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The Asian Crisis of 1997: No patent remedies for solving the Eurozone debt crisis

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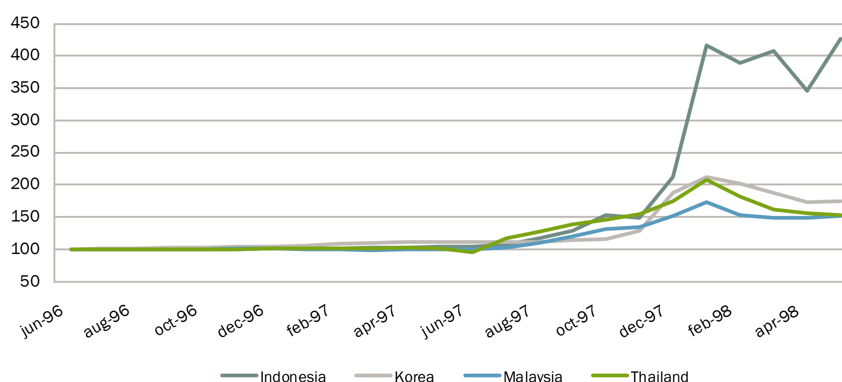
The economic turbulence in the Eurozone rekindles memories of the Asian crisis of 1997/98. At the time, a long boom phase ended in some of the Asian "tiger states" - their economies collapsed. Indonesia, South Korea, Malaysia and Thailand were most affected. In the Eurozone, Greece, Ireland and Spain in particular achieved impressive high-growth until 2007, before they (and Portugal) fell into a deep recession. Both crises revealed considerable structural weaknesses in the affected countries. The Asian economies, however, managed to recover quite fast. This paper compares both crises and argues that despite the existence of similar problem areas, the Asian experience does not provide any patent remedies for solving the Eurozone debt crisis.

The development of both regions before the crises broke out

In several countries of East and Southeast Asia, the socio-economic situation improved considerably between the mid-1960s and the mid-1990s. The world respectfully spoke of "tiger states" and "East Asian Miracle" (title of a World Bank study). The hallmarks of this impressive development were high growth rates of GDP, industrial production, exports and employment. Poverty dropped considerably. A major technological thrust made them internationally more competitive. To finance investment, enterprises were able to draw on high domestic savings and foreign capital inflows. Governments promoted the upswing with targeted economic and social policy measures. They succeeded in avoiding high domestic and foreign trade deficits, and at times some of these countries were even able to achieve a surplus in their national budgets and current accounts.

Today's Eurozone debt crisis countries - Greece, Ireland, Spain and Portugal - have developed in a significantly less homogeneous manner than the Asian tiger states did during their crises[1]. An economic boom swept across Ireland, Greece and Spain until 2007. Portugal's economy, in turn, grew only slowly. The drivers of growth in Ireland and Spain were the construction industry, the financial sector and exports. In Greece, growth was based on strong demand from the private and public sector that was fed by high wage increases and debt-financed government spending.

Chart 1: Exchange rate of Asian currencies to the US dollar in nominal terms, Index June 1996=100



Source: OANDA

The crises and their causes ...

