The Asian Currency Crisis

A decade ago before the global financial crisis we are witnessing today, which is like no other as economists and finance professionals alike are saying, there was the Asian financial crisis. Back in 1997 the crisis, too, was like no other. However, unlike the global financial crisis now, the effects of the Asian financial crisis were relatively contained within South and East Asia.

Amid the crisis of 2008, the financial community needs to revisit its history and check for things learned in past crises. For some, the current financial crisis and the Asian financial crisis a decade ago have similarities in causes. “In view of the recent currency crisis in a number of developing and developed countries” (Vithessonthi, 2009, p. 293), this paper aims to identify the main explanations for the 1997 Asian currency crisis and discuss its implications on the Asian economic paradigm.

First a background on the Asian currency crisis before a discussion on the main explanations of the crisis is presented. According to Garg, Kim and Swinnerton, the 1997 Asian crisis is the third international financial crisis in the history of finance (1999). The first international financial crisis took place in Latin American in the late 1970s and early 1980s while the second began in the Mexican peninsula. In each of these international financial crisis, theories, collectively the first, second and third generation financial crisis models emerged. These theories are discussed in the next sections of the paper.

The 1997 Asian currency crisis is believed to have originated in Thailand. At that time, the fact that the economic crisis in Thailand’s emerging economy could spread throughout the rest of the world in so short a time was astounding. The crisis a result of the massive capital outflows from Thailand as investors began doubting Thailand's ability to repay its foreign denominated debt which it accumulated to fuel the development of its economy. As a result, the Thai government abandoned the baht's peg on the United States dollar resulting to a snowball devaluation of the rest of the region's currencies.

Asian Currency Crisis of 1997: Causes

For many people, the Asian Currency Crisis was inevitable – that decisions made almost three decades ago made sure that the currency crisis will happen. One of these decisions was when the "Bretton Woods system of fixed exchange rates" (The Economist) was suspended and currencies were allowed to float. With this, the world and the face of the financial and banking system changed as well. Finance shows several currency crises in its history, but the most severe until now was the Asian crisis which according to first and second generation theories is the result of the Asian governments' mismanagement of their economies as well as their lack of credibility due to the reputation of several Asian governments of being corrupt (Krugman, 1979; Obstfeld, 1994).

In a freely floating exchange rate market, countries through their monetary authorities and central banks do not intervene in their foreign exchange markets, hence monetary authorities don't sell or buy foreign currencies to lend stability to their local currencies. The market fully determines the value of the local currency relative to foreign currencies. In the 1990s several of the countries affected by the Asian currency crisis have floating exchange rate markets; hence their hands were literally tied in formulating rescue plans for their currencies.

However, some economists believed that the first and second generation currency crises models are not enough in explaining the 1997 Asian currency crisis. In contrast to the basic concept behind the first models and second generation models that a currency crisis is the result of a government's mismanagement of a nation's economy and the lack of that government's credibility, most of the countries affected and involved in the 1997 Asian currency crisis, at that time, "enjoyed government surpluses, increasing foreign reserves, low unemployment and increasing exports" (Vithessonthi, 2008, p. 47). Thus, ruling out the possibility of economic mismanagement as the cause of the crisis, perhaps in some countries was a factor, but clearly in the rest of the economies affected by the Asian crisis mismanagement was never an issue. Hence, the development of the third generation theories with a common theme of a shock, which was amplified and exacerbated by a financial accelerator mechanism (Vithessonthi, 2008; and Bernanke, Gertler, and Gilchrist, 1999).

Moreover, the 1997 Asian financial crisis appeared to be more deeply rooted in the financial imbalances in the private sector than in the public sector financial problems which characterised the first and second international financial crises (Verschoor and Muller, 2007, p. 710) which is in contrast with what is proposed by the first and second generation currency crisis models.

