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Asian Financial Crisis and Recovery: Status and Implications for U.S. Interests

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ABSTRACT

Congress is concerned about the Asian financial situation because of its implications for U.S. regional security, economic, democratization, and humanitarian/human rights interests. This report provides an overview discussion of the economic, social, and political impact of the Asian financial crisis that began in Thailand in July 1997 and progress towards recovery. It surveys the scale and scope of the crisis, reviews the current status of the most affected Asian economies, examines some ongoing liabilities, and briefly discusses the prospects for the emergence of a post-crisis economic model for the region—one that relies less on high corporate debt and government-influenced resources allocation and more on equity capital and entrepreneurship. For further information, see CRS report RL30272, Global Financial Turmoil, the IMF, and the New Financial Architecture, by (name redacted). This report will be updated periodically if circumstances warrant.

Asian Financial Crisis and Recovery: Status and Implications for U.S. Interests

Summary

In terms of broad economic measurements, the Asian financial crisis largely has ended, but the surprisingly swift recovery has left lingering economic and political problems that still could have negative effects on U.S. interests. The economies that suffered most from the crisis that began with the collapse of the Thai baht in July 1997 have regained positive economic growth, bolstered their trade positions, sharply reduced interest rates, and rebuilt their international financial reserves. At the same time, the recovery has been uneven and most of the IMF-assisted economies—Thailand, South Korea, and Indonesia—along with less affected Southeast Asian economies and the regional giants, China and Japan, continue to suffer from serious problems of non-performing debt and corporate governance. Many analysts worry that as growth increases and international reserves strengthen, structural reforms will continue to be deflected by opposition from vested economic elites, labor unions, and populist, mass-based political parties.

One of the most striking initial consequences of the financial crisis was the revalidation and expansion of democratic governance. Whether these gains will be sustained and expanded depends on how effectively governments deal with the lingering socioeconomic effects of the crisis. In Indonesia, for instance, the democratic opening ushered in by the collapse of the authoritarian Suharto regime remains a fragile one. In late February 2000, Singapore's Finance Minister described the question about Indonesia's political stability a "key uncertainty" affecting the wider economic recovery of Southeast Asia.

The United States has suffered little evident economic harm from the crisis thus far, but the effects on U.S. regional political and security interests still could be substantial in the long run. U.S. prestige continues to be affected by the perception that the United States was dictating the IMF's painful conditionality while itself contributing little in the way of direct bilateral financial assistance. Generally speaking, the United States has not received much public credit for its role as the crucial market of first resort for the recovering economies. Japan, on the other hand, has earned plaudits for providing more than \$30 billion in aid and export credits, even though Japan's economic problems arguably contributed to and intensified the crisis. Because the crisis has tended to undermine the strength and solidarity of the Association of Southeast Asian Nations (ASEAN), while leaving China relatively unscathed, it also has created the potential for regional power shifts that could threaten U.S. interests.

Some indicators suggest that the so-called "East Asian" economic model, which relied on unrestrained debt and close government-business collusion, is in retreat, and that a more transparent, more equity-based, and more fully entrepreneurial economic model may be emerging. At present, however, due to the use of public funds for bank recapitalization, governments are even more heavily involved in many Asian economies than in the past, and powerful vested interests continue to fight a rearguard action against needed structural reforms and efforts to reduce huge levels of non-performing debt.

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Asian Financial Crisis and Recovery: Status and Implications for U.S. Interests

Congressional and Broader U.S. Interest and Stake in the Issue

Congress is concerned about the Asian financial situation because of its implications for U.S. regional security, economic, democratization, and humanitarian/human rights interests. In the past several years Congress has considered and appropriated funds for the International Monetary Fund (IMF), the World Bank, and the Asian Development Bank, and bilateral assistance in support of the crisis countries. Congress has held numerous hearings on issues related to the IMF rescue program and wider issues concerning the transparency and efficacy of the IMF's operations, as well as hearings on the status of the crisis and the situation in individual countries. At the moment Indonesia remains of particular interest to Congress because of the vast island republic's strategic and economic importance, the fragile nature of its new democratic institutions and its potential for disintegration.

From Crisis to Incomplete Recovery

With the notable exception of Indonesia, the East Asian economies that were hardest hit by the financial crisis that began in Thailand in July 1997 have made a remarkable, though still incomplete, recovery. The impressive success of most countries in rebuilding their financial reserves and regaining a growth path has surprised many if not most analysts. The rapid reversal of fortune has generated optimism within the international financial community, but also caution. A number of analysts and institutions warn that the regional recovery is uneven and

Figure 1. East Asia



Adapted by CRS from Magellan Geographix. Used with permission.

incomplete, that important structural weaknesses remain to be addressed, and that incomes and living standards are still well short of pre-crisis levels in several countries. A March 2000 Asian Development Bank report described the recovery as cyclical rather than structural.¹ These continuing problems raise a number of U.S. policy concerns concerning longer term regional economic prospects and regional stability.

Scale and Scope of the Asian Financial Crisis of 1997

The sharp drop in currency values in the most affected countries had a strong ripple effect in the broader East Asian region, both because of the accompanying slowdown in interregional economic activity and as a consequence of the sudden loss of confidence of lenders and investors about the prospects for Asian and other “emerging market” economies. The four most troubled economies—South Korea, Thailand, Indonesia, and Malaysia—together experienced a net reversal of private capital flows amounting to an estimated \$100 billion in the early part of the crisis, or about four times the magnitude of the outpouring of funds in the Mexican peso crisis of 1994-1995.² Moreover, while the crisis struck hardest in the three countries that became the object of IMF rescue packages—Indonesia, South Korea, and Thailand—many other economies in Asia experienced similar, albeit less severe, underlying problems of deteriorating trade positions, falling asset prices due to speculative real estate investment and excess manufacturing capacity, dangerous levels of non-performing loans, and related financial system fragility.