... in Asia

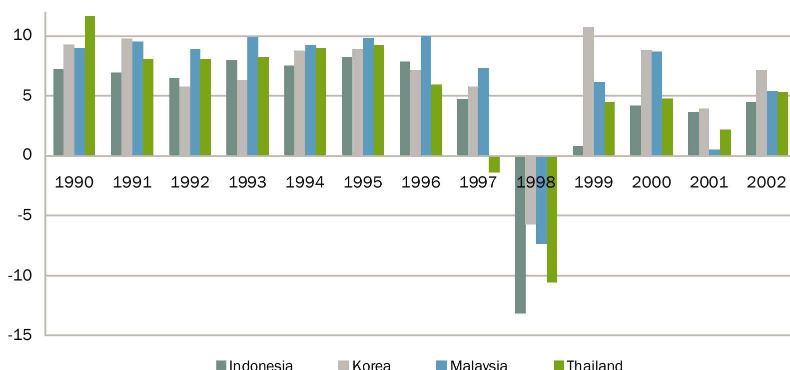
In the summer of 1997, the Thai authorities floated the Baht/US dollar exchange rate because foreign currency reserves were no longer sufficient to support it. The ensuing Baht devaluation prompted investors to withdraw capital, speeding up the exchange rate collapse. This shockwave spilled over into the other tiger states. Their exchange rates also plummeted (see Chart 1) while exports and stock market prices nosedived. Many banks became insolvent and others were taken over by the state or recapitalised. Inflation and unemployment increased, social unrest rattled the countries. Indonesia, South Korea, Malaysia and Thailand were most affected. In these countries an economic boom that lasted for years was followed by an extreme GDP drop of up to 13 % (Indonesia 1998, see Chart 2). The crisis countries took their troubles to the IMF, which granted them extensive financial support.[2]

Thailand's decision to float the exchange rate was, of course, not the cause of the Asian crisis but only ignited a storm that had long been brewing. Spoiled by years of success and admiration by the rest of the world, governments had suppressed fundamental problems. These can be summarised as follows (although not every aspect applies to all countries). A strong expansion of credit generated price bubbles on the real estate market. Overly optimistic expectations prompted excessive investment in the industrial sector. The banking sector had structural weaknesses (lack of supervision, inadequate consideration of credit risks). Investors relied on generous government guarantees (moral hazard). In the years before the crisis, foreign debt had risen substantially, particularly in the short-term segment.

An important explanation for the rise in foreign debt was the misguided exchange-

Note: This paper reflects the views of the authors and does not necessarily represent the position of KfW.

Chart 2: Real economic growth in Asia in per cent



Source: IMF

rate policy. The governments and central banks of the tiger states ensured stable exchange rates against the US dollar and the Japanese yen by intervening in the foreign exchange market with their currency reserves. The confidence in government-secured exchange rates led to a strong increase in long-term lending in domestic currency on the basis of short-term dollar/yen funding without hedging exchange rate risks. However, when the dollar then rose against the yen, European currencies and the Chinese renminbi, the local currencies had to be devalued for lack of currency reserves. This created massive difficulties for the banks and prompted investors to panic and withdraw their capital.

But these economic aspects do not fully explain the Asian crisis. Politico-economic and cultural factors also form part of the equation. These include the close interlinkage between politics, bureaucracy and industry which resulted in favouritism, corruption etc., as well as low transparency and inadequate checks and balances built into the social systems, which did not take kindly to open criticism.

Finally, foreign banks and investors also bore some of the responsibility for the Asian crisis. Blinded by the enduring boom, they had thrown caution to the wind and dismissed potential risks.

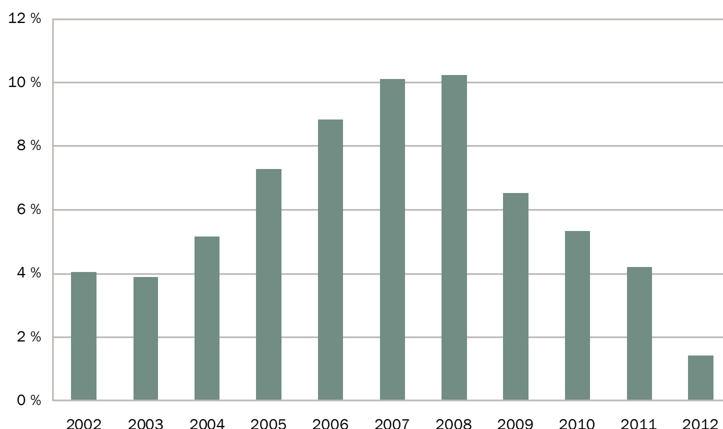
... and in the Eurozone

The crisis in the Eurozone periphery has individual causes in each country, although there are important commonalities. Each of the countries reviewed here had been increasingly spending more than it was taking in on a macro-economic level. Their external imbalances illustrate this. The average current account deficit of Greece, Ireland, Spain and Portugal increased continuously from 4.0 % to a very high rate of 10.3 % of GDP between 2002 and 2008 (see Chart 3). This should have been taken more seriously as a sign of these economies' serious structural problems.

