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Lessons from the Asian Financial Crisis

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The Asian Miracle is Alive

The Asian financial crisis may have finally put to rest the myth that the region's success is due to a unique system of capitalism rooted in Asian values, one immune to the depressions and other troubles that economies in the West have to endure. But this claim is being replaced with a skepticism that is equally wrongheaded: that the so-called Asian miracle had no substance, that it was built on a house of cards, which inevitably collapsed under the weight of cronyism and corruption.

The fact remains that real per capita incomes in the Asian economies had grown at an average rate of 4-6% per annum since the 1960s. This is not some national income accounting anomaly, but is evident in the high and rising rates of consumption that can be easily witnessed by all who have lived in or traveled through the region. It is also reflected in the vast improvements in health, life expectancy, and education of the people there. Even if the present crisis stopped all economic growth for the next five years, these economies would have performed well above the world average for some three decades.

The Asians' success has been built not on the discovery of a new form of capitalism, one that was advocated by Singapore's Lee Kuan Yew and Malaysia's Mahathir Mohamad and promoted quietly by Japan's faceless bureaucrats, but on a tried and true formula. The vital ingredients of which include a hard-working, well-educated, and trained labor force, and a vigorous entrepreneurial class that invests in plants and equipment. Each country spends more on human capital than do the vast majority of nations with comparable levels of per capita income. Most of these nations also encourage entrepreneurial activities and appreciate the importance of the market economy. They have promoted economic freedom through lowering taxes and by reducing barriers and restrictions in markets for goods and services and in labor and capital. Moreover, the physical infrastructure, like highways, office towers and factories these countries built at breakneck pace are still in place. None of these vital ingredients have been fundamentally altered as a consequence of the Asian crisis.

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What Went Wrong?

The issue of what went wrong can be usefully examined from a historical perspective. By taking into account the historical development of the Asian crisis the process of institution building stands a better chance of success in any future plans to reshape the global financial system.

The causes of Asia's crisis were quietly developing as far back as the late 1980s. Many factors had a role to play:

1. The economic recession in Japan after the collapse of its property market in 1989 and depressed Europe were tempted by the high profit margins of Southeast Asia.
2. The long economic boom and low interest rates in the U.S. markets had released a torrent of funds seeking higher yields in emerging markets.
3. The emergence of China as a major exporting nation in the region contributed to the worsening current account balance of some of the Southeast Asian economies.
4. The confidence of many Asian leaders eager to push their development plans without regard for economic fundamentals often supported by a chorus of international agencies, bankers, and investors.
5. Corrupt practices, outdated banking rules and weak supervision had left many Asian nations totally unprepared to handle a flood of foreign funds in a global capital market.
6. The mindset of the leaders and central bankers in the Asian nations was overwhelmingly confident in their own ability to successfully defend their currency against speculative attack finally led their country to total collapse and bankruptcy in the very end.

The 1987 Plaza Accord brought down the value of the U.S. dollar and ushered in a new era of the appreciating Yen. This led to a six-year cycle of Japanese investment in Asia that transformed and expanded the industrial base for Malaysia, Indonesia and Thailand. Japanese capital outflow reflected their own domestic problems. By refusing to write off mounting bad debts in the banking system after the asset bubble busted. Japan pursued a low interest rate policy to keep the banks solvent. The banks in turn took unusual risks by lending to many Asian economies in search of high yields in a bid to resolve their own domestic debt problems.

Foreign banks and funds, from Europe and later the U.S., flush with funds soon discovered these emerging markets where interest rates were high and risk very low because the currency was pegged to the U.S. dollar this lead to a five-year boom in Asian equities. As the Asian economies grew infrastructure bottlenecks became apparent. The World Bank's high profile claim that Asia needs $1 trillion worth of investment in infrastructure and bond markets soon captured the public's imagination. Japanese, European and to a lesser extent U.S. banks were soon providing short-term foreign currency loans at low interest rates to finance long-term infrastructure and real estate projects in Malaysia, Indonesia and Thailand. In Korea, the same short-term loans were given to support investments in projects favored by government industrial policy.

In addition, to currency and maturity mismatches, these loans were often extended without adequate assessment of credit risks. Indeed the current obsession with the lack of transparency and accusation of Asian crony capitalism were hardly mentioned then, as foreign investors and lenders ingratiated themselves to the powerful and influential and envied each other for their special and privileged access to the power elite. The lack of transparency in Asian business transactions that is much lamented today was viewed then as an opportunity for making huge profits that warranted taking large risks. These stories were well know among bankers then, they are now finding their way to the press as stories of failures are surfacing.

