

### Research Focus

#### *The Asian Financial Crisis after Ten Years*

*Max Corden\**

Many countries were affected by the Asian economic crisis that burst upon an unsuspecting world in 1997, but this article focuses on the four principal countries affected, namely Thailand, Indonesia, Malaysia and Korea.

**The Boom** An investment boom in the four countries in the early 1990s followed significant capital account openings in Thailand, Korea and Malaysia, and was financed both by local savings and by foreign capital inflow. Their macroeconomic policies and outcomes were favourable compared to other developing countries: budget deficits were low and in some cases there were surpluses; inflation was low; and growth rates were high.

As usual, the booms went too far. 'Irrational exuberance' occurred not just in the countries themselves but also in world capital markets. In Thailand and Malaysia, where investor funds initially went into developing manufacturing industries, real estate booms developed, but got out of hand. Investment shifted from manufacturing to construction. In both countries there was a huge stock market boom. All the four countries had been very successful, but they were not perfect. There was a lack of transparency in investment allocation, and excessive political influence over bank lending.

During the boom, capital inflow took essentially three forms. First, there was foreign direct investment (FDI), which was important in Malaysia. FDI flows were fairly stable, and did not reflect 'herd effects' (investor sentiment moving en masse together), but were in time influenced by expectations about exchange rates and investment profitability. Second, portfolio capital flowed into local stock markets, again especially in Malaysia. Finally, local banks, financial intermediaries, and corporations engaged in short-term borrowing

from the world capital market, all in the form of debt-creating instruments. The debts were (almost) all denominated in US dollars.

**The bust and the trigger** The 'herd effect' in international capital markets may lead to a sudden end in the form of a crisis or a 'hard landing', but it usually requires a trigger. In these four countries, the fundamental cause of the crisis was the inevitable ending of the investment boom, owing to eventual over-investment and the financial difficulties caused by excessive boom. In Thailand, the trigger was a combination of domestic and external factors, including the 1996 collapse in export growth and an increase in the current account deficit. This led to Thailand's 1997 exchange rate crisis and depreciation of the Thai baht. In the case of the other three countries, the trigger was this Thai depreciation. Without this, there would be a soft rather than a hard landing, and hence no crisis. Yet it is also possible that, without the Thai exchange rate crisis, eventually some other trigger would have occurred.

The international nature of the boom and subsequent slump was a product of the ability of international capital to move relatively freely. So the earlier liberalisations of international capital movement were crucial, especially because they allowed contagion. Thailand had gradually liberalised short-term capital movements, principally in 1993. Indonesia had fully liberalised in the seventies, but enforceable controls were hardly feasible anyway. Malaysia was liberal about both foreign direct investment (FDI) and portfolio capital, but not short-term debt-creating borrowing. Korea had controlled and discouraged FDI inflow, but liberalised short-term debt-creating borrowing, leading to massive short-term inter-bank inflows. On the other hand, India and China, which had strict capital controls, did not have crises.

**Exchange rate issues** Before the crisis, three of the countries had (more or less) fixed exchange rates to the US dollar. But even if exchange rates had floated and if the underlying changing expectations about investment profitability had been no different, a boom would eventually be followed by a soft or hard landing. The various crises ended the fixed rate regimes, and resulted in substantial (in the case of Indonesia, vast) depreciations, which eventually stimulated exports. With a floating rate at the outset, this stimulus to exports would have happened earlier.

Before 1996, Thailand's current account deficit increased sharply. The central bank used foreign exchange reserves and foreign borrowing in the forward market to keep the exchange rate fixed. When the asset price bubble burst and banks got into trouble, the central bank engaged in monetary expansion to rescue them, reducing foreign exchange reserves further. By 1996 the investment boom was clearly over, and the 'fundamentals' had deteriorated. Finally, in 1997, speculation on the exchange rate forced an end to the fixed exchange rate regime. Short-term capital flows sharply reversed. Thus the currency crisis clearly followed the investment and banking crises after a lag of one year or more.

Korea experienced excessive lending to unsound borrowers. Its terms of trade deteriorated in 1996, and confidence was shaken by problems in its banking system. Only late in 1997 did a currency crisis force the abandonment of the fixed exchange rate regime. Well before any currency crisis, Malaysia's stock market had risen to excessive heights and there were signs of banking problems. Indonesia's problems with fundamentals were much the same, but, because of lack of data there was less awareness of an international borrowing binge and thus of a likely problem. Indonesia's exchange rate crisis, triggered by the Thai

depreciation, came first; the financial crisis followed.

**Currency mismatch** In the cases of Thailand, Korea and Indonesia, borrowing in the form of debt was short term, was generally denominated in US dollars, and was not hedged against the possibility of a devaluation or depreciation of the domestic currency. As a consequence, when the domestic currency depreciated sharply—hugely in the case of the Indonesian rupiah—big losses were incurred by domestic banks that had acquired international debts in dollars and had on-lent domestically in local currency. This 'currency mismatch' then created balance sheet problems.

