

## **The East Asia Financial Crises**

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The current East Asia financial crises started in Thailand as early as the autumn of 1996. The Thailand baht came under increasing pressure from speculators and hedgers. The Bank of Thailand fought back hard against these forces, but eventually ran out of foreign currency reserves and in July of 1997, had to uncouple the link to the US dollar and allow the baht to float. As the baht sank dramatically, the contagion quickly spread to Thailand's neighbors and competitors, Malaysia, Indonesia, the Philippines, and South Korea. Singapore and Taiwan were also affected but they did not go down. Their devaluations were minor. Hong Kong was even able to avoid devaluation altogether because Hong Kong has a monetary and foreign exchange system that is fundamentally different from that of the rest of East Asia. China's currency being largely not convertible was able to avoid devaluation altogether.

In many economies, the currencies were devalued by some 50 per cent or more and their banking and financial systems are in a shambles. The turmoil is in the first instance a balance of payments crises that necessitated a significant exchange rate devaluation. It then triggered a sudden loss of economic and political confidence and made it necessary for many East Asia economies to adopt a battery of austerity measures. For these unexpected developments to have more than transitory effects, the state of the economy in many of these nations had to be fundamentally vulnerable. It is this vulnerability that makes the loss of confidence on the part of the public and the loss of credibility of the government so potentially damaging.

### **I. Early Warning Signs**

Dornbusch and Werner (1994) have used the "overvaluation hypothesis" to explain the economic origins of the Mexican Pesos crises. Their account is useful for understanding what happened to many East Asian economies recently. The overvaluation of the exchange rate in many East Asia economies and its subsequent devaluation was caused by a number of economic factors and the policy actions taken by the authorities.

First, the decision of the government to maintain a sort of pegged and a freely convertible exchange rate to the US US dollar.

Second, a deterioration in the current account balance caused by a deterioration of economic fundamentals due to changing internal or external factors.

Third, the use of short term capital inflows to finance the current account deficit to keep the currency up at least for a while in the hope that the economic fundamentals will improve over time.

Fourth, these short term capital inflows were mainly in the form of loans rather than direct foreign investments made the economies especially vulnerable to volatile market sentiments.

Fifth, these foreign loans were either poorly utilized or failed to be applied effectively to improve the economic fundamentals. When economic fundamentals further deteriorated, the speculators and hedgers began to move against the currency.

Sixth, the government failed to exercise effective leadership. They typically fought the speculators and hedgers without success. When the governments' foreign exchange reserves ran out they had little choice but to devalue their currency. Their credibility, however, had by then eroded. The confidence crises spread from the currency market to the general public and the currency crises turned into a financial, economic and political crises.

Using the Dornbusch and Werner framework Lau and Park (1996) looked for early economic warning signs of financial crises in East Asia. They enumerated ten economic indicators as being correlated with impending exchange rate crises. No predictions were made about the relative importance of these economic indicators as leading forecasts for the timing and onset of the crises. The ten economic indicators they identified were:

1. Falling real exchange rate
2. Low rate of growth of real gross domestic product
3. High rate of inflation relative to world inflation
4. High nominal interest rate differential relative to world interest rate
5. Rising interest rate differential
6. High real rate of interest
7. Low domestic savings rate
8. Large negative trade balance
9. Large negative current account balance
10. High ratio of foreign portfolio to foreign direct investment

In the table below we present a list of economic warning signs for East Asia economies produced by Lau and Park (1996).

Table

<b>Economies/Indicators</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
Mexico	X	X	X	X	X	X	X	X	X	X
China			X							
Hong Kong										
Indonesia	X		X			X			X	
South Korea				X		X			X	X
Malaysia	X			X	X				X	
Philippines	X	X	X	X	X		X	X		X
Singapore	X				X			X		
Taiwan										
Thailand	X	X		X				X	X	X

It is interesting to note that Mexico had economic warnings signs for all ten indicators. In East Asia, the Philippines had economic warnings signs in eight out of ten indicators and was followed by six economic warning signs in Thailand. Indonesia, South Korea and Malaysia each had four economic warning signs. Singapore had three economic warning signs, but Hong Kong, Taiwan and China were given the thumbs up.

