Falling from Grace: Why did the Asian Financial Crisis Occur?

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What lessons can be learned from the Asian Financial Crisis to prevent its reoccurrence? Is there any danger to Ireland's tiger economy from the same ailment that struck its Asian namesakes? Nigel Brook-Walters' contribution covers the background and response of the international community to events which threatened the global economy.

Introduction

The onset of the Asian financial crisis has once again served to highlight the interdependence between developing and more advanced economies. It can be argued that as the world economy evolves, the links between these two groups will become increasingly extensive and we will witness a reinforcement of this interdependency. The Asian crisis has brought a number of issues to the forefront of recent economic discussion such as the need for the reform of financial markets, the operation of key institutions, the need for a lender of last resort and the economic policies of the advanced economies with regard to the developing economies.

In this paper, we seek to analyse the fundamental components of the Asian crisis, including the exceptional growth experienced before the spectacular collapse and the contributory factors that essentially prompted the crisis. At the highest level the Asian crisis occurred because there was an exceptional susceptibility to financial panic, resulting from the emergence of a number of weaknesses in these economies. In addition, the problems encountered were exasperated by the application of inappropriate policies both by the domestic governments and international institutions, notably the International Monetary Fund (IMF).

The East Asian Growth Miracle

There remains considerable debate amongst economists regarding the reasons for the unprecedented levels of growth experienced by a number of Asian economies. The first wave of countries to experience this meteoric economic rise included South Korea, Hong Kong, Singapore and Taiwan. This group was followed by a second wave made up of Thailand, Malaysia, Indonesia and perhaps surprisingly China. This was of great significance because for the first time a large proportion of the world entered the process of transition from Third World to First. The rapid ascension of the development tables became a model for all policy makers in developing economies, eager to replicate their successes. However, it can be successfully argued that there was something in these growth strategies that led to the financial crash.

The economic indicators most commonly used to illustrate economic growth show that the average per capita income of Malaysia, Thailand and Indonesia quadrupled while Korean income rose seven-fold (see Table 1.1 below). A remarkable characteristic of these growth patterns was that the majority of investment came from high levels of domestic savings and not from foreign investment. There was a tendency for the benefits of growth to be enjoyed by a large cross-section of the economy. There are some arguments that propose that Asia's rapid development was merely a mirage, however these arguments are not convincing. Huge gains in income levels, health, education and general welfare testify to that.

Table 1.1 Output Per Capita in Selected Countries, 1960-92 (in 1985 U.S. dollars)

Country	*1960*	*1992*	*1960-92 Annual Growth Rate (% p.a.)*
Hong Kong	2,231	16,461	6.4
Malaysia	1,409	5,729	4.5
Singapore	1,626	12,633	6.6
South Korea	898	6,665	6.9
Thailand	940	3,924	4.6
Taiwan	1,255	8,067	6.4
United States	9,908	17,986	1.9

One reason that the crisis came as such a surprise was that it was on the back of a long track record of phenomenal economic success. Those countries hit hardest by the crisis had all embarked on a process of financial-market liberalisation and reform. In an attempt to reform the markets in a market-orientated approach the Asian countries had exposed themselves to the vulnerability of financial shocks. Linkages with the world economy had become more extensive, and exposure greatly increased mainly through the build up of short-term debts. Countries less keen to progress with financial reforms such as China and Vietnam did not receive short-term capital inflows so were able to emerge relatively unaffected by the speed of the apparently inexorable contagion effect, (a feature of the new debt crisis).

The Crisis was generally considered to have started on 2nd July 1997 with the devaluation of the Thai baht. Problems emerged at a macroeconomic level, sparking great concerns for the area and the region soon started to experience capital outflows. As a result of the crisis, the afflicted countries were forced into a dramatic reversal of their current account positions (see Table 1.2).

Table 1.2 Growth and the Current Account, Five Asian Crisis Countries

Variable	*1996*	*1997*	*1998*
Real output growth (% p.a.)	7	4.5	-7.6
Current account (% of output)	-5.1	-2.7	9

Triggering Events

In essence, the crisis was a massive, sudden outflow of capital. Successful, strong economies that had previously been enjoying a large influx of foreign capital suddenly suffered from an intense capital exodus.[1] According to estimates net private inflows for the Asian 5 plummeted from $93 billion to -$12.1 billion. Jeffrey Sachs identifies four main culprits as the causes of the crisis:

1. Weaknesses within the Asian economies, especially poor financial, industrial, and exchange rate policies.
2. Over-investment in dubious activities resulting from the moral hazard of implicit guarantees, corruption and anticipated bailouts.
3. Financial panic, in that what began as moderately sized capital withdrawals cascaded into a panic because of weaknesses in the structure of the international capital markets and early mismanagement of the crisis.
4. Exchange rate devaluations in mid 1997 in Thailand, (and later in the year Korea).