The effect of the Asian financial crisis on the market economies of Asia varied from severe in the cases of Thailand, South Korea, and Indonesia, to relatively mild in the case of the Philippines, which had only recently begun to increase its participation in economic globalization and had a comparatively well-regulated banking system. In Thailand, where the crisis began, the closure of 56 insolvent finance companies decimated the previously hyperactive real estate sector, leaving hundreds of projects unfinished. In South Korea, several major financial institutions and corporations went bankrupt or had to be saved from bankruptcy by governmental intervention, and the economy suffered its worst decline since the 1950-1953 Korean War. In Indonesia, the collapse of the banking system and the net loss of 20 percent of GDP between 1997 and 1998 left the country economically prostrate and on the edge of political collapse. Malaysia adopted an IMF type reform program even though it did not accept IMF assistance, and took the risky step of temporarily freezing capital exports. Even Singapore, with one of Asia’s best managed economies and banking systems, suffered a net drop of almost 9 percent in year-on-year growth due to its significant dependence on regional markets.

¹ Asia Development Bank, *Asia Recovery Report 2000*. March 2000. Highlights. [Http://aric.adb.org](http://aric.adb.org).

² Nicholas D. Kristof with David E. Sanger, *How the U.S. Wooed Asia To Let Cash Flow In* *New York Times*, Feb. 16, 1999: A1, A10.

China, Vietnam, and other non-market economies of Asia suffered less due to the maintenance of fixed currency exchange rates and, with the notable exception of China, small exposure to global markets. Except for China, which has successfully practiced what it calls “market socialism,” this was a small blessing, since the other non-market countries of Asia had not shared in the prior decades of high growth experienced by their market-oriented neighbors. Moreover, all of the non-market countries experienced some slowdown in growth as a result of the general decline in intra-Asian trade and investment

The crisis also hit Japan hard, since Japanese banks held the largest share of non-performing loans in South Korea and Southeast Asia. Among other effects, the crisis caused a decline in exports to South Korea and Southeast Asia and left Japanese manufacturing facilities in the region with mounting losses and idled capacity. This further exacerbated an ongoing financial sector meltdown. Japan’s biggest problems predated the crisis, however, and in some ways helped to precipitate it.³ Moreover, Tokyo’s inability to get its own economy moving has largely eliminated its ability to serve as an engine of regional recovery.

Deep Social and Political Impact

The financial crisis and related economic contraction imposed a harsh social cost on the most affected economies. The impact varied from country-to-country, but in general it hurt the urban poor and middle classes more than the residents of rural areas. In the most developed crisis country, South Korea, and in the cities of the developing countries of Southeast Asia, especially Bangkok and Jakarta, distress was the most palpable. Because the value of many tropical cash crops are determined by world prices, the currency devaluations tended to raise the incomes of farmers relative to their urban counterparts. Many urban workers in Southeast Asia returned at least temporarily to the villages from which they had once come looking for a better life, an option that South Koreans workers generally did not have due to their country’s more advanced state of development. Conversely, because of South Korea’s

³ Some analysts saw the crisis as the outcome of a failure by Japan to address the root cause of its own economic and financial problems. In effect, it has been argued, an economic “bubble” that built up in Japan in the late 1980s and burst in the early 1990s, reemerged in the rest of Asia as a result of the failure of the Japanese Ministry of Finance (MOF) and the Bank of Japan (BOJ) to take the necessary steps to liquidate hundreds of billions of dollars worth of non-performing domestic loans. Rather than force Japanese banks to sell assets to cover their losses or take the politically unpalatable step of using public funds for a financial system bailout, as the United States did to deal with its savings and loan crisis of the 1980s, the MOF initially allowed banks to disguise the decline of their assets by various accounting subterfuges and to continue to make profitable but risky loans to the fast growing Asian economies. By one account, Japanese lending to Asia alone rose from \$40 billion in 1994 to \$265 billion in 1997, much of it for speculative property investment and other doubtful purposes. Other analysts find the Japanese connection circumstantial at best, and note that European and American banks were also large lenders to Asia. Martin Feldstein, *Japan’s Folly Drags Asia Down*. 6 Wallstreet (online service), Nov. 26, 1997; Douglas Ostrom, *Japan and the Asian Economic Crisis: Part of the Solution or Part of the Problem*. Japan Economic Institute, *JEI Report*, No. 8A, Feb. 27, 1998: 3-6.

significantly greater wealth and resources, its government was able comparatively quickly to install a social safety net of unemployment benefits and other relief measures, while those of Thailand and Indonesia lacked both the means and the necessary administrative infrastructure to provide much income or consumption support.

Serious Impact on Living Standards

Although it now appears that incomes in the crisis countries did not fall as much as was initially estimated, the social impact was serious in every affected country. The World Bank calculated in mid-1999 that in South Korea the incidence of urban poverty more than doubled in the months after the crash—from 8.6 percent in 1997 to 19.2 percent in 1998—and that the overall urban standard of living declined by 21.6 percent. The Bank estimated that in Indonesia, the percentage of the population living below the nationally established poverty line nearly doubled—from 11.0 percent before the crisis to 19.9 percent afterward—and that the overall standard of living fell by 24.4 percent, or almost one-fourth. Rural areas in West Java and some other parts of Indonesia were also affected during 1997 and early 1998 by a severe El Nino-influenced drought, which added to the general economic distress and created widespread hunger. In Thailand, by contrast, the crash appears to have mainly affected the urban middle classes, who are still a relatively small proportion of the total population, with the effect that the overall incidence of nationally defined poverty increased only moderately – from 11.0 to 12.9 percent between 1997 and 1998, while overall incomes dropped by 13.6 percent.⁴

Because of certain characteristics of Asian social systems and labor markets, unemployment levels do not reveal the true depth of the crisis. In a 1999 year-end assessment and forecast the World Bank found that because of the “flexibility” of Southeast Asian labor markets, i.e., willingness to work for subsistence wages, if necessary, incomes fell further than actual employment. In Indonesia, by this account, employment actually rose slightly after the crisis while wages fell by 42 percent.⁵

Reinforcement of Democratic Trends

Contrary to what some anticipated, the sharp fall in incomes generally did not foster serious political instability, except in the case of Indonesia, where the crisis led to the forced resignation of President Suharto after more than 30 years of authoritarian rule, and to the first free elections since the mid-1950s. The political reverberations of the crisis were felt everywhere, however, in some degree.

