Chapter 3
Causes of the East Asian Crisis

Since the currency crisis started in July 1997, the first generation of currency crisis theory (which focused on public sector debt related to fiscal deficits) was adopted to explain the causes of this crisis. However, this theory possibly was inappropriate as most of the affected countries had consistently maintained budgetary surpluses in recent years. In addition, the crisis could not easily be explained by reference to other recent experiences such as the Mexican crisis in 1995 (Corsetti et al., 1998).

Hence, the second generation of currency crisis theory was established to explain that the East Asian crisis was mainly due to poor macroeconomic management. However, it became clear later that the region’s macroeconomic balances were not seriously bad. The focus then shifted to alleged 'crony capitalism'\(^1\) and its supposed consequences as a new explanation for the crises. It is suggested that crony capitalism could bear some of the responsibility for the vulnerability of the financial system and, more important, influences government policy responses in ways that have triggered the crisis (Jomo et al., 1997).

Alternative views attempt to identify whether financial panics\(^2\) or fundamental weaknesses in the affected countries led to this crisis. Some analysts support that financial panics could justify the deep crisis (Radelet and Sachs, 1998; Wolf, 1998). Other observers focus on growing weaknesses in the financial systems and governance including economic policy inconsistencies in the region and

---
\(^{1}\)This term defines 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.
\(^{2}\) It refers to sudden shifts in market expectation and confidence which are keys responsible for the market overreaction and financial turmoil.
deteriorating fundamentals at the root of the crisis, (Krugman 1998a; 1998b; Dornbusch 1998).

A great deal has been written on the causes and nature of the Asian crisis since its onset. This crisis is possibly due to by many factors, however, it is difficult to assign weights to distinguish the relative importance of different factors. Thus, I would like to highlight major factors that appear, to many analysts, to be important parts of the explanation of the East Asian crisis. They are:-

3.1 Economy Bubbles

Economy bubbles have been illustrated by many views (Folkerts-Landau et al., 1995; Fischer, 1998; Noland, 1998). Possibly, economy bubbles are due to (1) massive capital inflows which lead to domestic rapid credit expansion in the banking sectors, (2) 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 and (3) exchange rate misalignment.

The bubbles in Asian region had developed two implications. First, there was an excessive investment. Related study (Corsetti et al., 1998) shows that excessive investment in Asia was facilitated by several factors: (1) political pressures to increase capital accumulation and enhance economic growth, (2) the moral hazard problem faced by domestic financial institutions, (3) the low interest rates in Japan that push large capital inflows into the higher yielding Asian counties.

Second implication was a rise in price of assets that were limited in supply, such as land. This resulted in a significant gap between the value of the loans and the value of the real estate backing them.
3.2 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 amounts of international capital. Much of these borrowings were short-term and denominated in foreign currency as well as unhedged. It led to a large build-up of short-term foreign currency liabilities and large structural current account imbalances\(^1\).

Before the crisis, the imbalances had been bridged by capital inflows in the forms of portfolio investment and foreign borrowings. The Asian governments then sterilised these inflows to minimise consumer price inflation, and instead fuelled asset price inflation, mainly involving real estate and share prices. Besides, these foreign borrowings were easily repaid due to strong export performance and strong growth in domestic revenues. In addition, risks of foreign exposure were minimal as exchange rates were previously stable.

With export growth flagging, the excessive investment, especially in property sector, became all too apparent. 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 positions could not be managed due to loss of confidence.

\(^{1}\) Reisen (1998), however, argues that current account imbalances were not held to be significant in the Asia region, given the high past growth and expected growth potential. The crisis seems primarily a capital-account crisis of stocks due to conventional current-account sustainability or real overvaluation problems.
3.3 A Vicious Circle of Competitive Devaluation

The first wave of depreciation in 1997 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.

3.4 Weak Financial System

Most Asian financial systems were repressed due to various factors, (Goldstein, 1998b; Martinez, 1998; Noland, 1998; Stals, 1998): (1) heavy government intervention in the economy, (2) loosening controls on connected lending, (3) credit allocation to certain sectors, (4) financial market segmentation, (5) artificial ceilings on interest, (6) inefficient use of funds, and (7) governance problems, both public and private. It is alleged that financial decisions were strongly influenced by non-economic considerations.

3.5 Inadequate Preparation for Financial Liberalisation.

Financial liberalisation in Asian region during 1980s and 1990s inevitably increased risks of financial crisis (Goldstein and Turner, 1996). Such risks included interest risk, credit and market risk as well as riskier activities.

In most Asian financial systems, the governments insured deposits against adverse outcomes which encouraged moral hazard. Furthermore, there was a

---

1 It is also called "Beggar-thy-neighbor" game describing a policy and structural trade spillovers from one country to another.
lack of enforcement of prudential rules and inadequate supervision in terms of accounting, disclosure requirements and availability of economically relevant information. The worsening of information could discourage the quality of investment because funds might not be channelled to most productive sectors (De Gregorio and Guidotti, 1992; Mishkin, 1994).

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 and made the Asian currencies vulnerable to attack.

3.6 Financial Panics or Herd behaviour

Martinez (1998) suggests that the East Asian crisis was preceded by very elastic financial markets for the assets of the countries in question and by major inflows of capital. Once crisis arose, investors suddenly changed 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. In addition, some subsequent developments had triggered the crisis, namely:

(a) Credit downgraded by international rating agencies.
(b) Political uncertainties creating concerns over commitment to undertake the drastic policy measures to stabilise the macroeconomic situation and reform the banking sector.
(c) Blanket downward revision on the short-to-medium term outlook for the regional economies and banking sectors by private sector analysts.
(d) Emergence of external debt repayment problems in some of the regional economies.
The East Asian crisis was then exacerbated further through contagion effect which will be explained in the next chapter. Sharp depreciation and declining asset prices affected corporate earnings and finally developed economic crises in the region.