Problems began to occur in the 1990's at both a macroeconomic (capital inflows, real exchange rate appreciation) and a microeconomic level (credit expansion, financial regulation and supervision). The first evidence of problems emerged almost simultaneously in Thailand and Korea at the beginning of 1997, although by 1996 the IMF had already issued warnings to Thailand which went unheeded. A series of chaebols (large conglomerates) went bankrupt putting several merchant banks under considerable pressure, as they had acted as channels for these corporations' foreign borrowing. As more companies followed suit the Bank of

[1] Prior to the recent crisis Asia attracted over half of all capital inflows going to developing countries (approximately $100bn in 1996).

Thailand was forced to support struggling financial institutions, amounting to some \$8 billion over a six month period. Speculators correctly guessed that a currency devaluation was imminent due to poor export growth and financial distress and the central bank was forced to use much of its foreign currency reserves to support the baht in the face of continued speculative attacks. During this period, Thailand had reported foreign reserves of over \$30bn, in fact they had dwindled to \$1.14bn, equal to just two days of imports. On 2nd July 1997 the Thai Government attempted a controlled 15% devaluation. The moderate devaluation spun out of control, prompting two preliminary speculative attacks on the baht in November and December, producing a spectacular dive. The Thai economy is relatively small, however the sharp drop in the Thai baht was followed by speculation against the Malaysian, Indonesian and Korean currencies. Speculators recognised the same inherent weaknesses previously listed in each of the Asian economies.

Exchange rate policies adopted by the region's governments only served to amplify Asia's growing problems. The adoption of fixed exchange rate policies posed problems when the central banks were forced to defend their respective currencies, running down foreign currency reserves. As these reserves dwindled, so the vulnerability to financial panic grew. Everybody was aware that the Asian governments had committed themselves to defend their over-valued currencies and only had limited reserves available to them. During the 1990's the Asian Governments chose to adopt either a pegged exchange rate (Thailand, the Philippines) or a crawling peg exchange rate allowing small predictable changes (Malaysia, Indonesia, Korea). Investor confidence was boosted, as these policy choices effectively reduced the threat of exposure to exchange rate movements and subsequently attracted further capital inflows. The prices of tradable goods and services remained relatively constant while the prices of non-tradable goods and services rose as a result of the investment boom. Consequently, the Asian countries witnessed an appreciation of their real exchange rates. Most analysis carried out in this area proposes that the currencies were over-valued by approximately 20%, with Korea being slightly less at around 10%.[2]

The crisis clearly illustrates the inherent danger of adopting fixed exchange rates. There are two main justifications for adopting fixed exchange rates. The first is as a means of reducing volatility in thin currency markets. The second is to provide a price anchor, a previously successful weapon against hyperinflation, as shown by many of the Latin American countries, notably Brazil, who have already been

[2] Sachs (1998)

through a similar economic crisis. Flexible rates are by their nature more prone to bouts of volatility, but fixed or nearly fixed exchange rates are susceptible to massive shifts which are difficult to defend against. Governments are forced to drain foreign reserves against speculative attacks, ultimately bringing about devaluation. As a final point on exchange rates, there had been some suggestion that the East Asian countries had pegged themselves to the wrong currency, and that a wiser option would have been to replace the US dollar with the Japanese yen.

Another crucial factor in the development of the crisis was the over-investment resulting from a widespread belief among creditors that they would be bailed out if their investments turned sour. The precedent set by the IMF during the Mexico crisis of 1995 prompted Asian investors to believe they too would be rescued if things went out of control. The quality of investment definitely deteriorated during this period as investors chose increasingly risky opportunities in the belief they would be supported. Banks must also accept some responsibility, as they believed the government would support them if they were financing certain projects. This occurred because the banks were able to borrow funds on the basis of explicit or implicit guarantees. Newly liberalised banks and near-banks were operating under highly distorted incentives. Under-capitalised banks had incentives to borrow abroad and invest domestically, therefore acting as intermediaries for channelling foreign capital. In addition the banks were, at this stage, under-regulated and thus could provide funds for risky ventures. State-owned banks in particular believed they would be bailed out. A secondary feature of the Asian economy was the lack of bankruptcy laws applied at this stage. The weak laws made it difficult for creditors to collect any collateral in the event of default. Some economists have suggested that excessive lending, driven by "*moral hazard*", helped create an unstable boom in Asian economies and the inevitable end to this boom period caused a downward spiral of declining prices and failing banks.

Alternative Explanations of the Crisis

Early last year Time magazine aired a view which has since become widespread. Time writer Richard Hornik attributed the crisis to the "*Asian Model*" of capitalism. The top-down nature of the Asian model bred complacency, cronyism and corruption. Isolation from public opinion, just as they had insulated bankers and businessmen from market forces, permitted the Asian Governments to ignore clear warning signals. Many top economists levelled some degree of blame on the refusal to move towards a "*Western*" form of free market capitalism. Those who blame the crisis on the failure of the model argue that while there may be some intermediary triggers, the underlying causes were structural. The "*Asian Model*" argument fails to hold up when under close scrutiny, because it relies too heavily on these countries adopting interventionist policies, and these were clearly not much of an issue in the Asian economies, Hong Kong being one of the most open economies world-wide. In fact, as has been shown it is precisely for this reason that the crisis occurred: too little Government control over the financial liberalisation process.

