An analysis of the asian financial crisis

ASSIGN BUSTER

The miracle that was East Asia came to a sudden halt in 1997. After growing by an annual average of more than 8%, Asian economies not only shifted to lower gear, they even reversed course. The collapse of the Thai baht in July 1997 sparked off a massive financial and economic maelstrom in the region. As exchange rates and stock markets plunged, foreign debt denominated in foreign currencies soared. Many domestic firms became insolvent, interest rates skyrocketed and credits dried up as panic by domestic and international investors ensued. Meanwhile ethnic tensions, erstwhile contained by strong economic growth, flared up again, particularly in Indonesia. This, in a nutshell, was the 1997-1998 Asian financial crisis.

Despite prompt and concerted attempts by developing countries, industrial countries and international organization to contain it, the Asian Crisis of 1997 spread to other Asian, Latin and Eastern European economies to varying degrees. In fact, this crisis put one third of the globe into recession in 1998. The crisis raised various questions regarding, not only the future of the region's economy but also about the impact of the crisis on various multinational companies and the world.

Reasons

Although explanations differ, most accounts now agree that the weakness of Asian financial systems was pivotal. One scenario was that, the liberalization of capital accounts and financial systems in Asia interacted with poor and inadequate regulatory structures. This led to rapid domestic expansion, as reflected in asset price bubbles, which in turn fuelled more borrowing. As a result, the economy was held hostage to shocks like changing investor

expectations. When external events pricked the bubble, the spiraling increase in asset inflation became a downward spiral of asset collapses.

Another scenario highlights the role of short-term maturity debt and the term structure mismatch between assets and liabilities that made these economies extremely sensitive to investor expectations. The short-term liabilities of Asian ec`onomies were very high, with some–particularly Thailand, Korea, Indonesia, and Malaysia – far exceeding their liquid reserves prior to the crisis. This made them extremely vulnerable to sudden calls for repayments.

Yet another scenario emphasizes the policies of fixed exchange rates followed by Asian governments, which encouraged over borrowing and contributed to the fragility of the financial sector. When the US dollar appreciated against major industrial currencies, the Asian economies whose currencies were pegged to the dollar also appreciated, thus worsening their export competitiveness. Poor export performance due to lower competitiveness was compounded by weak domestic demand from Japan, and low cyclical demand for semiconductors worldwide. This, combined with the vulnerability of Asian financial systems, changed the overly optimistic outlook on Asia. The stage was thus set for the currency attack and financial crisis.

The question still being debated, however, is what made these economies pursue policies that rendered them vulnerable to external shocks, and what economic incentives or disincentives led to the weakening of the Asian financial structure, apparently to its very core?

Although much has been written about the Asian financial crisis, two competing explanations dominate the debate over the root cause of the crisis. One story is that the Asian financial crisis was caused by a panic-induced illiquidity of capital markets, the ‘ panic hypothesis’ or ‘ illiquidity hypothesis’. The other story maintains that the Asian financial crisis stemmed from latent structural defects, induced by adverse incentives, which then encouraged excessive risk taking, the so-called ‘ moral hazard’ hypothesis.

Panic & Illiquidity

The ‘ panic’ view, simply told, is that the frenzied haste to divest out of the region resulted in costly asset liquidations, asset price collapses, domestic bank runs and the drying up of credit. According to those in this camp, economic fundamentals, including government policies in crisis countries may have been unsatisfactory, but did not warrant a crisis. Real exchange rates, for instance, were only slightly overvalued. Instead, the crisis occurred because of adverse shifts in market expectations. These shifts can generally be precipitated by almost anything like the collapse of a big bank, political turmoil or lackluster export performance. Once panic prevails, however, sound fundamentals become irrelevant. Market expectations are therefore the key to understanding crises. What the ‘ panic’ hypothesis highlights is the inherent instability of international financial markets.

Structural Defects & Moral Hazards

The ‘ moral hazard’ view attempts to explain why economies like Thailand, Korea, and Indonesia reached such a level of vulnerability that they were like disasters waiting to happen. This view maintains that the root cause of the

crisis lays in the wrong economic incentives–induced by implicit or explicit government guarantees, connections with the powers-that-be or interlocking ownership structures-which then led to over borrowing, over lending, and over-investment. In other words, the ‘ moral hazard’ view places bad government policies at the heart of the crisis, even though these very policies were once lauded for achieving fast growth and material improvement for so many people. The point, however, that the ‘ moral hazard’ camp tries to drive home is that the vulnerability of the Asian economies resulted from the accumulation of many years of bad habits, glossed over while the going was good. Some of these bad habits were actually residues of the industrial policies and winner-picking that, ironically, was thought to have propelled these economies to tiger hood.

Policy Implications from the Lessons Learnt

The divide between the two views extends to policy implications for a post-crisis, global financial environment. On the one hand, the ‘ panic’ camp’s main policy focus was on reform of the international financial system, the inherent instability of which was spotlighted in the Asian crisis. Grand proposals like the need for an international lender-of-last-resort, an international bankruptcy court, burden sharing between private creditor and borrower alike in the event of a systemic crisis, and better provision of information to minimize uncertainty, were the major policy prescriptions of ‘ panic’ view adherents.