In all of the affected countries the crisis tended to accelerate existing challenges to the political status quo—generally, but not always, in the direction of greater democracy and transparency. In Thailand, whose currency collapse touched off the crisis, the crisis caused the resignation of the widely disparaged government

⁴ The World Bank, News Release No. 99/2214/S, June 2, 1999.
<http://www.worldbank.org/html/extdr/extme/2214.htm>

⁵ Martin Wolf, Asia’s Future Burning Bright. *Financial Times*, Feb. 23, 2000: 23.

of Prime Minister Chavalit Yongchaiyudh, and its replacement with a new coalition headed by Chuan Leekpai, a former prime minister. The crisis also tipped the political balance in favor of a new constitution—the sixteenth since the establishment of a constitutional monarchy in 1932—with provisions aimed at reducing political corruption, increasing accountability and transparency, and establishing minimum educational credentials for elective office; notably, the army kept to the background but lent its weight to adoption of the new constitution, as did the King who wields great influence. In Malaysia the crisis contributed to the acceleration of a political succession struggle that has not yet fully played itself out.

In South Korea, the crisis further tarnished the image of the then-ruling party and gave a boost to the presidential campaign of the Kim Dae Jung. His election in December 1997 was widely viewed as strengthening democratization in South Korea. Because of his long-standing reputation as an opposition leader, Kim has enjoyed considerable freedom of action and a reserve of good will that has allowed him to pursue policies that adversely affect a number of vested interests, including the *chaebol* conglomerates and organized labor. Kim faces a number of serious political and economic problems, including an opposition-controlled national assembly and resistance from the *chaebol* and labor unions to restructuring.

The most dramatic political reaction occurred in Indonesia, where food riots, mob violence against businesses owned by the ethnic Chinese minority, and university-based anti-government protests grew steadily after the initial collapse of the Indonesian currency in late 1997. Street demonstrations against governmental corruption and in favor of democratization forced President Suharto from office on May 21, 1998. His hand-picked vice-president, B. J. Habibie, set in motion a process that led to democratic elections in June 1999, the first such open elections since 1955, and a violence-marred referendum that led to independence for East Timor following intervention by UN peacekeeping forces.

Acceptance of the Need for Greater Economic Openness

The crisis also surprised some observers by generally reinforcing a preexisting trend towards greater openness to the global economy. Despite sometimes harsh criticisms of foreign investors and lenders, the IMF's initial fiscal austerity requirements, and perceived U.S. dominance of the international economic system, the wrath of most Asians was turned more at their own leaders, economic managers, and corporations, than at the impersonal forces of economic globalization. In general, Asians appear to have accepted, reluctantly in many cases, that their economic salvation will have to come mainly from adopting reforms aimed at more transparency in the management of their economies, more prudential financial sector behavior, and better corporate governance.

The willingness, however reluctant, to accept the IMF's policy conditionality rather than oppose it, appeared to go hand-in-hand with public support for political leaders who promised to end abuses such as favoritism towards well-connected individuals and corporations, generally referred to as "crony capitalism," and the desire to punish those associated with practices that had brought their national financial systems to the point of collapse. Even Malaysia, whose prime minister had railed against George Soros and other foreign "speculators," the IMF, and alleged U.S.

wire-pulling, unilaterally adopted IMF-style austerity measures to restore foreign confidence in its economic management, while also imposing controls on capital flight.

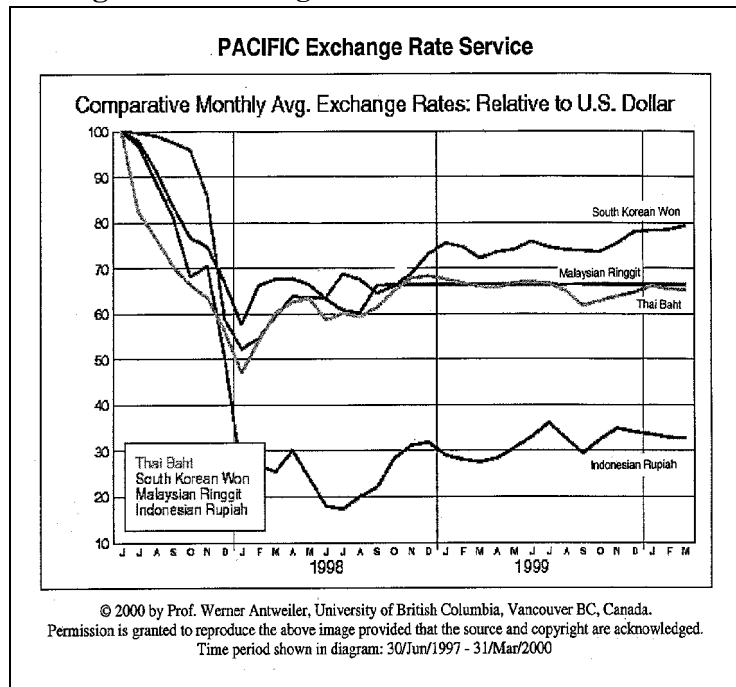
The comparatively mild reaction to the downside of economic globalization in Asia thus far may also reflect the fact that, until the crisis, the growing involvement of East Asian countries in world markets generally had been viewed as beneficial by the affected populations. In many Asian countries, authoritarian leaders justified their rule by delivering the benefits of rapid economic growth and rising living standards, gains that would not have been possible without attracting foreign manufacturing investment and plugging into world markets. Opposition to globalization has tended to come mainly from non-governmental organizations (NGOs) that champion causes such as workers' rights and environmentalism, agendas that have received relatively weak public support. The markets of the crisis countries had remained comparatively closed to all but capital goods, high technology, and industrial inputs such as chemicals and raw materials. Thus, following a path of openness to foreign capital and technology generally had produced more gains than losses in terms of domestic economic interests and employment.

