Chapter 3

Causes of the East Asian currency and financial crisis

Since the currency crisis started in July 1997, economist experts has been trying to explain the causes contributing to this contagion crisis. Some possible causes were:

a. Public sector debt related to fiscal deficits.
c. Poor macro economic management
d. Crony capitalism. This referring to connections between politicians in power and certain private enterprises which created a moral hazard problem as these enterprises were seen as carrying an implicit guarantee against insolvency. Crony capitalism could bear some of the responsibility for the vulnerability of the financial system and more importantly, influences government policy responses in ways that have triggered the crisis (Jomo 1998).
e. Financial panic or fundamental weaknesses. The sudden shifts in the market expectation and confidence are keys responsible for the market overreaction and financial turmoil.
f. Weaknesses in the financial systems and government including economic policy inconsistencies in the region and deteriorating fundamentals at the root of the crisis, (Krugman 1998a; 1998b; Dornbusch 1998).

The relatively important key factors of the causes are as follows:

a. Economy Bubbles

Economy bubbles possibly due to

- Massive capital inflows which lead to domestic rapid credit expansion in the banking sectors.
- The competition among over guaranteed and under-regulated Asian banks which results in asset price bubbles and persists as long as the government guarantee is maintained.
• Exchange rate misalignment.
  (Folkerts-Landau et al., 1995; Fischer, 1998; Noland, 1998)

There are two implications from this economy bubbles. Firstly, there was excessive investment. Study shows that excessive investment in Asia was facilitated by several factors:
• Political pressures to increase capital accumulation and enhance economic growth
• The moral hazard problem faced by domestic financial institutions
• The low interest rates in Japan that push large capital inflows into the higher yielding Asian countries.

Secondly, a rise in price of assets that were limited in supply, such as land. As a result, there is a significant gap between the loans amount and the value of the real estate collateral.

b. Current Account Imbalances

In the 1990s, several Asian currencies experienced a significant appreciation of their real exchange. Most Asian economies were also in the existence of an exchange rate peg. This peg acted as an implicit guarantee that there was no change in the value of the currency (Calvo and Mendoza, 1996). This partly contributed to massive capital inflows to the Asian region as banks including corporations borrowed large amount of international capital. Most of these borrowing were short-term and denominated in foreign currency and unhedged. Sluggish growth in the advanced economies, in particular Europe and Japan, made investments in fast-growing Asian countries relatively attractive and thus led to the build-up of foreign capital inflows. This resulted in a large build-up of short-term foreign currency liabilities and large structural current account imbalances.
Before the crisis, the imbalance had been bridged by capital inflows in the forms of portfolio investment and foreign borrowings. The Asian governments then sterilized these inflows to minimize consumer price inflation, and instead fuelled asset price inflation, mainly involving real estate and share prices. Due to strong export performance and strong growth in domestic revenues, these foreign borrowings were easily repaid. In additional, risks of foreign exposure were minimal as exchange rates were previously stable.

When the bubble burst, the Asian countries became exposed to foreign capital outflows and dropping real estate prices pulled down stock prices and put the solvency of financial institutions in question. Furthermore, vulnerable balance of payments position could not be managed due to loss of confidence.

c. Competitive devaluation

In 1997, the depreciation modified the effective real exchange rate and worsened cost competitiveness in affected countries that initially maintained the exchange peg. When one currency was devalued, such devaluation affected the equilibrium fundamental values of other currencies and eroded the competitiveness of trade competitors as these affected countries exported similar products (Corsetti et al., 1998). Eventually, other countries had to devalue their currencies to regain competitiveness.

When the crisis broke out, the currency depreciation increased the local currency value of the external debts owed by banks and businesses, creating solvency problems. As debts mounted, the firms attempted to reduce their foreign exchange liabilities by obtaining dollars to close out open positions. This further increased the demand for foreign exchange, thus leading to even greater depreciation of the domestic currency. (World Bank, BNM, 1998)
d. Weak Financial System

Most Asian financial systems were repressed due to various factors:

- Heavy government intervention in the economy
- Inadequate financial sector supervision
- Poor assessment and management of financial risk
- Loosening controls on connected lending
- Credit allocation to certain sectors
- Financial market segmentation
- Artificial ceilings on interest
- Inefficient use of funds
- Governance problems, both private and public

It is alleged that financial decisions were strongly influenced by non-economic considerations.