Third generation theories, on the other hand, explains that currency crises are the effects of changes in expectations of fundamental factors such interest rates (Bernanke, Gertlker and Gichrist, 1999). In the 1990s, the Asian region was comprised with more developing countries than developed ones. It follows that these developing countries in efforts to integrate with the global financial markets "have to forgo the ability to control capital mobility and liberalise [their] domestic financial [markets] so as to promote international trade and attract foreign investment" (Vithessonthi, 2009, p. 300). The capital inflows from these trades and foreign investments acculturated the development of these countries; however, unfortunately such rapid development also demanded the monetary policies of these countries to shift to expansionary, hence the real exchange rates of these countries appreciated. When capital inflows stopped or decreased, a currency crisis will ensue due to ballooning balance-of-payment account deficits.

It is interesting to note that the third generation models and theories on currency crises were developed after the Asian currency crisis. The first generation, on the other hand, was developed in response to the balance of payments crises in Mexico, Argentina and Chile in the 1970s and 1980s in the 1970s while the second generation theories were formulated after speculative attacks on the currencies of continental Europe and Mexico in the early 1990s.

Furthermore, the third generation models theorised that the Asian financial crisis was a result of several factors and biggest of these factors is the financial fragility of financial institutions (Liargovas and Dapontas, 2008, p. 1087). Microeconomic problems such as weak banking supervision and corruption eventually triggered the massive capital outflows from the region which resulted to the exponential devaluation of different local currencies.

In the same line of thinking, Chi Lo argued that “prolonged period of low interest rates leading to moral hazard, imprudent lending, regulatory oversight, excessive investment, and asset bubbles” (2008, p. 74) undoubtedly contributed to the Asian crisis. On a different line of thinking, some of the critics of the International Monetary Fund (IMF) blamed it for exacerbating the progress of the crisis instead of mitigating it effects. IMF so far has acknowledged that “its excessively tight fiscal policy had been inappropriate” (I.D.E. Occasional Papers Series, 2004, p. 22).

Although, almost everyone agreed that there was no single specific cause to the 1997 Asian financial crisis, there was considerable disagreement on the extent to which it spread (Jo and Willett, 2000. P. 407). Hence, the next section of this paper completely ignored the discussion on the extent of which the Asian crisis spread, but rather focused on the implications of the 1997 Asian crisis on the economic paradigms of the region.

Asian Economic Paradigm in the Aftermath of the Asian Crisis

Admittedly, the 1997 Asian currency crisis was the result of several factors acting upon and among each other that it is near impossible to single just one cause. However, what is much more important than identifying what single factor resulted to the crisis is the analysis of the impact of the Asian currency crisis to the economic policies and paradigms of the region. The following portion of the paper discussed how the economies in Asia revised their paradigms in view of the 1997 Asian currency crisis. Certainly, almost everyone made changes,

Japan, at that time was the biggest economy in Asia, was forced to review its economic policies and paradigm in view of the effects of the Asian crisis and in that fact that it happened at all. Japan’s economy, as David Flath said, is “made coherent through the logic of modern economics" (2005, p. 1) and during the Asian currency crisis, this logic was proven incorrect given the economic environments at that time.

Today China has and still is changing the financial and economic markets in Asia. As a new economic superpower (Center for Strategic and International Studies and the Institute for International Economics, 2006), its economic policies seem to have integrated the lessons of the 1997 Asian crisis. A look at China's current economic policies shows that its economic and finance managers have instituted strong capital controls which have been argued to mitigate the negative effects of currency crisis. These strong capital controls are believed t slow down the sell off of local currency which minimises excessive volatility in the country's exchange rate. A cautionary note on this though – during the Asian financial crisis in 1997, there was "[no] significant devaluations took place in China, which has remained relatively insulated from world financial markets" (Barro and Lee, 2003, p. 85) in contrast with the currencies of Thailand, Philippines, Malaysia, Indonesia, South Korea, Japan and Singapore which suffered devaluation in one agree to another.

South Korea, two years after the crisis, showed the "greatest progress in reforming its business practices and related legal framework and institutions" (Gray, 1999, p. 11). Some of the changes implemented by the Korean government are improved transparency, looser regulations for foreign investments into the country, and stronger rights for minority stockholders. Markedly, after the crisis, the relationship between the government and the *chaebol* or Korea's business conglomerates weakened thus closing some borrowing doors commonly available to Korean business. After the crisis, the Korea Asset Management Corporation or KAMCO was established.