Also, after what were perceived as some initial missteps in the direction of excessive fiscal austerity, the IMF moved relatively quickly to loosen its constraints to allow deficit spending to bolster consumption and provide a social safety net. Indonesia and Thailand successfully bargained with the IMF to allow progressive increases in counter-cyclical deficit spending, while accepting other aspects of the IMF reform program.

Current Status of the Most Affected Asian Economies

From the point of view of broad macroeconomic measurements, East Asia is now widely viewed as on a path to economic recovery, with the exception of Japan, which has a more complex set of problems and where the prospects for a turnaround continue to be a matter of dispute. Beneath generally positive gains in output and exports lie numerous

Figure 2. Exchange Rates: Relative to U.S. Dollar



indicators of serious, ongoing, problems, however, and a number of analysts question whether Asian countries will be able to summon the will to push through with needed structural reform once the recovery fully takes hold. The general situation is summarized below.

Exchange Rates

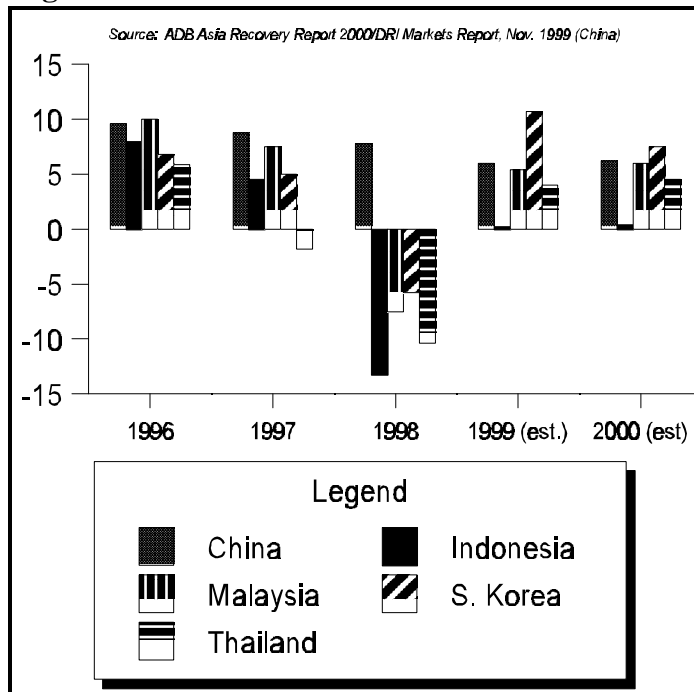
Except in the case of Indonesia, which continues to be affected by ethnic and religious strife and political instability, exchange rates have rebounded significantly. As shown in Figure 2, exchange rates among the most important Asian economies range from about 65 to 85 percent of their June 1997 (pre-crisis) values. As of the spring of 2000, most currencies continue to hover around the values attained in late 1998. Since the crisis was caused in part by overvalued currencies, the current values could be regarded as an appropriate level for most countries given other aspects of their economic situations. Indonesian analysts tend to believe strongly that their currency is artificially undervalued mainly because of political uncertainties, but others also see shaky fiscal fundamentals and an effectively “bankrupt” central bank as a major part of the problem.⁶

Marked Improvement in Macroeconomic Performance

At the level of macroeconomic indicators such as real growth in gross domestic product (GDP), trade balances, and international currency reserves, the most affected Asian economies have made significant gains since the depth of the crisis in late 1997 and early 1998. As shown in Figure 2, after falling sharply in 1998, domestic output in South Korea, Thailand, Malaysia, and Indonesia at least stopped falling or even grew slightly in 1999, and all of these countries currently are projected to return to a growth path, albeit a shallow one in some cases, in 2000.

In Thailand and South Korea, in particular, the multilateral banks and country financial authorities repeatedly have revised 1999 growth estimates upward in successive periodic reviews.

Fig. 3. GDP Growth Rates: Selected Asian Nations



⁶ Steve H. Hanke, The Hole in the Bank of Indonesia's Balance Sheet. *The Asian Wall Street Journal*, Feb. 15, 2000.

Thailand grew by an estimated four percent in 1999 after a 10.4 percent drop in 1998, a net increase of 14.4 percent.⁷ South Korea, registered a 10.2 percent gain following a 6.5 percent contraction in 1998, for a net gain of 16.7 percent. Initially, most projections only saw South Korea growing by one or two percent for 1999. South Korea is the only crisis economy in which GDP per capita now exceeds its previous peak.⁸

China, whose currency exchange rate is fixed by the government, is struggling to maintain growth in the 7 percent range and stave off deflation, mainly through massive deficit spending.⁹ China has experienced many of the same problems as the crisis countries with regard to its domestic economy, especially excessive speculative investment in real estate, and its banking system is also saddled with massive amounts of non-performing debt incurred by the grossly inefficient but politically powerful state-owned industries (SOEs). China escaped the Asian contagion, however, because it had—and still has—little overseas debt and large foreign currency reserves.

Most of the affected countries have been able to generate trade surpluses and rebuild their foreign currency reserves to reasonable levels. Even Indonesia, still in the throes of political uncertainty and civil unrest in dissident provinces, has at least moved back from the brink of financial collapse. Thanks to support from the IMF, the World Bank, the Asia Development Bank, and from Japan and other bilateral donors, as well the benefits of rising oil prices, Indonesia had \$25 billion in international reserves as of early 2000, enough to cover six months of imports.¹⁰ Indonesia's finances remain shaky, not the least of which because of IMF concerns about a lack of progress in implementing reforms (see below).