In all these cases balance sheets of banks and of corporations were severely affected by the exchange rate depreciations that resulted from the ending of the investment boom. Many banks and corporations were bankrupted. Thus the currency crisis greatly added to the financial crisis because of the currency mismatch problem.

**Policy responses** The first policy response involved attempts to moderate the depreciation by raising the domestic interest rate, and to adopt measures to restore confidence in the currency by foreign and local investors. It was also thought that fiscal and monetary tightness would improve confidence and thus moderate the depreciations. Initially, the IMF also emphasised the need to moderate depreciations, both through interest rate policy and by restoring confidence, but changed its line as the recessions' severity became apparent.

The second response by governments or central banks was to rescue private banks to save the

financial system, because consumption and investment demand depend on the availability of credit. Governments used asset management companies to buy non-performing loans. With bond finance and foreign loan finance, the costs of unwise or unlucky borrowing and lending were transferred from private sector borrowers and lenders to taxpayers in the four crisis countries. The essential argument in favour of such rescues was that the alternative of allowing the market to work would lead to prolonged recession and create collateral damage: the losers would not just be the relevant private domestic borrowers and domestic and foreign lenders, but all those citizens who lost their jobs or suffered drops in incomes as a result of continued recessions, or even a depression. Furthermore, international defaults would affect the reputation of the country as a future borrower.

The third possible policy response was to compensate for the decline in investment demand, and the various other sources of the recessions outlined above with a domestic demand expansion. By 1998 this Keynesian approach seems to have been followed in all countries to some extent, but most clearly in Korea and in Malaysia.

**Was it a liquidity crisis?** The evidence that it was a liquidity crisis is that Korea and Thailand had repaid all their IMF debts by 2004 and Indonesia had repaid about half by June 2006 and planned to repay the rest within a year or so. But it was superimposed on the 'fundamentals' discussed above. If more financial resources—that is, more liquidity—had been available, exchange rates might not have needed to depreciate so suddenly and

severely. The temporary and massive overshooting of Indonesia's exchange rate depreciation might have been avoided if major countries, notably the United States and Japan, had been prepared to provide more back-up resources quickly to the IMF.

It is arguable that these countries had managed their macroeconomic policies reasonably well, and did not really have solvency problems. Essentially, this was a market failure, reflected in inadequate international liquidity in the short term. The Korean 'roll over' coordinated by the IMF was very effective, and ensured that private lenders participated in the rescue. Probably, such roll-overs would have been harder to arrange for Thailand and Indonesia, since the major lenders were harder to identify

But the story is somewhat different with regard to the private borrowers—especially the banks, but also corporations—in the four countries. In their case, the solvency crisis was resolved eventually by governments and central banks. Moral hazard may be an issue here, especially for the foreign lenders who mostly lost very little. Nevertheless, it is not clear that the adverse effects of moral hazard outweighed the good reasons for government and central bank rescues.

\* Max Corden is at the University of Melbourne. This article is a summary of the 2007 H.W. Arndt memorial lecture, which is to be published in full in *Asia Pacific Economic Literature* (APEL).

## Events

**8 June**, PNG Update, Brisbane

**19 June**, Masaru Konishi, Hitotsubashi University/UNSW, *Depositors' response to deposit insurance reforms: Evidence from Japan, 1990–2000*, seminar, ANU

**1–4 July**, Japanese Studies Association Biennial conference, ANU

**12 July**, China Update, ANU

**13 July**, China's Conformity to the WTO: Progress and Challenges, conference, ANU

## Publications

### **Asia Pacific Press**

*From Election to Coup in Fiji: The 2006 Campaign and its Aftermath*,

Jon Fraenkel and Stewart Firth (eds)  
ISBN 978-0-7315-3812-6, RRP \$40

Co-published by Asia Pacific Press, ANU EPress and IPS Publications, University of the South Pacific [www.asiapacificpress.com](http://www.asiapacificpress.com)

### **Asia Pacific Economic Papers**

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### **New Books**

*Multinational Corporations and the Emerging Network Economy in Asia and the Pacific*,

Juan J. Palacios, ed., Routledge (forthcoming)

*Asia-Pacific Economic Co-operation: Critical Perspectives on the World Economy*, Peter Drysdale and Takashi Terada, eds, 5 vols, Routledge

[http://www.routledge.com/shopping\\_cart/search/search.asp?search=Asia-Pacific%20Economic%20Co-operation](http://www.routledge.com/shopping_cart/search/search.asp?search=Asia-Pacific%20Economic%20Co-operation)

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*Enquiries:*

Australia–Japan Research Centre

Tel: (61-2) 6125 3780

Fax: (61-2) 6125 0767

Email: [ajrc@anu.edu.au](mailto:ajrc@anu.edu.au)