(Goldstein, 1998b; Martinez, 1998; Noland, 1998; Stals, 1998)

e. Inadequate Preparation for Financial Liberalization

Financial liberalization in Asian region had increased interest risk, credit and market risk, and riskier activities; lead to higher risk of financial crisis. The governments insured deposits against adverse outcomes encouraged moral hazard. Besides, there was a lack of enforcement of prudential rules and inadequate supervision in term of accounting, disclosure requirements and availability of economically relevant information. There is no transparency and accountability. The worsening of information could discourage the quality of investment because funds might not be channeled to most productive sectors. (De Gregorio and Guidotti, 1992; Mishkin, 1994). While the benefits of free capital movements had frequently been propagated, its cost were often underestimated, including that of an outbreak of systemic crisis. (Prof Jagdish Bhagwati, BNM, 1998)
The result was higher bank lending due to minimal credit and market risk assessment. Higher lending also excessively supported optimistic expectations about future growth prospects in the region resulted over investment, unrealistic speculation, particularly in real estate, and inefficient resource allocation to politically connected individuals, all of which inflated asset prices. Improper public spending also contributed to the build-up to the crisis, following several years of rapid growth. (Prof Paul Krugman, BNM, 1998)

and made the Asian currencies vulnerable to attack.

f. Financial Panics

When crisis arose, investors suddenly change their attitudes and withdrawn capital from these countries. Such capital outflows unleashed a profound crisis in the domestic financial market and threatened the stability of the productive sectors. Furthermore, some subsequent developments had triggered the crisis, namely:

- Credit downgraded by international rating agencies.
- Political uncertainties creating concerns over commitment to undertake the drastic policy measures to stabilize the macroeconomic situation and reform the banking sector.
- Blanket downward revision on the short to medium term outlook for the regional economies and banking sectors by private sector analysts.
- Emergence of external debt repayment problems in some of the regional economies.

Sharp depreciation and declining asset and share price affected corporate earning and finally developed economies crisis in the region.

g. The contagion effect
The contagion effect possibly reveals real linkages between the affected countries through trade links and competitive devaluation, common domestic and external shocks, and financial links (Corsetti et al., 1998). Thailand might have acted as a "wake-up call" for creditors to reassess the creditworthiness of Asian borrowers (Goldstein, 1998a). When they did, they found that other economies within the region had similar fundamental weaknesses and suspected that these countries would eventually devalue their currencies.

Speculative attacks on their currencies possibly hastened the process of competitive devaluation. When countries experienced devaluation of their currencies, other countries who had not devalued, faced a deterioration in competitiveness and increased vulnerability.

h. Poor management of global financial system.

Financial market liberalization and globalization, advancements in information technology and the increasing sophistication of investment tools have outpaced improvement in management of the global financial system, which remained primitive and fragmented and rendered the international financial architecture incapable of coping with the demands of global finance. The main problem was the operations of the highly leveraged institutions, which could move vast amounts of funds around the world rapidly and with little or no regulation. By distorting or manipulating markets in search of profits, the highly leveraged institutions were "capable of throwing many smaller, vulnerable economies into chaos". (Mr Joseph Yam, BNM, 1998)

It is possible that many international lenders considered the Asian countries as a single entity and therefore expected other countries in the region to experience soon similar difficulties as Thailand (Radelet and Sachs, 1998). Therefore, the actual contagion could be driven by the irrational behavior of international lenders. However, it required weak
fundamentals in the affected countries in the first place for international financial investors to react irrationally.

As the crisis unfolded and its contagion spread, perceptions of the crisis have changed from being a localized to a regional and international problem. The search for a solutions has focused increasingly on reforms to the international financial architecture to ensure that globalization and financial liberalization proceed in an orderly manner. In particular, there are growing concerns on the need to manage capital flows and prevent manipulation of currencies.