Chapter Three

CAUSES OF ECONOMIC CRISIS

It is said that the Asian crisis was caused by events in the Japanese financial sector having a monetary effect on the real side of their economies. (Frowen and Karakitsos, 1997:66). In addition, Frowen and Karakitsos, 1997 postulated a number of factors that led to the increasing degree of vulnerability of the region to a crisis. These factors include increasing foreign liabilities of the banking sector in the 1990s (mainly short-term and unhedged), rising private sector indebtedness, large and growing current account deficits financed with short-term debt in the foreign currency (mainly unhedged), excessive investment in risky projects such as real estate, stock market as well as significant loss of competitiveness. According to Frowen and Karakitsos also, the two common features of the Asian crisis were the indebtedness of the private sector as well as the increase in foreign debt of commercial banks.

The private sector debt to commercial banks in Malaysia, Thailand and South Korea reached 140 percent of GDP (see Frowen and Karakitsos, 1997). The entire foreign borrowing by financial institutions in these countries was used to finance domestic bank lending, making credit growth to expand rapidly.

According to Sivalingam (Aug. 2000) in his paper, the impact of Globalization on the Malaysian Economy that there is now widespread consensus that the 1997 currency crisis was as a result of large currency account deficit; the reliance on foreign capital to finance the deficit; bank loans from Japan and Europe (whose interest rates were lower than in Malaysia); poorly functioning domestic banking system; failure of Government to adjust exchange rates and other policy instruments to an environment of decreasing availability of capital.

Other circumstances leading to the crisis include extended period of economic stagnation in Japan and the slowing down of demand for Malaysian export; the weakening yen in relation to the US dollar (those countries who used the yen as a reserve currency for trade suffered losses); and overvalued South East Asian currencies.

Montes M.F. in his article published in March 1998 entitled 'Global Lessons of the economic crisis in Asia is of the opinion that the precipitating factors of the East Asian economic crisis are by no means unique to the region. They have their roots in badly managed government liberalisation of the financial sector, excessive borrowing and lending by private industry, and the ability and unwillingness of both the public and private sectors to accurately assess risk.

The resulting collapse of domestic asset values (real estate, stock market prices) and currency is inevitable and has become a phenomenon already seen in the 1990s in Europe and Latin America.

Bank lending was used primarily to finance projects in real estate, property, and other assets, which according to Frowen and Karakitsos created bubbles in asset prices.

However, Malaysian Prime Minister, Dr. Mahathir Mohamad argued that the rapid growth of east Asian prosperity was not based on 'bubble economies'. Left to themselves, the countries would have coped, they would have continued to grow far beyond the turn of the century. (Mahathir 1999).

In fact Dr. Mahathir levelled the blame on unscrupulous currency speculators and manipulators as the real culprits responsible for the impoverishment of the Asian 'miracle' and the devastation of their currencies and economies.

Prior to the crisis, Malaysia and the region were experiencing increasing private capital inflows. While the net private inflows for China and Vietnam were foreign direct investment (FDI) dominated, short-term inflows were substantial for Indonesia, South Korea, Malaysia and the Philippines. During 1995 – 1996, Malaysia short-term capital was 4 – 4.5 percent of GDP, while its FDI was at 5 percent of GDP (NERP. 1998.5) Hence, the sudden withdrawal of `hot' from a country or region can have devastating effects on jobs, business and people. (NERP.1998.4)

According to Frowen and Karakitsos (1997), **financial crisis comprises of currency, banking** and **debt crises**. A **currency crisis** is a speculative attack that results in a sharp devaluation or depreciation or substantial loss in reserves. A **banking crisis** is an actual or potential run or failure that induces banks to suspend the convertibility of their liabilities. A **debt crisis** (foreign or domestic) is the inability of a country to service its debt. However, discussions on the causes of financial crisis are centred on two approaches.

The **first** is that of the **fundamentalist view** put forward by Paul Krugman, in his paper, ' What happened to Asia'; and Corsetti, Pesenti and Roubini in their 1998 paper, ' What caused the Asian currency and financial crisis. This view suggests that the crisis was due to structural weakness prevalent in the domestic financial institutions together with unsound macroeconomic policies and the issue of moral hazard.

