What caused the currency and financial crisis in Asian economies ?

The 1997-1998 financial crisis in Asia is the sharpest to hit the developing world since the debt crisis in 1982.This period highlights the main weaknesses in international capital markets and shows how vulnerable they can be to sudden reversals in market confidence. Many point to the change in market expectations and confidence as the source of the problem while others blame the fundamental imbalances in these Asian economies. Whichever view, it is no doubt that the panic and overreaction of investors, the questionable policy response of the International Monetary Fund {IMF} and policy mistakes made by Asian governments are all factors which only deepened the crisis. In this essay we examine the Asian meltdown and provide reasons for why stricter controls on international capital flows were needed. The countries hit hardest by the Asian crisis were Indonesia, Korea, Thailand, Philippines and Malaysia, known as the Asian five. Our discussion centers mainly on these countries.

Our examination of this crisis begins with the liberalisation of financial markets in the early 1990's. Amid political pressure to maintain high levels of economic growth, the banking and financial systems became deregulated. As a result, domestic banks offered higher rates of return to foreign investors, attracting huge financial inflows, as investors were only too keen to pour their money into these countries. Huge loans were being taken on for domestic investment at the cost of large and persistent current account deficits. Domestic banks were taking massive loans from abroad and lending recklessly to domestic firms who invested in unprofitable and risky areas.

The problem of misplaced investment was particularly evident in Korea and Thailand, where there was over-investment and over-capacity in the non-traded sector. A lot of funds were used to finance the building of multi-storey offices and luxury hotels. Over investment in this sector led to over-capacity, where in many hotels the room occupancy rate was typically 20% or less of capacity. This risky investment yielded very low rates of return which were way below expectation. Misplacement of investment was evident in Korea with the dominance large firms called conglomerates {"chaebols" in Korean} over domestic banks. Because these giant firms had a large, if not a majority share in domestic banks, obtaining loans on request was easy. This heavy borrowing to finance risky investments led to at least 7 of the top 30 conglomerates being effectively bankrupt in 1997, triggering the financial crisis.

To maintain large inflows of funds from abroad, Asian countries tied their exchange rate on a one-to-one basis with the U.S dollar. The objective of this was to reduce the risk premium on dollar denominated debt, making the cost of borrowing cheaper, and also to achieve stability and credibility. Initial reasons for this exchange rate policy were mainly for high investment rates and high levels of productivity and output. This exchange rate policy backfired for Asian countries when a rise in interest rates caused the value of the dollar to soar after mid-1995.

With the appreciation of the dollar, the price of exports increased, resulting in a loss of competitiveness. As Asian economies struggled to maintain their pegged exchange rate, investors lost confidence in the currency and the government's ability to maintain the one-to-one exchange rate. This reeked chaos for the exchange rate. By having to abandon this pegged exchange rate these Asian countries suffered a massive devaluation of their currency, triggering the currency crisis. After abandonment of the pegged rate against the U.S dollar, Korean currency devalued by almost 50% in a matter of weeks, causing serious economic upset.

Both the financial and currency crisis suffered by the Asian five stemmed from serious over-lending and over-borrowing, the outcomes of severe institutional and policy deficiencies. Under-developed financial systems in an environment where there are huge quantities of financial borrowing and lending with lax supervision and deregulated markets gives perfect conditions for excessive risk taking and poor banking judgement.

The extreme capital inflows seen into these Asian countries were followed by a rapid reversal when foreign investors became concerned over huge deficits and seemingly little foreign reserves to finance the debts. Investments were not providing large enough rates of return and the threat of default on payment on the principle debt amount plus service charges resulted in lenders no longer willing to roll over short term loans. Capital flight struck when investors tried to get their money out of these countries as quick as possible. The withdrawal of foreign capital caused exchange rates to depreciate and interest rates to soar causing a rapid rise in Non Performing Loans {NPLs}. Many real estate projects, financed on unhedged dollar denominated loans, went bankrupt, under the weight of currency depreciation. Even domestic investors grabbed their money in a rush to buy dollars as the value of the currency plummeted.

