Lessons from the Asian Financial Crisis : The Asian Financial Turmoil and Implications for Hong Kong
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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 has come about as a result of a unique system of capitalism rooted in Asian values—a system immune to the depressions and other troubles that economies in the West have to endure. Now, however, this claim is being replaced with a skepticism that is equally wrongheaded: a perception that the so-called Asian miracle had no substance, that it was a house of cards destined to collapse under the weight of cronyism and corruption.

The fact remains that real per capita incomes in the Asian economies have grown at an average rate of 4 to 6 percent 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 anyone who has lived or traveled in the region can easily observe. It is also reflected in the vast improvements in the health, life expectancy, and education of the Asian people overall. Even if the present crisis were to stop all economic growth for the next five years, these economies would have performed well above the world average for some three decades.

Asia's success has been built not on the discovery of a new form of capitalism—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 Asian 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—the highways, office towers, and factories

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that 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.

What Went Wrong?

The question of what went wrong can be usefully examined from a historical perspective. If we take into account the historical development of the Asian crisis, we will be more likely to succeed at any future attempts to build new institutions and reshape the global financial system.

The causes of Asia's crisis were quietly developing as far back as the late 1980s. Many factors played a role in its unfolding:

1. Banks in Japan and Europe were glad to lend overseas because of the economic recession at home and were also tempted by the high profit margins of Southeast Asia.
2. The long-standing economic boom and low interest rates in the U.S. markets 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 Southeast Asian economies.
4. The confidence of many Asian leaders eager to push their development plans without regard for economic fundamentals and to grow instant international financial centres by liberalizing financial markets prematurely was often supported by a chorus of international agencies, bankers, and investors.
5. Corrupt practices, outdated banking rules, and weak supervision left many Asian nations totally unprepared to handle a flood of foreign funds in a global capital market.

The Asian nations' leaders and central bankers' overwhelming confidence in their own ability to successfully defend their currency against speculative attack finally led some of their countries to total collapse and bankruptcy.

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 the country's own domestic problems. Japan's leaders refused to write off mounting bad debts in the banking system after the asset bubble burst. 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 other institutional investors from Europe and later the United States, all flush with funds, soon discovered these emerging markets where interest rates were high and risk was very low because the currency was pegged to the U.S. dollar. This led 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 one trillion dollars 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 type of short-term loans were supplied to support investments in projects favored by government industrial policy.

In addition to effecting currency and maturity mismatches, these banks often extended the loans without adequately assessing credit risks. Indeed the current obsession with the lack of transparency and the accusations of Asian crony capitalism were hardly mentioned then, as foreign investors and lenders ingratiated themselves with 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, and they are now finding their way to the press as accounts of failures surface.

By 1995 the era of the strong yen was being replaced by the era of the strong U.S. dollar, and a number of these Asian economies were slowing down and experiencing current-account deficits, but capital inflows continued to accelerate. Thailand was the country whose exports were most obviously 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 slowdown as the government acted to restrain credit growth that had occurred as a result of quickly inflating asset prices.

At the end of day the economies in Asia grew vulnerable as markets became increasingly aware of a buildup of excesses that were the consequences of poor investment judgments that had been made in an attempt to employ huge increases in portfolios for investment. In some cases these excesses were fed by unsound real estate and other lending activity on the parts of various financial institutions in these countries—lending activity 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 nonfinancial firms would not have been possible without the availability of cheap credit. The international banks and other foreign lenders allowed these excesses to take on disastrous proportions. 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 they had in the case of Latin America in the 1980s and Mexico in 1993/94. There is little doubt that the actions taken by the International Monetary Fund (IMF) 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 is done with all this information, and on who does it. A novel suggestion proposed by Charles Calomiris to invite banks to police each other is worth serious consideration, especially if it could be implemented.[3] Some 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 important, 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 businessmenpeople 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 it was genuine. Against such a background, advocates of Asian values found a willing audience. But their failure to sense the dangers of borrowing short in foreign currency and investing in long-term projects with earnings denominated in local currency was disastrous. It is worth noting that the World Bank's study, *East Asian Economic Miracle*, published in 1993 also failed to decisively dispute the dangers inherent in governments dominating credit markets and their use of this power to achieve national and developmental goals The ambitions and confidence of many of these Asian emerging economies' political leaders were seldom challenged. In the past, the political system also discouraged such embarrassing confrontations.