The **second** view is that of a **' financial panic'**, a view advocated by Jeffrey Sachs and Stephen Radelet in 'The Onset of East Asian Financial Crisis' and Joseph Stiglitz, Chief Economist at the World bank.

This view emphasizes the role of expectations, panic and adjustment in explaining the propagation of the crisis.

The Fundamentalist View

The 'fundamentalists' begin their argument with an agreement that the East Asian crisis was unlike other currency crises. The conventional early warning indicators were not present. The economies had persistent budget surpluses, unemployment was low, the savings rate of the economies was high and the inflation rate was moderate.

However, as the fundamentalists argue, the economies were growing increasingly more vulnerable to external shocks due to series of factors revolving around capital flows and government policies surrounding these flows.

Weaknesses in financial systems in the region were also cited as a further cause. It was also argued that formal or informal pegs to the United States dollar led to increased recourse to unhedge external borrowings, especially in an environment of wide interest rate differentials. Inconsistent reforms and inappropriate sequencing of liberalisation measures were also said to have added to the vulnerability of the financial system. The regulatory framework was criticised as not keeping pace with the reforms taking place, especially in the areas of prudential management of currency exposures and credit evaluation.

At the root of the fundamentalist's view is the issue of moral hazard – the perception by investors of implicit /explicit guarantees by governments for their borrowings from international lenders.

This perception arose from the close links between public and private sector institutions as well as the link between banks and their customers. One can also argue that moral hazard of bank lending to emerging markets has always been prevalent as the IMF provides balance of payments support to its member countries in time of need. In all crises, IMF borrowings were used to repay loans to international banks and creditors.

This issue of moral hazard added to the vulnerability of the economies at the financial and international level. There was the perception by lenders that some banks were too large to fail, and that government would step in to bail out troubled banks.

For certain countries, onshore banks borrowed excessively from abroad and lent excessively at home. With the implicit guarantee of a commitment to maintaining a stable nominal exchange rate by the Government, the banks did not adequately hedge their external liabilities from currency risks.

This moral hazard problem was not confined to domestic banks. The behaviour of international banks was also influenced by the guarantees of bailouts by direct government intervention or IMF support programmes. This led foreign financial institutions to lend large funds, mostly on a short-term basis, to domestic banks in the region without adequate appraisal of the risks involved.

With financial and industrial policies enmeshed within a widespread business sector network of personal and political favouritism and with governments that appeared willing to intervene in favour of troubled firms, markets operated under the impression that the return on investment was somehow `insured' against adverse shocks. (Okposin et.al 2000).

Along this `false impression' were the long list of structural distortions in the pre-crisis Asian financial and banking sectors: lax supervision and weak regulation; low capital adequacy ratios; lack of incentive-compatible deposit insurance schemes; insufficient expertise in the regulatory institutions; distorted incentives for project selection and monitoring; outright corrupt practises; non-market criteria of credit allocation, according to model `relationship banking'; that emphasis semi-monopolistic relationships between banks and firms, somehow downplaying price signals (Okposin et. al.2000).

The adverse consequences of these structural and policy distortion were crucially magnified by the rapid process of capital imbalance.

Moreover, the sharp appreciation of the US dollar relative to the Japanese yen and European currencies since the second half of 1995 led to deteriorating cost competitiveness in most Asian countries whose currencies were effectively pegged to the US dollar.

As a result of the cumulative effects of the structural, policy and real imbalances, by 1997 Asian countries appeared quite vulnerable to financial crises either related to sudden switches in market confidence and sentiment, or driven by deteriorating expectations about the poor state of fundamentals. (Okposin et. al.2000).

The Financial View

The Fundamentalist view, however, failed to explain both the speed and the severity of the crisis. While explaining the financial meltdown, the argument seems less persuasive when attempting to explain the successive domino effect on the other countries in the region as well as the subsequent over-adjustment that took place.