KAMCO's function is to acquire non performing loans from banks and provide aid to banks in converting short term debts to long term.

David Meyer did a study on the structural changes of the Hong Kong's economy since 1997. 1997, which was the year that the Asian financial crisis became evident, was the same year that the governance of Hong Kong was returned to the Chinese Sovereignty. At that time, Hong Kong's currency was pegged to the United States dollar and speculative attacks o the currency were made during the crisis (Meyer, 2008, p. 7). However, after the crisis, "the networks of capital which link the city's international firms to Asia and to the rest of the global economy set the basis for the recovery. Hong Kong's economy transformed to more sophisticated intermediary services for China, the rest of Asia, and the global economy" (Meyer, 2008, p. 10).

As a consequence of the blame given to a fully floating exchange rate system, most countries in the Asian region have adopted a hybrid exchange rate system. In a hybrid exchange rate system central banks and other monetary authorities can actively trade currencies in the foreign exchange markets to manage the volatility of their currencies. Hence, emerging market countries in Asia are now using this system to reconcile inflation rates within and without – inflation rates is one of the factors affecting exchange rates in a floating exchange rate system.

Moreover, some Asian countries have adopted the currency board paradigm, perhaps in response to the Asia currency crisis. A currency board is a "monetary institution that issues domestic currency that is fully backed by holdings of foreign assets (Vithessonthi, 2009, p. 302). According to Frankel, a currency board has its distinct advantages: an exchange rate is fixed by both policy and law; reserve requirement ensures that each dollar's worth of domestic currency is backed by a dollar's worth of foreign reserves; and a self-correcting balance-of-payments mechanism, in which a payment deficit automatically reduces the money supply, results in a fall in spending.

In Thailand where the crisis originated, the government, right after the crisis, facilitated the restructuring of private sector debts, and several state owned enterprises were privatised. The Thai government also made drastic changes in it banking system. It aggressively recapilatlised and reorganised its banking sector. The country's Ministry of Finance and the Bank of Thailand, its central bank, instituted stricter regulatory reforms in the banking and financial sectors.

After the crisis, it is not uncommon to see countries implementing much more strict regulation for their banking system. This was supposedly to prevent a prolonged period of low interest rates leading to moral hazard and imprudent lending which were attributed to be contributory to the collapse of the region's economic system in 1997. Perhaps this is why China's banking system is considered a 'dinosaur system. Lo added that "China's banking system has been seen as the Achilles' heel of its economy due to poor asset quality, lack of market discipline, and an opaque operation model. The banking industry is still heavily regulated, risk control systems are still defective, and policy intervention still distorts the price of credit" (2008, p. 76). This researcher can not help thinking that this heavy regulation was the resulting paradigm from the lessons learned by China's finance and economic managers in studying the 1997 Asian currency crisis.

Conclusion

As we go through another financial crisis, policy makers in Asia and around the world desires for the development of a warning system that will give advance warnings for currency crises which will give policy makers enough time to lessen the effects of these crises. Yes, a warning system is truly desirable, but until it is not yet developed what is needed must be done.

Overall, the above analysis of the 1997 Asian currency crisis indicate that the complexity of the Asian economic system at that time including the exchange rate systems adopted by member nations contributed to the eventual collapse of Asian economic system. Affected nations in the region shifted their economic paradigm as a result of the crisis. Some adopted more strict banking regulatory systems; however a look into the financial crisis today makes it apparent that the financial markets of these Asian countries have slowly integrated into the international financial markets.

Clearly, what caused the 1997 Asian financial crisis is the agglomeration of s lot of economic and social factors that it is difficult to pinpoint a singular explanation. Hence, in shifting economic paradigms as a result of the crisis, economic and finance managers must take into account these different factors, individually and as a whole. Otherwise, the new paradigm will eventually follow the same road that its predecessors traversed – and, we all know that that road ended with the 1997 Asian currency crisis.

As we go through another financial crisis, as history has proven – the third generation currency crisis model developed after the 1997 Asian currency crisis – a new generation of currency crisis model and theory will emerge and will add much to our knowledge in mitigating the impact of such crises in the future, and of course, prevent their happening again.

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