In all four countries the private sector had been spending more than it was earning, and so had the public sector in Greece and Portugal. Private households and enterprises financed their excessive expenditure with foreign debt. These funds were invested primarily in real estate, so mortgage loans increased and the construction sector expanded (Ireland, Spain). In all four countries, growing private demand was also fuelled by strong wage increases that substantially exceeded productivity growth and reduced international competitiveness. In Greece and Portugal, the net savings to borrowings ratio was negative - not only in the private sector, but in the public sector as well. Greece had long masked its high public debt by providing manipulated statistics.

Nevertheless, these national factors do not adequately explain the crisis. It was exacerbated by the low risk awareness among banks that was evident on a global scale, where banks extended loans at very favourable terms and conditions even to debtors with poor credit quality. Banks as well as rating agencies were obviously too uncritical of the risk situation in the monetary union in general and the countries of the Eurozone periphery in particular. From early 2010, banks began to change their lending policy and reduced their exposures. This triggered a self-perpetuating and destabilising process in which capital outflows from the periphery countries into the core countries of the Eurozone increased substantially (capital flight to save havens). Consequently, the funding costs of banks and sovereigns in the Eurozone periphery rose sharply. Real estate bubbles burst, banks became distressed and had to be bailed out by the governments.This situation also led to enormous budget deficits in Ireland and Spain, whose national budgets until then had been very solid. A bankruptcy of states, an event previously considered to be impossible, became a real danger. The EU, ECB and IMF then established big financial rescue programmes and initiated institutional reforms in the monetary union.

Chart 3: Current account deficit of country group GR / IE / ES / PT in per cent of GDP a)



a) with weighted average GDP (preliminary 2012 figure)

Source: Eurostat, own calculation

Nevertheless, to understand the crisis it is important to consider the macro-economic conditions of the European monetary union.

Various aspects can be referred to here. (i) As the risk of devaluation of a domestic currency no longer existed, a great temptation existed for states to take on excessive public debt in the new common currency. (ii) Investors were ready to provide this funding because they did not take the non-assistance clause enshrined in the Euro treaty seriously.[3] (iii) Interest policy applies uniformly across the entire currency region; thus an overheated economy of an individual country cannot be addressed effectively through monetary policy. (iv) The exchange rate was no longer available as a mechanism to intervene when excessively high wages damaged international competitiveness.

The Asian crisis countries recovered fast

After the dramatic collapse in 1997/98, Indonesia, South Korea, Malaysia and Thailand were able to recover quite fast. Exports increased in all countries already in 1999, and the recession was over as they returned to the path of growth (see Chart 2). They addressed the structural weaknesses with targeted reforms and policy changes in the financial and corporate sector as well as in fiscal and monetary policy. Foreign investors exercised restraint for a certain period of time but then regained confidence again with new direct and portfolio investments.

The tiger states adjusted their monetary policy and gave market forces more room to influence exchange rates. In addition, they learned the fundamental lesson from the painful experience from the crisis that low currency reserves made them vulnerable to external shocks. So the central banks increased their foreign currency reserves by purchasing dollars. This dampened the currency valuation process at the same time, a very welcome effect that helped to secure the improved international competitiveness that had resulted from the devaluation in the crisis. The countries also pressed ahead with regional economic integration. Regional trade expanded on the back of government policy. Finally, the ASEAN countries as well as China, South Korea and Japan established a currency swap arrangement ("Chiang Mai Initiative") with which they are indeed also pursuing the goal of reducing their dependence on support from the unloved IMF.

On balance, it had thus become clear that the Asian tiger states were not completely "healthy". But they had not been extremely "ill" either. On a fundamental level, they possessed great internal growth potential. After the corrections referred to above were made, this potential was reactivated again on a medium and long-term basis.