The `financial panic' view states that the region's economies fundamentals were essentially sound in the period leading up to the crisis. The crisis was not predicted by most market participants and analysts, as reflected in the optimistic reports on the regions by the IMF, credit rating agencies and analysts in the period just before the crisis.

There were some sign of vulnerability in the economies, such as current account deficits; overvalued exchange rates and a slowdown in export growth. But, the point stressed by the `financial panic' view was that these indicators pointed to a slowdown, not a full-blown crisis.

The crisis was largely due to an abrupt change in investor expectations, both foreign and domestic. The irrational investor behaviour was compounded by the IMF's approach to managing crisis. The IMF essentially applied policy responses that were generally for crises originated from the private sector. Blame is also placed on the international financial system, as Jeffery Sachs writes, 'The crisis is a testament to the shortcomings of the international capital markets and their vulnerability to sudden reversals of market confidence'.

The globalisation of financial markets

The surge of capital flows around the world was essentially driven by the globalization of financial markets and the rapid development of information technologies. The daily currency turnover in the foreign exchange market is 1995 was about USD 1.2 trillion, compared with an average of USD 190 billion a decade ago. (NERP.1998.4) The amount of private capital flowing into emerging markets was USD 50 billion is 1990; the figure was USD 336 billion in 1996 (NERP.1998). These private capital flows, which grew by about 30% annually was led by commercial bank debt and portfolio money. Financial institutions scanning the global for profitable opportunities were attracted to the East Asian region due its rapid rates and relatively stables exchanges rates. (BNM.2000)

On the domestic side, liberalisation of capital account transactions created new incentives to private agents to take advantage of the easy access to international capital. A surge in domestic demand and a credit boom ensued. As good investment opportunities became scarce, funds were directed towards the stock market and the property market. In several countries, the credit boom led to an increase in asset prices, particularly real estate property. The wealth effect from the rise in asset prices prompted spending and encouraged yet more foreign borrowing. (BNM.2000)

Role of Currency Speculators in the Crisis

Malaysia was among the first countries to highlight the role of currency speculators and highly leveraged institutions in the crisis. Despite initial scepticism, there is now a greater international consensus on the need to ensure that their operations do not contribute to excessive volatility in international financial markets.

The rapid pace of technological and financial innovation, coupled with an international financial regulatory infrastructure that lagged these development, implied that large market players, such as highly leveraged institutions (HLIs) and hedged funds, could manipulate developments, particularly in small, emerging market, given the size of their position taking and the influence they have on other market participants. (BNM, 2000)

In operating in the international financial markets, HLIs are not subject to any rules or disclosure requirements. Anecdotal evidence from the experience of the crisis-affected countries indicates that HLIs caused financial instability through their manipulation activities in the markets. While their modus operandi varied across countries, there were several common features of HLIs speculative attacks. These included spotting a potential change in trend in the exchange rate and establishing a position to capitalise on the herding or trend-following behaviour of the market. (see BNM, 2000).

To achieve this, the HLIs would undertake aggressive selling tactics, often at the price below market value, signalling to their market players that a currency attack is underway, thereby causing herding behaviour. In certain cases, the speculators had also resorted to issuing pessimistic views and comments about the target economy on other participants' desire to sell and unwind their short position, thereby making gains. (BNM.2000).

As mentioned earlier, there is no consensus surrounding the causes of the East Asian financial crisis. It should be noted, however, that the two broad views on the origin of the crisis are by no means exclusive. There are issues both sides agreed on.

It is agreed that the subsequent contagion effect that spread throughout the region was caused by panic (Corsetti, Pesenti and Roubin) while the alternative `financial panic' view does agree that there were some fundamental concerns about the east Asian economies that warranted a slowdown in growth.

There is currently no complete hypothesis to explain what precipitated the crisis although there are a couple of characteristics of the regional economies and certain government policies that increased the countries vulnerability to the crisis and magnified the aftershocks (NERP.1998) Hence, there is yet to be an international consensus on the causes of the crisis. But it had become obvious that the contributing factors that had led to the crisis were due to both domestic as well as external in nature.