Uneven State of Financial Sector Reforms

Reform of the affected countries' financial systems and corporate governance has progressed much more slowly than overall economic performance. In general, South Korea, Thailand, Indonesia, and Malaysia have recapitalized their banking systems with the help of government funds and effectively converted short-term private debt to longer-term sovereign debt.¹¹ They remain in the grip of a "credit crunch," however, partly because so many firms are bankrupt and borrowers who can meet strengthened standards of credit-worthiness are still scarce. Reforms in all of

⁷ IMF Concludes Article IV Consultation with Thailand. IMF Public Information Notice (PIN) No. 00/5, Feb. 10, 2000.

⁸ Asia Development Bank (ADB), Asia Recovery Report 2000; Tracking Asia's Recovery—A Regional Overview, p. 4; Republic of Korea, Ministry of Finance and Economy, *Korea Economic Update*, March 30, 2000 (Vol. 29, No. 4).

⁹ Tish Saywell, Trade Cheer, Deflation Gloom. *Economic Monitor: China. Far Eastern Economic Review*, Sept. 30, 1999: 75.

¹⁰ IMF. Indonesia Letter of Intent, January 20, 2000, Memorandum of Economic and Financial Policies; Medium-Term Strategy and Policies for 1999/2000 and 2000. para 27.

¹¹ For more information, see country Letters of Intent on the IMF's internet site <<http://www.imf.org>>

the countries have been slowed by opposition from politically influential vested special interests.¹²

Both Indonesia and Thailand have experienced serious scandals related to the bail-out operations of their bank restructuring agencies. These scandals appear to have stemmed from efforts by politically well-connected groups to protect their equity interests in bankrupt entities or otherwise to exploit opportunities presented by the recapitalization of the banking system with public funds. In Thailand, the government of Prime Minister Chuan Leekpai survived a December 1999 no-confidence motion in parliament over allegations that the brother of the finance minister had been involved in fraudulent lending to wealthy individuals and corporate clients by the state-owned Krung Thai Bank, whose losses had required the injection of \$5 billion in public funds, and that the official and the defaulting borrowers were being shielded from prosecution. Meanwhile, it was claimed, the government had made little apparent effort to prosecute well-connected borrowers. The government maintained that the finance minister had no involvement in the loans and that the high level of non-performing loans claimed by an outside auditing firm was based on inaccurate data.¹³

In Indonesia, some \$80 million provided to recapitalize the state-owned Bank Bali is alleged to have ended up in the coffers of the former ruling party, GOLKAR, and to have been used to finance the failed reelection campaign of interim President B. J. Habibie.¹⁴ At a January 18, conference in Singapore, Bank Indonesia Senior Deputy Governor Anwar Nasution reportedly acknowledged that Indonesia's central bank had served as a "cash register for those who are close to power." An independent audit December 1999 revealed that some \$ 7 billion in emergency loans handled by the central bank had disappeared, some of it apparently to a bank in Amsterdam. The IMF suspended its support to Indonesia in September 1999, towards the end of the Habibie administration, as a result of inadequate progress on resolving the Bank Bali scandal, and only resumed lending in February 2000 after reaching a new letter of intent with the Wahid government. In negotiations on the new letter of intent with the IMF—the twelfth in two years—the Indonesian government reportedly agreed to make a full disclosure of past wrongdoing at the Bank of

¹² With regard to Indonesia, the trip report of an US-ASEAN Business Council mission to Indonesia during January 2000 concluded that "corporate restructuring looks unlikely to move quickly, as vested interests seem to have placed themselves strategically in key advisory roles and are likely to lobby hard for protection in legislative branch." Final Trip Report on January 18-20 Indonesia Mission, Feb. 4, 2000. Website: www.us-asean.org.

¹³ The bank official in question denied that the bank had improperly lent funds. The government disputed the finding of an outside auditor that 84 percent of loans, mainly to corporate clients, were non-performing, but most analysts agreed that lending practices raised major questions about "crony capitalism." Thailand's Corruption Debate. *Asian Wall Street Journal*, Dec. 21, 1999: 10;

¹⁴ Mark Lander, Baligate,. *Why It Matters, Indonesia's Recovery, and Democracy, Tested by Scandal*. New York Times, Sept. 29, 1999: C1, C 25; Shawn W. Crispin, The Power of PwC. *Far Eastern Economic Review*, Dec. 23, 1999: 9.

Indonesia and state-owned monopolies, in return for the resumption of IMF loans.¹⁵

The resumption of support to Indonesia was brief. For reasons that still are not entirely clear, the IMF acknowledged in late March 2000 that it would delay disbursement of a \$400 million “tranche” of financial support from April to May. Reportedly, the IMF was dissatisfied with the pace of progress on the reform program and decided to delay a planned review for two weeks.¹⁶ Perhaps in response to the IMF’s concerns, the Chairman of the Indonesian bank Restructuring Agency (IBRA), fired his deputy chairman on March 29, 2000, allegedly for moving too slow to recover nonperforming loans.¹⁷ On the same day the government detained Suharto crony and timber merchant, “Bob” Hasan, reportedly to prevent him from interfering with an investigation into alleged fraud at a state-owned company he controlled.¹⁸

Slow Pace of Corporate Reform

Likewise, politically influential corporate interests have resisted government efforts to force consolidation and industry restructuring. In South Korea, which has made the most progress, the politically powerful *chaebol* conglomerates and labor unions have fought tooth and nail against the Kim Dae Jung government’s plan for a major rationalization and consolidation of major industrial sectors. The country’s second largest *chaebol*, Daewoo, which alone reportedly has debts totaling \$50-65 billion, resisted government divestiture and consolidation pressures almost to the point of bankruptcy. Had the government not intervened forcefully, according to one industry analysis, Daewoo’s collapse would have brought down the already insolvent investment trust companies (ITCs) that are the chief source of financing for Korean companies and the dominant players in the country’s equity markets.¹⁹