The recovery in the Eurozone is more difficult and requires patience and perseverance

The crisis in the Eurozone periphery is not yet over. According to OECD estimates, in 2013, the third year since the beginning of the crisis, Greece, Spain and Portugal will suffer a renewed GDP contraction, the extremely high unemployment rate and public debt will continue to rise. Only in Ireland are these indicators now gradually improving again. That means the crisis in the Eurozone is significantly more far-reaching than the Asian crisis, and it will take more time to overcome. The essential differences between the two cases lie in four areas. First, the global economic environment is very different. In 1997 the global economy was in good health. In early 2010, however, the world was still suffering from the global financial market crisis. Second, the domestic growth potential of the Asian tiger states was fundamentally high. At the outbreak of the crisis, the Eurozone periphery countries were considerably richer and had a higher welfare level than the tiger states at the time of their crisis,[4] but their longer-term growth potential is likely to be lower. Third, the job markets in the tiger states were more flexible at the time than in the Eurozone periphery countries today. In Asia the informal sector was bigger and the share of employees in total employment and level of unionisation were lower, and unemployment insurance was less common. After the outbreak of the Asian crisis, the poverty problem also worsened considerably as a consequence, but the flexible job market did facilitate the structural adjustment process.

Fourth, Asia was able to make corrections through the exchange rate as well. Adjustments of relative prices on the product and labour markets were made by devaluing the currencies without nominal price reductions (and therefore relatively painlessly). The monetary union does not have this option. Here, wages in particular must be reduced in nominal terms in order to rebuild international competitiveness. On the other hand, currency devaluation is not a miracle drug. In the Asian tiger states it had considerable undesired side effects. Foreign currency debt increased in value, placing a burden on the state, banks and other sectors as well. Finally, with regard to external trade, it has to be noted that while devaluation benefits exporters, it makes imports more costly.

The economic adjustment process in the Eurozone periphery countries is underway

Although the countries are not yet out of the woods economically, they have made more progress in eliminating macroeconomic imbalances than widely recognised. This is evident in the balance on current account, national budgets and the development of wages[5]. The fatal trend of rising current-account deficits has already reversed since 2009 (see Chart 3), and Ireland actually generated a surplus in 2010. On the other hand, it has to be conceded that this looks better than it actually is. The decline in current account deficits can be rated unconditionally positive only if it is based on export growth (and, hence, improved competitiveness). In fact, exports did increase in all four Eurozone periphery countries since 2009 (with the exception of Greece in 2012). However, improvements in the current account balance are also greatly due to a considerable drop in imports, and this is mainly a result of cyclical factors, i. e. it is not yet proof of any lasting improvement of the economic structure.

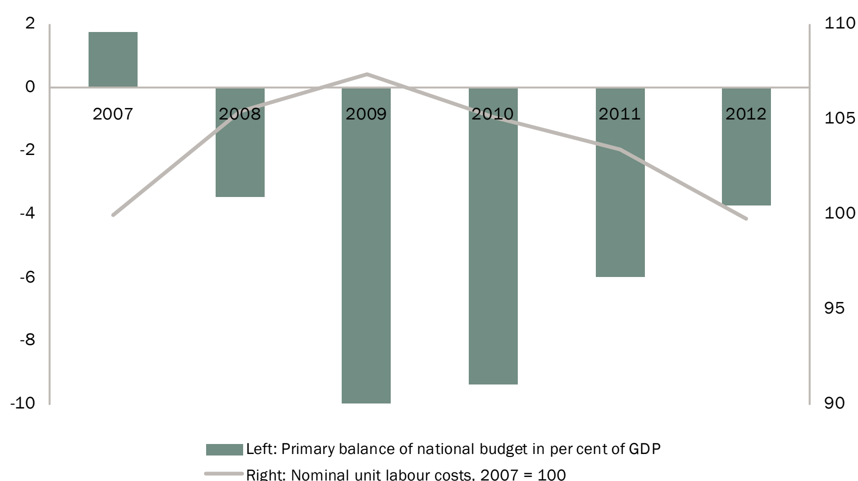
Consolidating the national budgets is an uphill climb. The primary balance (expenditure without interest payments) is still negative in all Eurozone periphery countries. Nevertheless, the primary deficit was successfully reduced from a high 10 % of GDP on average for the group of countries (2009) to 3.7 % in 2012 (see Chart 4).