The ‘ moral hazard’ camp, on the other hand, was more concerned with removing the incentives that gave rise to economic vulnerability. It proposed an arm’s length relationship between banks, instead of the old cozy

relationships. It also advocated increased transparency and improved corporate governance, as well as the strengthening of banking supervision and regulation.

Most of the policy recommendations for strengthening the international financial system focused on the following:

Improving Corporate Governance

Improving corporate governance means addressing the bad incentives or moral hazards stemming from certain ownership structures. In Asia, these structures include interlocking directorships between banks and firms; family-dominated, corporate ownership; ineffective legal and regulatory frameworks; and a lack of transparency and adequate disclosure rules. These all contributed to the overleveraged characteristics of Asian corporations. For this reason, an effective legal and regulatory framework, coupled with strict rules of transparency and disclosure, is fundamental for sound corporate governance and efforts are going on in this direction.

Financial Restructuring

Closely connected to corporate governance reforms is the supervision of banks and the financial sector. In contrast to governance issues, however, this is more straightforward. Bank restructuring, for instance, has had a slow start but has nevertheless advanced. Solvent firms have been closed, some banks have been recapitalized, mergers are taking place, and Asian governments have established appropriate agencies to take care of foreclosed assets. Rules on the foreign ownership of banks and financial institutions have also become more liberal, non-performing loans are finally

being tackled, and securitization attempted. Financial restructuring must go hand in hand with better corporate governance and an improved regulatory and supervisory structure. Supervision needs to be tight and strong, professional and arm's length.

Regional Cooperation

The imperative for maintaining the momentum of systemic and institutional restructuring lies with national governments, but there is some scope for support at the regional and international levels. Opportunities exist, at a regional level, for East Asian governments to engage in policy consultation and to share their experiences in reforming the corporate and banking sectors. The formation of the ASEAN Surveillance process is a significant development along these lines. Its main purpose is to set up a monitoring and early warning system for the region, but it also provides the institutional setting where a frank exchange of views on policy directions in ASEAN can take place and where joint action, if appropriate, can be forged.

Performance of East Asian Economies and Financial Markets since the Crisis

After the outburst of the crisis, East Asia recovered at an impressive pace. For those countries most affected by this financial crunch (e. g., Thailand, Malaysia, Indonesia and South Korea), their real GDP growth rates turned from negative in 1998 to positive in 1999 and 2000, and their currency and stock markets also largely recovered. Moreover, interest rates remained below pre-crisis levels, and inflation was well controlled for some time. In addition to the favorable domestic environment for these countries, the international economy also showed an unusually strong performance, giving

East Asia's economy a lift. The world GDP growth rate surpassed 4. 1% in 2000, more than twice the rate of 1998; and the international trade growth rate reached 11% in 2000, more than twice the rate of 1999. Two major factors appeared to explain this fast recovery:

Strong U. S. economic growth and currency value.

Net cash inflows in foreign direct investment and current account surplus of crisis-hit countries.

Factors Contributing to Recovery

Following factors appeared to contribute towards the recovery from the crisis:

Strong economic growth and solid currency value of the U. S.: The economic growth and the rising import demand of the U. S. generated a positive shock and exerted a strong influence on East Asian emerging economies. We note that the U. S. recorded a strong GDP expansion after the crisis, with growth rates of 4. 5% in 1997, 4. 3% in 1998, and 3. 8% in 1999, and the value of U. S. dollar exhibited an upward trend in those three years. Stimulated by an expanding economy and currency appreciation, the domestic demand for import went up strongly in the U. S. throughout the post-crisis period, creating tremendous export opportunities for East Asian economies.

Net cash inflows in FDI and current account: In 1996, the net direct investment and other capital accounts were in surplus, while the current account was in deficit. After the crisis, massive foreign capital fled East Asia. The deficit of capital account was large, which further contributed to the

instability in this region. How-ever, the net direct investment remained in surplus and the outflow in capital account slowed down considerably in 1999. In addition, the current account reversed from deficit to surplus after the crisis largely due to increasing ex-ports to the U. S. The overall cash flow balance turned from negative to positive in 1998 because of the sizable surplus in current account and the net inflows in capital account. Hence, the net cash inflows in 1998, 1999, and 2000 have helped the crisis-hit countries build up substantial foreign reserves.

Conclusion

The Asian crisis was an eye-opener. The Achilles heel of the Asian economies, their financial systems finally gave in after years of excess. What caused the financial systems to give way is still a matter of academic debate. A pragmatic reading of the crisis suggests that the bulk of the policy responses had to be carried out on the home front. It is imperative that domestic reforms focus on both systemic and institutional restructuring. Asia clearly needed and needs to change continuously. It needs to be open to the West and the Western style of business, from the provision of information to business relationships. Domestic efforts should also be supported by regional and international mechanisms.