Some analysts despair of seeing significant near-term corporate reform in other Asian economies, except among already viable companies that are responding to global competition. The tendency appears to be for companies to find ways to stay afloat financially, often by defaulting on loans and postponing payments to suppliers, in hopes that a general economic turnaround will put them back into the black. A March 2000 report by the Asian Development Bank (ADB) warned against the dangers of a “growth first” strategy, in which financial and corporate restructuring is postponed until growth begins to restore asset values. The ADB found this approach “risky,” given the uncertainties about future growth prospects, but also said it could

¹⁵ Michael Shari, Will Candor Pay Off? *Business Week International*, Jan. 31, 2000.

¹⁶ BBC, Indonesia: Next Tranche of IMF Funds To Be Disbursed May 2000. *BBC Monitoring Asia Pacific - Political*; London, March 30, 2000.

¹⁷ Grainne McCarthy, Deputy Chairman of IBRA Is Ousted—Boss Says Eko Moved Too Slowly to Recover Debts; IMF Delays Tranche. *Asian Wall Street Journal*, March 29, 2000: 3.

¹⁸ Jay Solomon and Puspa Madani, Jakarta Charges Suharto Ally with Corruption. *Asian Wall Street Journal*, March 29, 2000: 1.

¹⁹ Charles S. Lee, Last Gasp? Daewoo Receives a Debt Reprieve. *Far Eastern Economic Review*, July 29, 1999: 59; Nomura, *Korean Economics*, October 1999: 10.

“invite a recurrence of problems at a later date,” when governments would have no flexibility to assume more debt.²⁰

Flight of Ethnic Chinese Capital from Indonesia

One problem for Indonesia is the flight of ethnic Chinese capital in the wake of the financial collapse and anti-Chinese riots. Various accounts estimate the size of the capital outflow from tens of millions to over \$100 million. Some of this capital flow may have been facilitated by large loans made to well-connected borrowers during the recapitalization of the failing banks; loans that were not covered by real assets. In other cases, ethnic Chinese families and business interests simply left the country with what liquid capital remained after the collapse of their businesses. Whatever the source of the funds and whatever the method of sending them abroad, most analysts judge that ethnic Chinese Indonesians and others with capital outside the country do not yet see the time as ripe for returning to Indonesia and reinvesting their capital.

Two reasons are cited in particular by analysts: First, political uncertainties weigh heavily in the minds of the ethnic Chinese, who were the targets of scapegoating and mob violence during May 1998 riots leading up to the resignation of President Suharto, and they don't want to be victimized again.²¹ The Wahid government has taken a number of steps to provide reassurance, including allowing open celebrations of the Lunar New Year for the first time in several decades, but no one can guarantee that this new era of tolerance will continue. Second, both ethnic Chinese and other absent owners of property and bank loans who are in default on their obligations may not want to come to the attention of creditors or government prosecutors seeking to fulfill an IMF mandate to take action against bankers and businesspeople suspected of having engaged in corrupt dealings.²²

Ongoing Economic and Political Problems

Not all countries are in similar situations, but several exhibit common problems, including:

Huge Unresolved Bad Loans

The real size of the nonperforming debt in the crisis countries remains unclear but most indicators suggest bad loans are declining slowly as a ratio to total debt in most crisis countries, but possibly still rising in absolute terms.²³ Rescheduling of

²⁰ ADB. Tracking Asia's Recovery—A Regional Overview. March 2000, p. 17.

²¹ Antara [Jakarta], Indon Predicted To Need US\$12.5 Bn Loan, Sep. 30, 1999; article in *KOMPAS* (Jakarta) cited by U.S. Embassy Press Summary, March 4 and 6, 2000.

²² Pruginanto, Jakarta Out To Cut Shady Ties Between Groups, State Banks. *Nikkei Weekly*, Dec. 30, 1999: 30.

²³ ADB. Tracking Asia's Recovery—A Regional Overview. March 2000, p.10.

loans in many cases has made bank and corporate balance sheets look better but corporate restructuring has moved slowly and powerful economic interests seek to use their political clout to avoid taking a “haircut.” Worse, in Thailand and Indonesia bank officials reportedly have directed available funds to political cronies leaving even more bad loans on the books of government and government-aided banks.²⁴ In December 1999 Indonesia’s Coordinating Minister of Economy, Finance, and Industry, Kwik Kian Gie, reportedly described the country’s bad loan problem as “horrifying,” and possibly as much as 60 percent of GDP. Kwik attributed massive failure of state-owned and private banks to collusion between borrowers, bankers, and bureaucrats during the Suharto era that continued even after the economic collapse. Reportedly, central bank statistics in Indonesia indicate that loans to individuals from state banks rose from an already high 34 percent of total banking credit in 1997 to 47 percent in 1998.²⁵

Continuing High Unemployment

Even as the affected countries return to a growth path, unemployment remains high in historical terms, and could tend higher when and if corporate restructuring begins in earnest. As in other areas, South Korea has made the best progress, reducing unemployment from a high of 7.9 percent in December 1998 to 5.3 percent in January 2000—still more than twice the pre-crisis level. Unemployment in Thailand has declined to 4.2 percent but underemployment remains high and the Thai Ministry of Finance projects a substantial increase in unemployment during 2000.²⁶

Political Obstacles to Reform

The advance of democracy has also imposed constraints on the pace of reform. In South Korea, which will hold a crucial parliamentary election in April 2000, politics tends to revolve around strong personalities, rather than issues or party programs, a situation that invites behind-the-scenes maneuvering by powerful economic interests seeking government favor and relief.²⁷ Thailand’s first-ever Senate election, held on March 4, reportedly was marred by rampant vote-buying despite extraordinarily strict legal limits on fund-raising and advertising.²⁸ In Indonesia the problem of promoting corporate reform has been made more difficult by the fluid political situation and, ironically, by democratization. The election of a parliament with real—albeit yet uncertain powers—has given beleaguered corporations and

²⁴ Henry Sender, *Smoke and Mirrors*. *Far Eastern Economic Review*, Sept. 30, 1999: 34.