## **II. Japan and the East Asia Financial Crises**

The remote origins of the East Asian financial crises can be traced to the collapse of the property market bubble in Japan in the late 1980s. Many of the loans that the Japanese banks and financial institutions made became in effect bad loans. In principle, the banks had to write those bad loans down to market value, taking the losses into income. Recognizing bad loan losses that way, however, erodes the bank's capital ratios, and banks whose capital ratios are impaired, or close to it, cannot make new loans. They can thus no longer play their traditional role of providing finance for business activities.

The bank regulators feared that recognizing bad loans would impair the capital of their banks and lead to a liquidity freeze-up that would damage the economy severely. The regulators hoped that the problems were transitory. They pretended that by keeping the firms with the bad loans afloat these bad loans can still be considered as performing. They hoped that the economy will soon revive and the seemingly bad loans will be repaid.

In Japan, the sense of urgency may have been reduced by the seemingly endless store of bank capital represented by the unrealized capital gains on the stock of Japanese firms held by the banks. As the Nikkei 225 Average steadily sank, however, this cushion of capital dried up. And by the time the average was flirting with 14,000, as it did in 1996, the cushion was effectively gone.

In an attempt to restore Japanese bank capital, the lawyers who run the Japanese Ministry of Finance had a choice of strategies. They could have insisted that the banks write off the bad loans and raise more outside capital. But, that would both have damaged the existing stockholders and forced them to share their control with foreigners. Instead, the Ministry of Finance adopted another strategy which, unfortunately, destabilized the rest of East Asia.

The Japanese opted for a strategy of driving down short-term interest rates; and drive them down, they did, to levels not seen since the depression years of the United States in the 1930's. The Ministry of Finance's hope, of course, was that Japanese banks would obtain thereby some low cost short term funds that could be invested in higher yielding long-term securities to generate earnings and adding it to their capital. Indeed many of those loans went to the banks and firms in the East Asia economies. It was hoped that as the profits came in, more bad loans would be recognized and written off. The only cloud facing such a strategy would be an unexpected rise in the yen, but that was unlikely given the depressed condition of the Japanese economy. And, under the pressure of that depression plus the low interest rates the yen kept falling.

The real culprit for the financial crises in East Asia was the low and falling value of the yen. The real trouble with a falling yen is a rising US dollar. Thailand and other countries in East Asia had linked their currencies to the US dollar. As the yen fell and the US dollar rose. Currencies linked to the US dollar, therefore, inevitably seemed overvalued and ripe for speculator attack, particularly so after China, began to enter the export markets in a big way.

### **III. Credit Risk in East Asia**

Thailand's exports were perhaps particularly affected by Chinese exports. As Thailand's current account balance deteriorated, the authorities relied on short term foreign borrowing to finance its balance of payments deficit to maintain the peg to the US dollar. These short term loans were then lent to finance long-term investments in infrastructure and property development.

The other East Asia economies were far less affected by Chinese exports. Nevertheless they too borrowed short from abroad and invested heavily in dubious long term projects including infrastructure and property development. In the case of countries like Malaysia, Indonesia and South Korea, part of the bad loans were not simply ordinary commercial loans gone sour, but political loans reflecting the country's industrial policy. Writing them off would have been a huge embarrassment to the governments involved.

Many of these economies and particularly Thailand became vulnerable to both a rise in interest rates and a fall in the exchange rate. The East Asia banks and firms were not simply borrowing short and lending long, but were borrowing short in one currency—typically the US dollar or the yen—and lending long in another, the local currency. If, therefore, a country's exchange rate falls substantially relative to the US dollar, the cost of renewing or rolling over those short-term floating rate, US dollar or yen loans can become very high in local, real terms. When interest rates rise the borrowers are similarly dealt a double blow: the value of their long-term assets declines, and, at the same time, the cost of renewing, or rolling over their short term borrowings increases.

The US dollar and yen short-term loans to local borrowers are provided mainly by banks, especially, but by no means only, Japanese banks. The restructuring process would inevitably mean a big surge in loan losses and problem loans for the Japanese banks already staggering currently under their huge load of bad loans. The overhang of bad loans in Japan has led already to a virtual freeze-up of normal bank lending operations there and elsewhere in Asia. This credit crunch emanating from Japan and the Japanese policies for dealing with it are at the heart of the current East Asia financial crises, crises that cannot be fully resolved until Japan at long last, puts its house in order.