This created a huge contractionary shock in several Asian countries. The closure of banks severely restricted bank lending because, {1} they were illiquid and {2} because they were forced to maintain capital adequacy ratios required by bank supervisors. In Indonesia, Korea and Thailand, this rush to improve capital adequacy ratios under threat of closure of under-capitalised banks by the IMF was particularly evident. Yet this only added to panic and contractionary force. The introduction of IMF programs in this period threatened bank closures as required restoration of adequacy minimum capital standards, tightened domestic credit and enduced fiscal policy contractions all added to the banking panics already underway.

With an abrupt cut in domestic banks lending, exports dropped as firms were unable to obtain working capital even with confirmed export orders from abroad. Such abrupt institutional changes are almost always poorly thought through and badly implemented, creating a sense of confusion and panic rather than building confidence. In several cases, especially Indonesia, IMF programs actually weakened the economy further

To add to complications during this economic nightmare, a severe drought hit Indonesia in December 1997. This resulted in higher food prices and food shortages. A fall in world petroleum prices {one of Indonesia's main sources of revenue} at the same time, reduced revenue from exports, applying further pressure to the exchange rate. Indonesia is a prime example of contagion leading to panic, and to severe, unnecessary economic contraction.

Four of the Asian 5 {Korea, Thailand, Indonesia and Philippines} all entered reform packages in co-operation with the IMF to pull them out of economic crisis. The goals of these programs installed were to prevent fraud on foreign obligations, limit currency depreciation, preserve a fiscal balance, limit the rise in inflation, rebuild foreign exchange reserves, restructure and reform the banking sector, remove monopolies, preserve confidence and credit worthiness and to limit the decline of output.

Fiscal policy contractions lay at the core of the programs, helping support the money contraction and defend the exchange rate. Much needed funds were injected into the dwindling financial system. Restored confidence in the banking system was achieved with immediate bank closures, which limited the losses being accumulated, whereas banks that were not closed were being pushed into rapid recapitalisation. This showed strong signs of implementation of policies and reform. Foreign exchange targets were met with the help of "bailout funds" and the tightening of domestic credit, reducing credit availability and raising interest rates, defending the exchange rate. The previous problem of over-investment in certain sectors was eradicated with the opening up of other sectors to foreign investment. However, as good as these reforms sound, none of the initial programs lasted more than a few weeks before being re-written. This was mainly due to poor continued implementation of programs by the governments in the region. There are still reasons to believe that certain elements of the programs had adverse effects themselves.

The need for closure or mergers of banks in the region was undeniable but the process in which it was done is questionable. Abrupt and immediate closure of financial institutions with no programs for sector reform only deepened the panic. The attempt to show "toughness" backfired by dramatically undermining confidence in the entire banking system. Many feared their bank would be next in the firing line and this sparked a bank run. A more sensible approach would have been to construct a more comprehensive strategy for bank restructuring over a larger time frame. Closure was not the only option for problem banks. They could have been put under receivership, protecting depositors and allowing good borrowers continued access to credit.

The time scale problem re-appears on the issue of how quickly should banks have been to re-capitalise during such a period of economic turmoil. Immediate request of re-capitalisation increases distress for private firms and leads to a rise in non-performing loans {NPLs}, this problem being particularly evident near the end of 1997. A lesson learnt by the IMF is that in order for policies to operate without causing further economic distress is that an appropriate time scale must be applied so that panic is kept to a minimum.

The events that took place in the Asian five over the period we have discussed certainly, in my opinion, provide a very strong argument for the introduction of controls on international capital movements. Protecting countries from such economic chaos that was evident in Asia is of paramount importance to the world wide economy. Yet, when considering the construction of mechanisms to control international capital flows, it is of vital importance that such controls do not hinder trade finance or production. Economic growth is a top priority for all developing countries, so to introduce restrictive controls over their interaction with foreign economies is a delicate issue, and must be given serious consideration.