The overarching self-confidence of Asian leaders and central bankers also blinded them to the severity of the emerging economic and financial problems. During the Mexican crisis speculative funds had made short-lived attacks against a number of Asian currencies, which had alerted governments the to 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 one justify attacking Asian currencies when the problem was halfway across the globe in Mexico, a country 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. They were clearly prepared to defend themselves when they were attacked, and speculators were viewed as pure opportunists. Hong Kong authorities had another reason to be concerned about the prospect of a speculative attack

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

against the Hong Kong dollar spurred by the 1997 handover of the sovereignty over the territory 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 speculators, but it eventually ran out of foreign currency reserves and in July 1997 had to uncouple the peg to the dollar and allow the baht to depreciate. It eventually lost some 50 percent 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 speculators, but it can actually benefit those who have already sold currency short in the forward exchange market. And, in the process, raising rates also inflicted terrible damage on Thailand’s citizens, so many of whom were borrowing short and lending long.

The Bank of Thailand’s most damaging mistake, however, was its concealment of facts about the true state of its foreign exchange holdings. The deception concerned the amount of dollars and foreign currency reserves the bank had left for fighting off 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 that its foreign reserves were mostly gone, there was a massive run against the baht, which quickly swamped the additional liquidity that the IMF had brought in and which changed 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. What might otherwise have been a minor realignment of 10 or 15 percent turned into a major disaster.

The speculators were probably encouraged by the 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 though their currencies were devalued slightly, they didn't go down. Hong Kong was able to avoid devaluation altogether, largely because of its currency board system, the relative transparency of its monetary and banking system, and the fact that the people of Hong Kong did not lose confidence in their government and its promise to maintain the value of the currency. As long as the public maintains this confidence, mere speculation can have little impact, especially in a currency-board system like Hong Kong’s.

I am not convinced that the rapid spread of these events throughout Asia is the cause of some contagion effect inherent to international financial crises. That the events happened more or less simultaneously can be easily attributed to the fact that many of these economies became vulnerable, to different degrees, at around the same time. Their plights were 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 on the soundness of their monetary and financial systems.

The Asian economies were due for a major readjustment after a decade of rapid and excessive growth. But the total collapse of the monetary and financial systems in some of these countries was unnecessary and could have been headed off if better policies to manage the speculative attacks on the currency had been adopted. The implementation of such policies 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 as a result.

The IMF's attempt to help the economies was largely unproductive. While the evidence is not out yet, there is a lingering suspicion among many quarters that what the IMF has done to date is to become the unwitting handmaiden of the brokerage of a bailout of lenders and bail-in of borrowers at the expense of the public. The funds the IMF could put together were too little, too late, and its effort was focused 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 clear that there is a lot the IMF could have done quickly to address this most urgent issue, given its own limited ability to perform the role of international lender of last resort.

Another issue that is being much discussed is that of whether an international lender of last resort should be created to deal with a crisis situation after it has happened. The purpose of such a facility would be 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 mentioned at the outset, none of the vital ingredients 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. We may even have reason to hope that some of the flaws in the economic and political system and the much too cozy relationship between the government and 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. There is little doubt that any future recovery will require the inflow of capital from abroad, and that won't be forthcoming unless the Asian economies' houses are 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. There is much to be said for its transparency, its single-minded policy objective, and its necessary implied discipline on domestic macroeconomic policies. Indeed a further step toward monetary unification to dollarize the Hong Kong currency altogether is well worth considering. It would altogether remove any doubt about the possibility of either devaluation or revaluation.

The Asian crisis will 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 serious 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 systems. They all lost sight of the purpose and objectives of financial liberalization and became enamored 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 for a fundamental review of the way things stand. From an intellectual perspective, it puts to rest the idea that new laws of economic growth have been uncovered by Asia's miracle.