By 1995 the era of the strong Yen was being replaced by the strong U.S. dollar, a number of these Asian economies were slowing down and experiencing current account deficits, but capital inflows continued to accelerate. Thailand was most obvious whose exports were most affected by China's entry into the world market, but South Korea, the Philippines, Indonesia and Malaysia were all slowing down for a variety of different reasons. China was trying to engineer a soft landing after earlier excesses had led to intolerably high inflation rates. Hong Kong also experienced a slow down as government acted to restrain credit growth due to fast inflating asset prices.

At the end of day the economies in Asia became vulnerable as markets became increasingly aware of a buildup of excesses that were the consequences of poor investment judgments in seeking to employ huge increases in portfolios for investment. In some cases, these excesses were fed by unsound real estate and other lending activity by various financial institutions in these countries, which, in turn, undermined the soundness of these countries' financial systems. These excesses were reflected in overvalued exchange rates, growing current account deficits, and sharp increases in asset values.

The excesses of Asian governments, financial institutions and non-financial firms would not have been possible without the availability of cheap credit. The international banks and other foreign lenders made it possible for such excesses to be turned into disastrous excesses. The availability of cheap foreign currency denominated credit that was extended almost indiscriminately set the stage for the Asian crisis. Foreign lender were no doubt encouraged by the willingness or perceived willingness of international agencies and the U.S. government to bail out bankrupt countries, as in the case of Latin America in the 1980s and Mexico in 1993-4. There is little doubt that the actions of the International Monetary Fund in bailing out countries had created a serious moral hazard problem in international lending.

The moral hazard problem in international lending is a serious one that has to be properly addressed in any future design of the global financial system. Calls for greater transparency and better surveillance systems are all very fine but their effectiveness and value are difficult to assess and would depend on what one does with all this information and by who. A novel suggestion proposed by Charles Calomiris[2] to invite banks to police

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[2] See "The IMF's Imprudent Role as Lender of Last Resort", *Cato Journal*, Vol 17, No 3, Winter, 1988, pp. 275-294.

each other is worth serious consideration especially if it could be implemented. Part of the solution would be to reduce 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. 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.

It is interesting to note that unlike their Latin American counterparts, Asian businessmen by and large trusted their governments' ability to make correct policy decisions. The economic successes were often attributed to the sound policies pursued by their governments. The choice of market oriented policies reflected the wisdom of their governments and political leaders. Their trust might have been misplaced but genuinely existed. Against such a background advocates of Asian values found a willing audience. But even more disastrously they failed to sense the dangers of borrowing short in foreign currency and investing in long-term projects with earnings denominated in local currency. It is interesting to note that the World Bank's study *East Asian Economic Miracle* published in 1993 also failed to decisively dispute the dangers of government dominance of credit markets and to use it to achieve national and developmental goals. The ambitions and confidence of the political leaders in many of these Asian emerging economies were seldom challenged. The political system in the past also discouraged such embarrassing questions.

The overarching confidence of Asian leaders and central bankers in themselves had also blinded themselves to the severity of the economic and financial problems that were emerging. During the Mexican crisis speculative funds had made short-lived attacks against a number of Asian currencies, which had alerted them to do the dangers of such short run capital movements. It also led them to view such speculative activity as purely opportunistic and unjustified by economic fundamentals, for how else could you justify attacking Asian currencies when the problem was half way across the globe in Mexico whose economic ties to Asia were very limited.

This episode nevertheless prompted most Asian central bankers to come together to devise "repo agreements" to strengthen each other's staying power in defending their currencies against speculative attacks. Their mindset was clearly prepared to defend when attacked and speculators were viewed as pure opportunists. Hong Kong authorities had another reason to be concerned about the prospect of a speculative attack against the Hong Kong dollar because of the hand-over of sovereignty over the territory in 1997 from Britain to China. They were convinced that they should be armed to the teeth and were prepared to fight it out.

This mindset was first put to the test in Thailand. The Bank of Thailand fought back hard against the speculators, but eventually ran out of foreign currency reserves and in July of 1997, had to uncouple the peg to the dollar and allow the baht to depreciate, losing eventually some 50% or more of its value relative to the U.S. dollar. The Bank of Thailand's first mistake was to try to fight off the speculators by raising interest rates and tightening market liquidity. Raising interest rates not only does not substantially discourage the speculators, but could actually enrich 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 were borrowing short and lending long.

The most damaging mistake of the Bank of Thailand, however, was the concealment of the facts about the true state of its foreign exchange holdings. In the case of the Bank of Thailand, the deception was over the amount of 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.

When the Bank finally had to admit its foreign reserves were mostly gone. That admission led, in turn to a massive run against the baht, which quickly swamped the additional liquidity that the IMF had brought in and which changed the terms of the battle from one of countering speculators to one of stemming widespread capital fight 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. And in the process what might otherwise have been a minor realignment of ten or fifteen percent turned into a major disaster.