Unit labour costs have already been falling significantly in all four countries since 2009 (see Chart 4), which points to an improvement in price competitiveness. Many wages have fallen in nominal terms even without the "help" of currency devaluation. However, this is a bitter pill to swallow because it amplifies economic stagnation (weak domestic demand) and puts a great strain on the countries' internal stability.

Consequences for the European Monetary Union (EMU)

The crisis of the Eurozone periphery coun-

Chart 4: National budget and unit labour costs in the country group GR / IE / ES / PT a)



a) each with weighted average GDP of the country group (preliminary 2012 figures)

Sources. IMF, EU Commission, own calculation

tries revealed flaws in the EMU regulatory framework established by the Maastricht Treaty. The EMU was adopted in the 1990s without at the same time pursuing far-reaching political integration. In particular, the member states' continuing fiscal autonomy was guaranteed. The relevant disciplinary measures of the Stability and Growth Pact were regarded as sufficient. Whether this is a fundamental design flaw is being debated intensively. What is certain is that the budget deficit in Greece, in particular, evolved into a problem because the sanctions provided for in the EMU regulations for exceeding debt limits were not applied and foreign investors provided the country with high volumes of funding out of a combination of recklessness and misjudgement of its situation. In retrospect, the misguided developments in the financial and real estate markets of the crisis countries should have been corrected sooner and more forcefully. It would be a clear mistake to simply blame all current problems on the introduction of the euro. Nevertheless, without the euro the risk premiums for countries with high government debt would probably have risen sooner (or not fallen so sharply), which might have halted the debt buildup, particularly in the case of Greece.

The crisis has shown that not only are national measures necessary but also changes to EMU rules in the areas of fiscal policy, financial market regulation and the management of states' liquidity and solvency crises. These issues are being addressed, and much has been accomplished.

What remains?

The experience of the Asian crisis does not offer any patent remedies that might be applicable to the Eurozone debt crisis. But common problem areas are the flaws in the national banking sectors and, on the part of foreign banks and investors, their recklessness in the choice of partners and lack of willingness to accept longer terms. Without a doubt, greater awareness of risk in these areas and, accordingly, early countermeasures would have prevented many problems in the Eurozone periphery countries. This applies not only to the decision-makers in the individual euro countries but also to the ECB, EU IMF and other international organisations, as well as to rating agencies which, as mentioned, took too long to react and failed to clearly put the finger on the problems in their analyses. ■

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[1] Crisis countries are defined here as those for which financial aid packages were put together, that is, without Italy and (so far) Cyprus, for example.

[2] Financial support from the IMF, however, was made conditional on economic policy measures such as prime rate increases, government spending reductions and financial sector reforms. This IMF policy was heavily disputed. Numerous critics accused the IMF of missing the true causes with this treatment and actually aggravating the crisis.

[3] The assumption made by investors that a cash-strapped debtor country would receive help from other Euro countries despite the non-assistance clause of the Maastricht Treaty was nurtured particularly by the experience with Greece. Over the course of a full decade, Greece was able to report a budget deficit far greater than the Maastricht threshold of 3 % without ever being exposed to the sanctions provided for under the Stability and Growth Pact.

[4] The welfare indicator used in this comparison is per capita income (according to the "Atlas" calculation method of the World Bank) in the last "good" year before the outbreak of the respective crisis. In 1996 per capita income in the tiger states was between USD 1,080 (Indonesia) and USD 12,070 (South Korea). In 2006 this income ranged from USD 18,720 (Portugal) to USD 46,110 (Ireland) in the Eurozone periphery countries.

[5] It also has to be noted that foreign direct and portfolio investments have been entering Spain again since mid-2012. No current data is yet available for Greece, Ireland and Portugal.