exports. These losses are, however, at least partly counterbalanced by cheaper oil imports.

ISSN 0805-505X