

# East Asian Crisis

## Economies of East Asia ECON 3077

### The East Asian Crisis



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## The East Asian Crisis: Background

- The Asian crisis is generally pegged at starting on July 2, 1997 with the devaluation of the Thai baht.
- The sharp drop in the Thai currency was followed by speculation against the currencies of Malaysia, then of Indonesia and eventually of South Korea. Other economies including Singapore, the Philippines and Japan were also badly hurt by the crisis.
- Main features of the crisis:
  - Collapses in domestic asset markets
  - Widespread bank failures
  - Bankruptcies on the part of many firms

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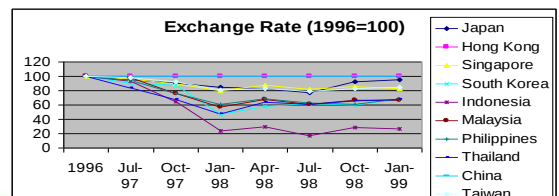
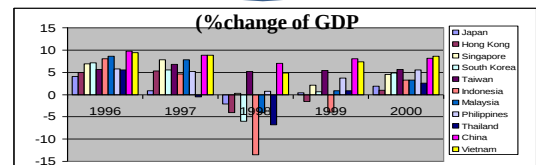
## The East Asian Crisis: Thailand

- In 1996, Thailand experienced an unsustainable investment boom
- Trade deficit 8% of GDP
- late 1996 attack on the baht
- Early 1997: collapse of finance companies and bank runs
- July 1997: collapse of the baht (first country in trouble)
- Intervention of IMF
  - high interest rates, credit crunch
  - cut in budget deficit
- Drop in demand, investment, consumption, etc
- 1998 Deep Recession
- Decline in GDP -7 percent, industrial production -20%
- Change of government.
- Late 1998, signs of stability at low level
- Substantial recovery in 1999-2000

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## The East Asian Crisis: What Happened? (%change of GDP and Exchange Rates)



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# East Asian Crisis

## Current Account Deficits

| East Asian (Current Account)/GDP |      |      |      |      |      |      |      |      |
|----------------------------------|------|------|------|------|------|------|------|------|
| Country                          | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
| Indonesia                        | -2.6 | -3.3 | -2.0 | -1.3 | -1.6 | -3.2 | -3.4 | -2.3 |
| South Korea                      | -0.8 | -2.8 | -1.3 | 0.3  | -1.0 | -1.7 | -4.4 | -1.7 |
| Malaysia                         | -2.0 | -8.5 | -3.7 | -4.5 | -6.1 | -9.7 | -4.4 | -5.9 |
| Philippines                      | -6.1 | -2.3 | -1.9 | -5.5 | -4.6 | -2.7 | -4.8 | -5.3 |
| Thailand                         | -8.5 | -7.7 | -5.7 | -5.1 | -5.6 | -8.1 | -8.1 | -2.0 |

Source: World Bank, World Development Indicators.

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## The East Asian Crisis: What Went Wrong?

- The main issue
  - Rapid growth suddenly collapsed in the entire region.
  - Why were so many countries affected, but not all?
- What were the Internal Issues?
- What were the external forces?
- Was it institutional (cronyism)?
- Was it a business cycle swing?
- Was it caused by international speculators?
- Was it a loss of confidence (contagion)?

The Asian economic crisis happened quickly and with little warning. While the crisis has provoked a large number of studies, there is no consensus on its causes. – Some explanations are provided on the next slides.

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## The Failings of the Asian Model School

- This school suggests that, while there may have been various immediate triggers
  - a property price bubble
  - macroeconomic mistakes (e.g., supporting for far too long a nominally fixed exchange rate)
  - fall in the rate of growth of exports, or a regional contagion effect
  - the underlying causes were structural and an integral part of the Asian model of capitalism.
- The crisis manifested itself in the form of 'over-investment', misallocation of foreign capital inflows, and severe problems in the financial sector. The financial structure of the corporations and the banks, as well as other deficiencies of the state-guided or state-directed financial systems in Asian countries, made these economies very fragile.

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## Adverse External Factors

- Many Asian political leaders blamed on the activities of foreign speculators.
- Based on careful theoretical and empirical analyses, research show that it is entirely possible for a financial crisis to occur even when a country's fundamentals are totally sound. It may arise because of changes in investor sentiment or perceptions which may be triggered off entirely by external events such as changes in interest rates or equity prices in advanced countries.
- Some models use the analogy of the classic panic-induced run on the bank to describe the financial crisis in East Asian countries.
- Problem in Japanese economy

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# East Asian Crisis

## Financial Liberalization

- This school ascribes the crisis to liberalisation of the global financial markets, and particularly to the deregulation of the capital account which many Asian countries had undertaken in the preceding period.
- It is argued that the crisis occurred directly as a result of deregulation and liberalisation when the governments relinquished controls over the financial sector as well as corporate investment activities. This led to misallocation (towards, for example, the property sector) of investment as well as over-investment.

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## Evidence

### (1) Fundamentals

- It seems that all the affected countries prior to the crisis had for a long time enjoyed strong "fundamentals": strong growth; low inflation; high domestic savings; healthy fiscal positions.
- A significant blemish on the pre-crisis record was the current account balances in some of the affected countries.
- Asian countries suffered to varying degrees from short-term imbalances such as overvalued exchange rates, as well as short term liabilities of the financial sector which exceeded the value of the central bank's reserves. This required some macroeconomic adjustments and restructuring of debts.

