

Impact of the Asian financial crisis with special reference to Sri Lanka.

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Abstract

The primary purpose of this article is to gain an insight into what triggered the South East Asian financial crisis that transpired in the past few years and what lessons can be learnt from this. Added to this are the risks of financial liberalisation. The crisis highlighted the threats of volatile and large short-term capital movements resulting from the economic instability of developing countries such as Sri Lanka. Stress will be made on the primary economic aspects concerning Sri Lanka, such as full growth rates of the economy, internal and external balance of employment and socio-economic aspects.

The purpose of this article is to gain an insight in to what triggered the South-East and East Asian financial crisis that took place in the late nineties, the aftermath of the crisis, international rescue operations to mitigate the impact of the crisis and the lessons to be drawn from this crisis. This article will attempt to highlight the main impact of the Asian financial crisis with special reference to Sri Lanka.

The Asian financial crisis was only the prelude to a real economic crisis in Asia where economic growth was declining, thousands of firms and factories were closed down and millions of jobs were lost.

The prospects for a quick Asian recovery appear to be bleak for several reasons. First, the anticipated export, consequent to currency devaluation has apparently failed to materialise; the stock market indices indicate clearly that all the currencies in Asia are not yet out of the woods by a long way. Second, the currency stabilisation programmes have failed to revive the stock market because of economic depression caused by deflationary policies and sluggish export growth and the uncertainty regarding the future in the region. Thirdly, in the early nineties, recorded unemployment was around two percent but the economic depression that brought bank failures, corporate bankruptcies, closure of firms and retrenchment have more than trebled. In developed countries, social safety nets such

as unemployment insurance protect the unemployed but in South and East Asian countries, there are no such social safety nets.

The movement for free trade could be further obstructed by a series of political upheavals that are about to break out across East Asia. They will delay reform and paralyse decision making as governments change and leaders grapple with challenges to their rule.

The most immediate problems loom large in Tokyo, where an enfeebled Prime Minister and a paralysed bureaucracy seem to be incapable of making structural changes to revive the economy. The government in its latest spending package has further inflated Japan's huge public debt while failing to put a floor under the stock market or to boost consumer spending.

It has been noted that most countries now embraced a managed float structure and not a free float, and the country needed a good industrial base to face external shocks. The government should not borrow in the money markets and must revert back to borrowings from captive sources like the NSB, ETF and EPF to bring down interest rates, (Howard Nicholas 2001).

This current financial crisis has clearly shown that abrupt or premature liberalisation of the capital account is inappropriate for developing and transition economies, a fact that is now generally recognised through strong domestic financial systems. Regulation and supervision are essential elements to guarantee appropriate liberalisation. However, even with strong fundamentals in these areas, it has proved quite difficult for developing and transition economies that liberalise the capital account to adapt to the conditions generated by volatile international capital flows which may, in fact, weaken or destroy those fundamentals.

Under these conditions, developing and transition economies should retain the right to impose controls on in-flows, particularly in times of capital surges, and on outflows during severe crisis. A flexible approach in this regard is certainly superior to convertibility. Considerations regarding the anatomy of developing and transition economies to manage the capital account should therefore be incorporated in the current discussions on broadening IMF mandates to include capital account convertibility, and in possible future discussion on multilateral investment agreements, including the agreement being negotiated in the framework of OECD.

The importance of Regulation in global and national financial systems

The East Asian crisis has shown that the threats of quick change and large short-term capital affect the economic stability of developing countries. Therefore What is important is, we should be able to see how the global financial players and markets operate and what measures should be taken at both international and national levels to regulate these speculative flows.

However, the approach of the rich countries (G7) is to gain as much business as usual. They do not want to change the present system of free and liberal flows of short-term or long-term capital. They also do not want any controls at global or national level.

Their main intention is to get national governments in developing countries to strengthen their banking systems. So that the banks will be able to withstand the shocks and volatile flows that might occurring in the future.