The speculators were probably encouraged by willingness of the Asian nations to support their currencies despite the vulnerabilities of their economies and their ineptitude at defending themselves successfully against such attacks. With the baht down so dramatically, the speculative attack quickly spread to Thailand's neighbors and competitors, Malaysia, Indonesia, The Philippines, and South Korea. Singapore and Taiwan were also affected, but they didn't go down. There were only minor devaluations in their currencies. Hong Kong was even able to avoid devaluation altogether largely because of its currency board system, the relative transparency of its monetary and banking system, and the people of Hong Kong have not lost confidence in their government and its promise to maintain the value of the currency. 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

I am not convinced that the rapid spread of these events throughout Asia is due to some contagion effect inherent to international financial crises. The fact that it happened more or less at the same time can be easily understood by the fact that many of these economies became vulnerable to different extents at more or less the same time. Their plight was to a large extent the culmination of the same global market forces that had been in operation for about a decade before the crisis emerged. These economies are remarkably similar in the fundamental nature of their problems. And, moreover, their responses to speculative attacks were again very similar even though the final outcomes varied depending on the relative strength and soundness of their monetary and financial systems.

The Asian economies were due for a large correction after a decade of rapid and excessive growth. But the total collapse of the monetary and financial systems in some of these countries were unnecessary and could have been avoided if better policies had been adopted to manage the speculative attacks on the currency. This would have been followed by a period of painful adjustment but the current plight of the economies in Thailand, South Korea and especially Indonesia could have been avoided.

The role of the International Monetary Fund in helping the economies was largely unproductive. While the evidence is not out yet, there is a lingering suspicion among many quarters that what it has achieved to date is to become the unwitting handmaiden of brokering a bail out of lenders and bail in of borrowers at the expense of the public. The funds the IMF could put together were too little, they came too late, and its effort was focussed initially on austerity measures that pushed the economies into depression when the most immediate issue at stake was a collapse of the credit system that had adversely affected many otherwise sound companies. To be fair it is not evident that on this most urgent issue there is a lot that the IMF could have done quickly given its own limitations to perform the role of international lender of last resort.

Another much discussed consideration for the future is to create an international lender of last resort to deal with a crisis situation after it has happened. The purpose of such a facility is to lend (a) freely, (b) to banks that are distressed but solvent, (c) against collateral and (d) at a penal rate of interest. This would let insolvent banks fail and help sound banks facing a temporary lack of liquidity. The difficulty here is that the moral hazard problem is unlikely to be easily or fully mitigated in practice. And any lender of last resort flush with funds is likely to invent a new role for itself from time to time.

Recovery and Lessons

As I mentioned at the outset none of the vital ingredients of the success of the Asian miracle has been fundamentally altered as a consequence of the Asian crisis. Moreover if there is anything still remaining of the term Asian values that still applies to the population there today then it is their untainted record of relying on self-help, hard work and entrepreneurship. Before long their many positive fundamentals will extricate these economies from their present problems.

A new era of prosperity is possible as these nations rebuild their banking and financial systems. There is even positive hope that some of the flaws in the economic and political system and the much too cozy relationship between the government and the business conglomerates could be transformed into a more open and transparent system. This would encourage new businesses activity to flourish for the benefit of all. And there is little doubt that any future recovery will require the inflow of capital from abroad and that won't be forthcoming unless their house is back in order.

The Asian crisis has once again revealed that currency crises are a result of the compromise between monetary unification (the only true fixed rate regime) and a freely floating exchange rate. The performance of Hong Kong's currency board system despite its many minor flaws and hiccups has presented itself as a viable option for many open economies. Its transparency, single minded policy objective and the necessary implied discipline on domestic macroeconomic policies have a lot to be said for. Indeed a further step towards monetary unification to dollarize the Hong Kong currency altogether is well worth considering. It would remove any doubt about the possibility of either devaluation or revaluation altogether.

The Asian crisis would no doubt lead to a growing demand for imposing capital controls, transaction taxes, or other market-inhibiting initiatives to limit international flows. This would be highly undesirable and would have large and adverse, unintended consequences. In a global system suppressed markets in one area would be rapidly displaced by others outside the reach of government controls and taxes. Furthermore risk taking would be curbed to the detriment of rising living standards.

It is worth noting that the global financial system is not an end in itself, but an institutional structure that has developed in response to and to facilitate the production and distribution of goods and services. There are bound to be incongruities between the institutional requirements of a global financial system and the prevailing institutions in an emerging market. This is part of the problem some Asian economies faced when they began to partly liberalize their financial system. They each lost sight of the purpose and objectives of financial liberalization and became enamoured with the ambition and grandiosity of developing an international financial center for their own country. The crisis may well be a blessing in disguise for the region because it provides an opportunity to review things in a fundamental way. Intellectually it puts to rest the idea that there are new laws of economic growth that have been uncovered by Asia’s miracle.