### **IV. Foreign Exchange Crises**

Thailand became the first target of speculators in the foreign exchange market because its economic and financial problems were most obvious. The Bank of Thailand tried to fight

off the speculators by raising interest rates and tightening market liquidity. The higher rate was intended to punish speculators by raising the cost of borrowing the currency to sell it short. Unfortunately raising interest rates not only does not substantially discourage the speculators, but actually enriched those who have already sold the currency short in the forward exchange market. And, in the process, raising rates also inflicts terrible damage on your own citizens. so many of whom, it will be recalled were borrowing short and lending long.

The Bank of Thailand also attempted to conceal the true state of its foreign exchange holdings. The deception was over the amount of US dollars and foreign currency reserves the Bank had left for fighting off the speculators and maintaining the value of the baht. The Bank said, and the public believed, that those reserves were substantial. But the speculators knew better, because they know that the battles over the value of a currency are not fought in the spot market but in the forward market. The Bank of Thailand, which was fighting the speculators in the forward market by taking a long position to offset the speculator short positions, could, for a while at least, continue to show substantial amount of foreign currency reserves on its books, even though, in effect, it had already committed those reserves in the forward market.

Central banks cannot postpone collateral calls indefinitely. The Bank finally had to admit that its foreign reserves were mostly gone. That admission led, in turn to a massive run against the baht, which changed the terms of the battle from one of countering speculators to one of stemming widespread capital flight by the Thai people themselves. With the deception by even the trusted Bank of Thailand revealed, the remaining Thai institutions, financial and political, could not withstand the loss of confidence. In the process what might otherwise have been a minor realignment of ten or fifteen percent turned into a major disaster.

The collapse of the currency in Thailand was followed by similar collapses and capital flight in Malaysia, Indonesia, the Philippines and South Korea, but not, as noted earlier, in Taiwan or Singapore, and especially not in Hong Kong whose has exactly the same value it had before East Asia's financial crises began. Hong Kong has been able to buck the tide because the people of Hong Kong have not lost confidence in their government and its promise to maintain the value of the currency, that is, to maintain the value of so much of their life's savings. As long as the public has this confidence, mere speculators can have little impact, especially in a currency-board system like that of Hong Kong, where nothing is supposed to distract the monetary authorities from their primary task of maintaining the peg. Indeed, the only serious threat to the peg can come when the monetary authorities misunderstand their role and start behaving like a central bank and follow Thailand's example of raising domestic interest rates to fight speculation.

## **Conclusion**

Where do we go from here? The answers will vary substantially over the region. For Hong Kong, for example, the answer is simple. The Hong Kong banks unlike the banks in Japan and South Korea are among the strongest, best managed and most honestly regulated in the whole world. The Hong Kong currency board, moreover, eliminates the need for a central bank, and the mischief such central banks can cause. It is just that you cannot hope to

maintain both the internal and the external value of currency at the same time. You have to choose one or the other.

Hong Kong has correctly adopted the strategy of maintaining a stable foreign exchange value for its currency by firmly pegging it to the US dollar. Exporters, of course, and in Hong Kong's case that includes the local tourist industry, will always be clamoring for devaluations. But the citizens of Hong Kong should remember that if they do choose to lower their peg, any gains will be temporary. Other countries will match the cuts. Import prices will quickly adjust leaving the exporters no better off competitively; but with Hong Kong's priceless reputation as an island of financial stability gone forever.

For those countries with weak banking systems, which includes most of East Asia except for Hong Kong, and possibly Singapore and Taiwan, a more rational system of bad loan recognition must be developed which in turn means huge amounts of new capital must be pumped in to make the banks capable of playing their role as financial intermediaries. The countries must recognize, however, that the needed capital can come only from one source: foreigners. And that those foreigners will be unwilling to put that capital in without substantially more control over the management of that capital than many locals are willing to give up to outsiders.

Such steps to shape up the local banks, though urgent, represent short-run solutions at best. Improve banking institutions, yes. But recognize that banking itself is disaster-prone, 19th Century technology. We must look ahead ultimately to reducing our dependence on banks as suppliers of capital to industry, partly by shrinking the banking industry itself, but, even more, by steadily expanding the number and variety of market alternatives to bank loans through developing the capital market. Here as so often in economic life, we must rely on decentralization and diversification—in this case diversification of financing alternatives—and not on the presumed superior judgments of large banks and their regulators for directing capital to its most productive uses.

## References

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