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## Evidence

- (2) The Capital Supply Shock: It is widely agreed that the proximate cause of the crisis in Malaysia, Indonesia, Thailand and Korea was the capital supply shock - the sudden interruption and reversal of normal capital inflows into these countries.
- (3) Structural Factors:
  - Transparency: Because of the nature of the Asian corporations (involving extensive cross-subsidisation of subsidiaries) and their close, the markets did not have enough information about the true financial status of the corporations and the banks.
  - Over-investment and misallocation of investment
  - Chaebols in Korea

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## Evidence

- (4) Financial Liberalisation: The typical corporation particularly in Japan, Korea, or Thailand is heavily geared, i.e. has a high ratio of debt to the equity capital of the shareholders. Such a corporate system became dysfunctional when the government a process of financial liberalisation. It permitted companies and banks to raise money abroad without the traditional supervision and control.
- The East Asian crisis has sparked an intensive debate. Different authors emphasised different roles of fundamentals; the capital supply, structural factors and financial liberalisation in explaining the causes, onset, and evolution.

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# East Asian Crisis

## The Immediate Impact of the Slowdown During the late 1990s was Shortlived and Differed Across Countries

Growth rates of Real GDP

|               | 1996A1 | 1997A1 | 1998A1 | 1999A1 | 2000A1 | 2001A1 |
|---------------|--------|--------|--------|--------|--------|--------|
| INDONESIA     | 8.0    | 4.5    | -13.1  | 0.8    | 4.8    | 3.2    |
| THAILAND      | 5.9    | -1.5   | -10.8  | 4.3    | 4.4    | 1.5    |
| MALAYSIA      | 10.0   | 7.3    | -7.4   | 6.1    | 8.3    | 0.3    |
| KOREA         | 6.8    | 5.0    | -6.7   | 10.9   | 8.8    | 2.6    |
| HONG KONG     | 4.5    | 5.0    | -5.3   | 3.0    | 10.5   | -0.3   |
| JAPAN         | 3.6    | 1.8    | -1.0   | 0.7    | 2.2    | -0.4   |
| PHILIPPINES   | 5.7    | 5.2    | -0.6   | 3.4    | 4.0    | 2.9    |
| SINGAPORE     | 7.7    | 8.5    | 0.1    | 5.9    | 9.8    | -2.9   |
| PAKISTAN      | 2.9    | 1.8    | 3.1    | 4.1    | 3.9    | 3.7    |
| TAIWAN        | 6.1    | 6.7    | 4.6    | 5.4    | 6.0    | -2.2   |
| SRI LANKA     | 3.8    | 6.4    | 4.7    | 4.3    | 6.0    |        |
| BANGLADESH    | 5.0    | 5.3    | 5.0    | 5.4    | 6.0    | 4.7    |
| INDIA         | 7.3    | 4.9    | 5.8    | 6.8    | 6.0    | 4.4    |
| CHINA         | 9.6    | 8.8    | 7.8    | 7.1    | 8.0    | 7.3    |
| UNITED STATES | 3.6    | 4.4    | 4.3    | 4.1    | 4.1    | 1.0    |

Source: IMF, December 2001

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## The Recovery Happened– But There is Always the Question of Sustainability

- Most East Asian economies have performed strongly since 1999.
- Main factors behind the recovery include:
  - Strong exports, partly due to depreciated exchange rate levels;
  - Rebuilding of foreign reserves, partly because of collapsing imports in 1998;
  - Fiscal deficits and low interest rates stimulating aggregate demand;
  - Various structural reforms to strengthen the financial system; and
  - Sustained foreign direct investment inflows.

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## Is there a Need to Reform the World's Financial "Architecture?"

- The Asian crisis convinced nearly everyone of an urgent need for rethinking international monetary relations because of two reasons:
  - The fact that the East Asian countries had few apparent problems before their crisis struck
  - The apparent strength of contagion through the international capital markets

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## Ideas for Reforming Global Capitalism

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| <p><u>Market-reinforcement</u></p> <ul style="list-style-type: none"> <li>– transparency                             <ul style="list-style-type: none"> <li>• reserve transactions</li> <li>• economic statistics</li> <li>• foreign indebtedness</li> </ul> </li> <li>– regulation                             <ul style="list-style-type: none"> <li>• capital adequacy</li> <li>• a global regulator</li> </ul> </li> <li>– reduce moral hazard                             <ul style="list-style-type: none"> <li>• curb the IMF</li> <li>• bail in private lenders</li> <li>• "orderly workouts"</li> </ul> </li> </ul> | <p><u>System reinforcement</u></p> <ul style="list-style-type: none"> <li>– guarantor for loans</li> <li>– capital controls                             <ul style="list-style-type: none"> <li>• tax forex transactions</li> <li>• control ST inflows</li> </ul> </li> <li>– "lender of last resort"</li> </ul> <p><u>Regional mechanisms</u></p> <ul style="list-style-type: none"> <li>– Currency swaps</li> <li>– Surveillance</li> <li>– Common currency or basket</li> <li>– Asian Monetary Fund</li> </ul> |
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