²⁵ Pruginanto, *Jakarta Out To Cut Shady Ties Between Groups, State Banks*. *Nikkei Weekly*, Dec. 20, 1999: 30.

²⁶ Ministry of Finance, Thailand, *E-Thailand Monthly Economic Review*, Feb. 2000.

²⁷ Frank Ching, *In Korea, No Party Loyalty*. *Far Eastern Economic Review*, March 30, 2000: 34.

²⁸ Shawn W. Crispin and Rodney Tasker, *First Steps*. *Far Eastern Economic Review*, March 16, 2000: 18.

economic interests new avenues to promote their interests via strategic alliances with legislative leaders and parties.²⁹

Concerns about the political impact of historically high levels of unemployment also weigh heavily in political calculations. As a consequence of democratization, worries about exacerbating the unemployment problem are likely to continue to act as a political brake on structural reforms.

On the more positive side, even with its imperfections and opportunities for corruption, the democratic process and the accompanying institution of a free press still provide more transparency and accountability than the previously prevailing authoritarian models. Further, supporters of democratization note that elections are only one part of the process. To live up to its promise, democratic processes must be accompanied by reform of the justice system and imposition of the rule of law, improvements in other institutions of governance, and the development of civil society. All of these objectives are included in the assistance programs of the IMF, the World Bank, and the Asian Development Bank, and the bilateral aid programs of the United States and other donor countries, but they are very difficult to implement due to the power of vested interests and deeply ingrained practices.

Declining IMF and Other Multilateral Bank Influence?

Progress towards broader reforms has been slow in most Asian crisis countries. Below the level of fiscal and other macroeconomic policies, the IMF and other international financial institutions are finding it difficult to make much headway pushing for structural and corporate governance reforms. Some analysts judge that Thailand and Indonesia are simply too large for the IMF to abandon, even if they fail to follow through with needed reforms. Although the IMF has several times suspended support to Indonesia on account of insufficient progress towards reform, and has periodically criticized slow progress in other countries, some analysts argue that now that the most immediate liquidity crisis is over and most affected countries have built up comfortable international reserves, IMF leverage is declining.³⁰

Some accuse the past actions of the international financial institutions of being part of the problem. In a number of countries, activist NGOs are taking the multilateral banks to task for allegedly having turned a blind eye to the kind of corruption that brought the borrowing countries to the brink of national insolvency. In the runup to a February 2000 meeting in Jakarta of the Consultative Group on Indonesia, a World Bank-led group of bilateral and multilateral aid donors, NGOs criticized the Bank for lending and encouraging others to lend to Suharto's Indonesia despite widespread corruption. Because of its past "mistakes," NGO's in Indonesia

²⁹ US-ASEAN Business Council, Final Trip Report on January 18-20 Indonesia Mission [by Walter Lohman, Director, Indonesian and Singapore Affairs. Feb. 4, 2000. (www.us-asean.org)].

³⁰ Insufficient Leverage. *Far Eastern Economic Review*, Sept. 30, 1999: 38-39.

reportedly have called on the Bank to assume responsibility for debt relief or loan restructuring.³¹

Implications for U.S. Interests

Despite signs of a general economic recovery, U.S. interests continue to be affected by several lingering aspects of the crisis.

Asian Doubts About U.S. Leadership and Intentions

First, while the crisis underscored the continuing importance of U.S. influence over the international financial system and of the U.S. market, the countries of the region perceive that the United States has been more ready to exert its leverage over the IMF than to contribute resources. At the time of Thailand's initial foreign exchange crisis, the U.S. Treasury Department appeared to view the issue as a regional matter of little significance to the U.S. or global economy, and declined to deploy financing available in the Exchange Stabilization Fund.³² Subsequently, in early 1998, the United States announced some \$1.7 billion in trade credits and aid, but Thais still tend to see the United States, a treaty ally, as failing them in their moment of greatest need.³³

The Clinton Administration took a more serious view of the crisis when it appeared in late 1997 that South Korea, the world's 11th largest economy, might default on international loans amounting to tens of billions of U.S. dollars. The Administration provided about \$5 billion in accelerated funding in support of the IMF's \$57 billion rescue package, and helped negotiate the rollover of \$15 billion in international loans that were coming due in early 1998.³⁴

Despite its role as the largest shareholder in the IMF and a significant albeit "minor" aid donor, U.S. assistance to the crisis countries compared unfavorably with sizeable Japanese loans to South Korea and Tokyo's \$30 billion "Miyazawa Fund" (named for the current Japanese finance minister) for Southeast Asian recovery. Moreover, South Koreans and other Asians resented the strong influence of the United States in what started off as a very painful IMF-directed austerity program. In Indonesia, for instance, the United States continues to be viewed favorably overall, according to a poll published by the U.S. Information Agency in January 2000, but the one-third of urban respondents who see the United States in a negative light most

³¹ Donors Meeting Determined To Keep Indonesia Afloat. *Jakarta Post*, January 31, 2000.

³² Paul Blustein, Thailand Seeks IMF Bailout to Shore Up Its Financial System. *Washington Post*, July 19, 1997: A11; Michael Vatikiotis, Pacific Divide. *Far Eastern Economic Review*, Nov. 6, 1997: 14-16.

³³ See CRS Report RL30312, Thailand-U.S. Security, Economic, and Narcotics Cooperation Relations: Findings of a Congressional Staff Visit During August 9-15, 1999 [by (name redacted)], p. 11.

