# Why is the Southeast Asia Crisis a Global Economic Issue

# 1.0 East Asia Financial Crisis

The 1997 South East Asia (SEA) financial crisis was one of the two biggest financial crises of the 20th century, second only to the 1929 crisis. It was the most economic-devastating event in the region, deeply affecting those countries that took the full impact. In 1998 it quickly spread to north Asia, Russia, Europe and North and South America, and caused approximately one third of the world to go into recession.

"*The loss of global financial wealth in the three months following peak in July*

*[1997] was 2.3 trillion dollars*”

(Karunatilleka, 1999)

Korngkaew (1999) points to six major factors that attributed to the crisis. These are excessive current account deficit, financial mismanagement, high domestic interest rates, uncontrollable capital flow, a rigid exchange rate, political bureaucracy and corruption, and decline in export performance.

Evidence suggests that the SEA crisis was the product of bad decision-making, such as unsustainable economic policies adopted by South East Asian countries, in particular the one that unofficially pegged their exchange rates to the U.S dollar. In 1995, the U.S dollar begun to appreciate and this in turned caused the SEA currencies also to appreciate against other currencies. The labour intensive and export dependent nations lost competitiveness in exporting markets and their current accounts were severely affected.

In July 1997, one of the fastest growing “tiger countries”, Thailand devalued the Thai baht, and entered into a currency crisis following months of heavy speculation on the foreign exchange markets (FEM). Speculations on the FEM then turned their attention to Malaysia, Korea, Indonesia, Taiwan, Singapore, and their currencies were too devalued. A rescue package of $112 billion was organised by the IMF for Indonesia, Thailand and Korea was expected to stabilise their economies. A year later, the contagion effect of the SEA crisis is in full swing and in July 20 1998, Russia raises interest rates to over 100% over night. In September that year Malaysia imposes further capital flow controls and fixes its currency at RM3.30 to the dollar (Karunatilleka, 1999).

## 1.1 It’s Effect of Short-Term Capital Flows

Over the past fifty years we have seen technology advancing at an incredible rate and developing countries reforming their economic and political policies so as to become part of a highly globalised market. These are important aspects to bear in mind when assessing the impact of Asian crisis on the global financial structure.

Technology and globalisation have made short-term capital flow (or hot money) between countries possible. Short-term capital flows refer to capital investments on e.g. stocks and bonds, with a maturity of less than a year. In essence, it is the flow of money (capital) generated by investors that are looking for quick returns on their capital invested. Therefore, it takes a short period of time to withdraw short-term capital from a country. Short-term investors are always looking for the best return on their capital invested. For example, if bank X offers a 5% interest rate on saving and bank Y offers a 6% interest rate on savings, the best thing to do would be to deposit money in bank Y, because it has the highest return. This exactly what happened in Thailand when it entered its currency crisis.

Before the 1990’s, Thailand was the fastest growing economy in SEA and attracted fund managers from all over the globe. But during the 1990’s the U.S begun to experience further economic growth and to address possible inflation the U.S Central Bank increased interest rates to reduce spending and prevent a rise in prices. Investors noticed an increased flow of capital to U.S assets and withdrew investments from SEA so as to get a better return on U.S assets.

Furthermore, foreign short-term creditors financed a significantly large proportion of Thailand’s and SEA lending boom. SEA banks took advantage of low interests rates offered by foreign banks and used it to lend long-term domestically, also at a low interest.

“June 1997, 66% of outstanding loans to Thailand were short-term, 68% of outstanding loans to South Korea were short-term, 59% of outstanding loans to Indonesian banks were short-term and 56% of loans to Malaysia were short-term”

(Library House of Commons, 1999)

A loan repayments crisis eventually unfolded in Thailand, which caused foreign short-term creditors fears of loan defaults and so decided to withdraw funds from Thailand’s financial institutions. Shortly after, the Central bank in Thailand reported that 8% of loans made by Thailand’s largest financial firms were non-performing. In Korea it was 6% and in the Philippines it was over 3%.

Investors and Thai companies saw the unfolding events and converted their baht into dollars. Thailand responded by buying baht with dollars to sustain the baht’s fixed value to the dollar. However, in July 2 1997 Thailand run out of dollars and the value of the Thai baht fell more than 15% (Suk H, Mahfuzul. 2002). In December 1997 interest rates peaked 26% and during the year the stock market fell 55.2% (Library House of Commons, 1999).

International firms that had factories, subsidiaries, and poured FDI (Foreign Direct Investment) in Thailand were also affected and decided to move their operations elsewhere. Therefore, Thailand started to loose and repel foreign long-term investments too.

## 1.2 Effect on the Global Economy

Once the Thailand currency crisis became apparent to all, investors and companies took a closer look and were quick to find parallels between Thailand and neighbouring countries. The same factors that put Thailand’s economy at risk, such “high foreign borrowing and current-account deficits; a worrying proportion of bank lending going to finance a property glut; dollar-linked exchange rates, and slowing export growth” (economist, 1997) were also found in the Philippines, Malaysia, Korea and Indonesia. So these also converted local currencies to U.S dollars to hedge against probably losses, and led to a free-fall in value of the peso, rupiah, and won.