But rich countries (G7) focus is to have 'greater transparency' at the national level so that investors will not foolishly put money in weak spots. They also focus on having tighter banking regulations so that there will be less chance of banks collapsing as a body.

But surely this 'national approach' in developing countries such as Sri Lanka is totally insufficient and needs to be complemented by a global approach to monitor and regulate cross-border financial flows. At the national level, Sri Lanka and other developing countries should also be allowed and encouraged to reduce the power of speculative fads and to reduce the volatile inflows and outflows of short-term capital.

What we can learn from the Asian crisis is developing countries should rethink the benefits and risks of financial liberalisation. In particular, they have to take great care to limit their external debt (especially short-term debt), improve balance of payments and build up their foreign reserves. There is, therefore, a need for great caution about financial liberalisation and globalisation with regards to Sri Lanka.

One of the most important lessons of the Asian crisis is that the developing countries should realise the importance of properly managing the interface between global developments and national policies especially in planning a national financial system and policy.

'Stagflation, inflation and low growth was expected while the government was likely to raise General Sales Tax (GST) and personal taxation'. The biggest worry was not the exchange rate fluctuations but the rise in interest rates. Also, free float of exchange rate uncertainty for both importers and exporters in Sri Lanka. At present, in a rapidly globalising world, developing countries face tremendous pressures to totally open up their economies, (Nicholas *ibid.*)

In some cases and under certain conditions, liberalisation can play and has played a positive role in development. However, the Asian crisis has shown that in other circumstances liberalisation can wreak havoc, especially on small and dependent economies.

Surely, then, a clear conclusion from the Asian crisis is that it is prudent and necessary for a developing country to have measures that reduce its exposure to the risks of globalisation and thus place limits on its degree of financial liberalisation.

The process of opening up to capital flows should be done at a very gradual pace, in line with the growth of knowledge and capacity locally on how to adequately handle the new processes and challenges that come with the different aspects of liberalisation.

This must control policy makers at the centre including banks, finance ministry, securities commission and planning unit and have the proper understanding of the processes at work out the policy instruments to deal with them.

The private sector players (including banks and other financial institutions, and private corporations) will also have to understand the control processes such as inflows of funds through loans and portfolio investment.

At the macro policy level, a very critical lesson from the Asia crisis is that governments have to pay great attention to external debt management.

The interrelationship among different markets in the economy is important to understand the short term and long term oscillations in the economic affairs of a country. While the crisis in the East Asian countries started in the financial market, as a result foreign exchange rates deteriorated rapidly. This led to big changes in the retail sector in those countries. Large-scale factories, Banks and financial companies had to be closed down. The price of imported consumer goods as well as industrial inputs soared. As a result, the inflation rate increased, investment decreased and the growth rate of the economy retreated. These were the important consequences of that crisis.

In the East Asian financial crisis the IMF acted with two objectives. Among them, the main and more important objective was to minimise the recession that could arise in the financial and trade patterns of the world through the crisis. Its second objective was to minimise the possible impact of the crisis on the living standards of about 350 million people living in the three principal member countries (Thailand, Indonesia and Korea) of the ASEAN which face the crisis.

As mentioned previously, the crisis manifested itself first in Thailand. Thereafter, it spread to other countries in East Asia. Signs of the crisis were seen in countries like Brazil, which did not belong to East Asia. The main feature of the countries that faced the crisis was the rapid depreciation of exchange rates in a short time. The Asian financial crisis didn't affect Sri Lanka directly, as the factors that contributed to the crisis were not present in Sri Lanka. That is the private sector had not obtained short term loans which had been invested in the development of immovable property and public facilities which were not in the long run productive. Likewise, private sector organisations had been allowed to obtain loans directly from foreign monetary institutes while the capital account of the balance of payment had been clearly left open.

In the context of Sri Lanka, the Governor of Central Bank has stated that Sri Lankan economic fundamentals were strong. For example, foreign reserves are high, the rupee is