³⁴ Paul Blustein, \$10 Billion in Loans Rushed to S. Korea. *Washington Post*, Dec. 25, 1997: A1, A32.

often complain about perceived U.S. “interference.” Overall, Japan and China earned higher marks as a bilateral partner.³⁵

Ongoing Instability

Second, while the crisis has brought about some “creative destruction” and tended to foster further democratization, it has also led to a significant increase in instability. This is particularly true in the case of Indonesia, the world’s fourth largest country, with a critical geostrategic location astride major trade routes. Ethnic and religious riots in the tiny and distant Molucca Islands, and separatist agitations in Aceh, on the large island of Sumatra, have taken thousands of lives in the past year. In early February 2000, the government of Abdurrahman Wahid found itself in a standoff with the former head of the Indonesian military, General Wiranto, who had refused a demand that he resign his position as Coordinating Minister for Defense and Security based on recent findings that he played a direct role in human rights abuses in East Timor. Wiranto subsequently was fired. Analysts have speculated that Indonesia will not be able to regain stability and attract foreign investment and loans until it has resolved the issue of what role the military will play in the state.³⁶

Weakened ASEAN

Third, the crisis has tended to weaken the cohesiveness of the Association of Southeast Asian Nations (ASEAN) and raise the profile and influence of China. While some economists argue that official Chinese exchange rates have little real significance, and that the Chinese yuan effectively has been declining in unofficial exchange markets, Beijing has received considerable credit in the region for holding the line on the yuan. At the same time, a number of China’s neighbors, notably Taiwan and Southeast Asian claimants to disputed islands and atolls in the South China Sea, have sensed a growing Chinese self-confidence and readiness to flaunt its military might.

Continued Nationalistic Resistance to Foreign Ownership of Assets

Fourth, while Asian countries have not rejected economic globalization, and continue to welcome foreign investment of the traditional joint-venture type, the crisis has done little to reduce resistance to foreign ownership of national assets. A few high profile deals seem to signify change, such as Newbridge Capital Ltd.’s purchase of Korea First Bank and a semiconductor plant in Indonesia, or Goldman Sach’s hard-fought purchase of Bangkok’s prestigious Regent Hotel, but in general foreigners have been distrustful of Asian bookkeeping and Asians have been reluctant to sell potentially valuable assets to foreigners at prices that reflected current market conditions. Ford, for instance, reportedly has been stymied in efforts to buy into the

³⁵ U.S. Department of State, Office of Research, Opinion Brief B-2-00, Jan. 6, 2000.

³⁶ Wahid’s Coming Clash. *Far Eastern Economic Review*, Feb. 3, 2000: 9-10.

South Korean auto industry.³⁷ A plan by Japan's Mitsui Trading Company to use loans from the Japan Bank for International Cooperation (previously the Export-Import Bank) to invest in the South Korean petrochemical industry reportedly foundered in part over the objections of the would-be South Korean partners (Hyundai and Samsung) to plans by Mitsui to export products of the new, consolidated unit, independently.³⁸ The purchase of the Indonesian Bank Reconstruction Agency's 40 percent share of P. T. Astra, the country's largest vehicle assembler, was long stalled by the refusal of the controlling faction to allow a thorough review of the company's books. In order to clear the way for the sale, IBRA had to force the resignation of the company's president and chief financial officer.³⁹ In the sale that was finally concluded at the end of March, 2000, a U.S. consortium led by Gilbert Global Equity Partners and Newbridge Capital Ltd., lost out to a consortium led by Singapore-based Cycle and Carriage Ltd., an automobile distributor.⁴⁰

An Emerging Post-Crisis Economic Model?

Some signs point to the tentative emergence of a more entrepreneurial and more market-oriented economic model in East Asia even as the state's role deepens in the older industrial economies as a result of bank recapitalizations. A combination of pressures from economic globalization and political obstacles to fundamental reform, have in some areas sparked new independent entrepreneurial initiative. Japan's financial sector "Big Bang" (financial sector deregulation) and similarly incomplete efforts towards financial and economic liberalization in other Asian countries appear to have been enough to spark a movement towards more reliance on equity and less on government-guided bank financing. Some analysts have noted, for instance, a boom in initial-public-offerings in Asia.⁴¹ Likewise, the more advanced sectors of the Asian economies have benefitted from a resumption of strong growth in computer-based technologies. New investments in the high technology side of Southeast Asian economies are being made even as older industries and sectors wallow in excessive non-performing debt.

Whether this is a trend or a short-term response to an ongoing liquidity crisis or a longer term movement towards a more global style profile of debt/equity ratios could depend on how far governments are prepared to push for broad structural reform and effectively dispose of non-performing assets. The World Bank's year end 1999 report on global Economic Prospects warned that the region's most affected

³⁷ Robert Frank, Despite Asia's Financial Crisis, Bargains Are Few To Be Had. *Wall Street Journal*, Jan. 21, 2000.

³⁸ Japan-South Korea Industrial Talks Fail. *Nikkei Weekly*, Feb. 7, 2000: 9.

³⁹ Jay Solomon, Jakarta Fires Astra Chiefs To Clear the Way for a Sale. *Asian Wall Street Journal*, Feb. 8, 2000.

⁴⁰ Southeast Asia Briefs, *Asian Wall Street Journal*, April 4, 2000: 3.

⁴¹ G. Pierre Goad and (name redacted), New Building Blocks. *Far Eastern Economic Review*, Feb. 3, 2000: 38-39; Charles S. Lee, The New Frontier. *Ibid.*, p. 40.

economies had fallen into a deep debt trap, which imposes an enormous burden on society and also inhibits new lending. The Bank judged that the Asian economies could grow out of the problem given a “benign” international economic environment, but then only if they undertook the necessary reforms—steps that remain substantially unaddressed as of now.

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