Another argument is centred around shifts in international market conditions. Before the crisis, market conditions were favourable to the East Asian countries with low US interest rates, stable commodity markets and falling risk premia on loans, each country experienced impressive export growth. However, immediately before the crisis struck export values collapsed. In the case of Thailand the dollar value fell by 1% after two years of 20%+ growth, similarly Korea's exports grew by only 4%, down 30% on the previous year. Some people argue there was simply a glut in labour intensive production, and this was reflected in slower export earnings. Others suggest the impressive take-off experienced by China, now eleventh largest exporter in the world, had shifted export-orientated production away from the rest of Asia. Concerns over the competition offered by China were compounded with the 50% devaluation of its currency, the yuan, in 1994. Although nominal appreciation will have eroded the significance of this last point. China's emergence would certainly have affected some markets, but it would have only contributed to export slowdown in a relatively moderate capacity.

IMF Intervention

The initial response of the international community, guided by the IMF, only served to magnify the crisis. The IMF imposed tight monetary and fiscal policies, having wrongly interpreted the situation as a balance of payments crisis. However, in reality the problem was born out of a crisis of confidence and the IMF programmes simply added to the panic and contractionary force of the financial crisis. The austerity did not build confidence nor reassure investors but deepened the economic contraction. The IMF reacted relatively quickly in amending its fiscal policies, yet adopting the appropriate monetary policies proved to be more demanding. The IMF faced a dilemma: raising interest rates would attract foreign investment and prevent further decline of the Asian currencies but at the same time would make it more difficult for domestic firms to service their loans.

The IMF's approach to the banking system was particularly misguided. Its initial approach was to commence on a series of closures of bank and financial institutions.

Such measures were never likely to encourage confidence. In addition, the IMF is not suitably positioned to enhance confidence in the markets, and the mere presence of the IMF amplified misgivings about the economies in question. As Jeffrey Sachs said:

> *"The arrival of the IMF gives all the confidence of seeing an ambulance outside one's door."*

There is no reason to believe that such strong regulatory policies of closing banks and financial institutions, in the middle of a panic, would improve market confidence. In fact this is the complete opposite mindset of creditors who would recognise banks will not be supported by a lender of last resort and only contribute to further panic. The IMF seemed aware of the risky nature of their policies:

> *"During the process of financial restructuring a key objective will be to ensure that confidence in the remainder of the banking system is maintained. The authorities are mindful of the risk that bank closures could induce a run on healthy institutions."*[3]

However, unfortunately for the Asian economies the IMF failed to appreciate fully the level of risk involved with their actions.

Summary and Conclusions

In summary, the Asian economies suffered from a number of growing weaknesses in the build up to the crisis, including expanding and un/undersupervised financial systems, large highly liquid short term capital inflows being used to finance increasingly poor investments and a rapid deceleration of export growth. Together these factors contributed to the downturn in creditor perceptions and the onset of the crisis. The key question is whether the sum of these factors was sufficient to warrant the economic collapse of an entire economic region. The initial prognosis suggests it was, yet a closer analysis reveals that the severity and depth of the crisis cannot be explained by this alone, but rather that financial panic and overly-liberalised financial systems were to blame. It is also true that the crisis was magnified by some policy misjudgements both by the domestic governments and the IMF, however, the costs of not intervening in Asia's crisis would have been extraordinarily high. Investors would have fled even more quickly, countries would have been forced to

[3] Indonesia (1997), p. 18.

default on their debts, and the region (and perhaps the world) would have been plunged into an even more serious crisis.

The outlook for the Asian economies is still uncertain, stabilisation has returned and interest rates are decreasing. Many of the countries are once again featuring exceptional growth figures as shown in the Appendix, even those worst affected like Thailand are now experiencing growth of 7.7%. Just as economists struggled to ascertain the reason behind the original success of Asia, they are equally perplexed by the sensational re-emergence of the economies after such a dramatic fall from grace.

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Appendix

Emerging market indicators.
GDP, industrial production and consumer prices all shown as % change on previous year.

Country	*GDP*	*Industrial Production*	*Consumer Prices*	*Foreign Reserves $bn 2000*	*v. 1999*
China	7.3	8.8	-1	156.8	148.6
Hong Kong	4.5	-6.3	-4	96.3	89.6
Indonesia	0.5	20.2	0.4	26.3	20.8
Malaysia	8.1	16.2	1.6	30.6	25.6
Philippines	4.6	-11.7	2.6	12.9	8.9
Singapore	6.7	7	1.4	74.3	74.9
South Korea	12.3	24.1	1.6	74	52
Thailand	7.7	15.3	0.5	34.1	28.8
Taiwan	5.1	10.9	0.5	103.5	88.1