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Irrational behaviour leads to 'rational panic'

Hardev Kaur

HARVARD: Various reasons have been cited for the currency crisis in South-East Asia.

In almost all instances, the blame is placed at the doors of developing countries, their leaders and domestic policies.

Among the reasons frequently repeated are: the fixed exchange rates, political cronyism, rigid government control, lack of transparency and poor banking supervision.

But are the developing countries and their domestic policies solely responsible for the problem?

Most analysts tend to fall into the trap of making generalisations and lumping all countries in the region into one large area.

The strengths or weaknesses and the economic fundamentals of individual countries are not looked at or even considered anymore.

The currency crisis began with Thailand's devaluation of the baht in July, spread to one of the Tigers in East Asia - South Korea - and is now casting its long shadow on countries in the west.

In an increasingly globalised world with open markets and technological advancement, it is almost impossible to isolate problems into compartments, countries and regions.

Problems are bound to have far-reaching consequences beyond their geographical and political boundaries, as the western world is beginning to realise.

Given the rapid globalisation and internationalisation of the world economy, can the problems in East and South-East Asia be blamed solely upon the domestic situations and policies of these countries?

The lack of liquidity is now said to be a major problem. The international banks, brokers and financiers who were pouring funds into markets in the region and creating this excess liquidity are not totally blameless.

One estimate indicates that international bank lending to Asia rose by about US\$70 billion (US\$1 = RM3.48) in the 18 months to June this year.

Some international finance institutions were bending over backwards to provide loans as they certainly did not wish to miss out on the opportunities in the fastest-growing region in the world.

These finance companies are among those who have pulled out, creating some of the problems. As Jeffrey Sachs, Director of the Harvard Institute of International Development (HIID), pointed out, "rational panic" took hold.

These financiers and investors felt that it was "rational" on their part to withdraw their funds as others were also pulling out.

It did not matter that the economic fundamentals that had attracted them to the region in the first place remained intact.

They moved into Asia in a torrent when they thought the going was good. At the slightest sign of a problem they decided to pull out just as swiftly without, even stopping to consider the fundamentals.

These financial decisions can now be executed in a matter of seconds, thanks to modern technology and communications.

The sovereign countries and the political leadership have little control over the massive movement of funds. They, their countries, their economies and the livelihood of their people are left to the mercy of the market and major financiers and foreign pressures.

Take South Korea, for example. Over-regulation is being blamed for Seoul's problems.

But in the 1970s and 1980s when the Government controlled the financial institutions, its growth was rapid. The problems followed faithfully in the footsteps of deregulation in the 1990s.

According to Alice H. Amsden of the Massachusetts Institute of Technology (MIT) and Yoon-Dae Yuh of the Korea University, it is the "Government's decision to allow banks and other financial institutions to borrow and lend without interference that created the current crisis".

Writing in the New York Times, they pointed out that in the 1990s the Government allowed the banks to have more of a say on interest rates and to establish foreign operations.

The Government also went too far in 1995 when, in exchange for membership in the Organisation for Economic Cooperation and Development (OECD), it agreed to US demands to loosen almost all controls on financial institutions, both international and domestic.

The banks borrowed from abroad, bought and sold large amounts of foreign currency and relaxed conditions imposed upon manufacturing companies.

These relaxed conditions proved detrimental as companies over-indulged and borrowed in excess. The resultant bad loans created a crisis for the banking system.

Now the call is for South Korea to overhaul its manufacturing and financial sector.

While this may be necessary, Amsden and Yoon conclude that the current crisis shows that the "the US, acting out of self interest, was wrong to push the South Korean government into opening up its financial system so quickly".

They argue that the "Government and its financial institutions did not have time to develop adequate ways to control and monitor this brave new world."

This is a mistake well worth remembering in the face of the current crisis affecting the whole region, not just South Korea.

Currency transactions today account for a much larger proportion of international trade than actual goods and services. The world has made tremendous efforts to manage trade and set rules for its conduct. Now these rules are being extended to cover the services and financial sectors. But what about the currency trade?

In 1978 Mr James Tobin proposed a tax on foreign transactions to limit volatility. His views were summarily dismissed. Perhaps he was a man ahead of his time since it certainly makes sense to study his proposals in the light of the current crisis.

In fact, Prime Minister Datuk Seri Dr Mahathir Mohamad's proposal for regulating and coordinating currency traders is not so far-fetched in reality.

It can be seen as a refinement of Tobin's idea and is certainly not as "difficult as setting a worldwide retail price for eggs" as some argue.

Just as the international community is also responsible for the currency crisis in East Asia, it must also play its part in helping to resolve it.

This is not to say that the individual countries in the region should sit back and do nothing about it. They have a sovereign obligation to take care of their economies.

It is important to restore confidence rather than call "for deep emergency surgery, which the IMF is doing too much of".

Sachs suggests that the Asian countries should allow their exchange rates to float and keep the interest rates low instead of pushing them up.

In addition, he suggested that they should not follow the contractionary effect of the withdrawal of credit with contractions of their own, as

"their budget policies are already in pretty good shape".

Genuine and sincere efforts by foreign powers are needed. They should not exploit the situation to extend their influence and to score points.

While the IMF has provided standby credit to Thailand and Indonesia and is now considering assistance to South Korea, Sachs said the Asian-led efforts which the Japanese had proposed about a month ago would have provided the much needed liquidity "at a much lower cost and with much less adverse symbolism". But it was not to be.

He blames the US for "beating that initiative back". This he felt "was a mistake" and he argues that the US "wanted it done through Washington, but you know we don't want to put money into this, we just want to have control".

Contrary to what the US Secretary of State Madeline Albright says about the "Asian Miracle" now turning out to be an "Asian Meltdown", the economic fundamentals of the region remain intact.

The growth rates this year and the next may slow down but this does not mean that the countries are down and out.

If the western developed world does not want to see a deflation, it is time they allowed the Asian economies and their leaders to resolve the problems instead of hampering them and demanding emergency surgery which some of them may not need and which could in fact kill them.

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