

4. Literature review

4.1 Causes of the Asian crisis :

Financial Panic vs Fundamentals Hypotheses

Views on the origins of the financial crisis can be broadly classified under two main alternative hypotheses. According to one view sudden shifts in market expectations and confidence- i.e. **financial panic** - were the key sources of the initial financial turmoil and regional contagion in the second half of 1997 (Radelet and Sachs, 1998). An alternative which will be termed the **Fundamentals Hypothesis** suggests that the crisis reflects poor economic policies in the affected countries (Roubini, Corsetti and Pesenti, 1998).

4.2. The fundamentals hypothesis

This hypothesis suggests that the deterioration of key macro-economic fundamentals triggered the crisis:

4.2.1 *Real exchange rate appreciation*

Since middle of 1995, there was a real exchange rate appreciation in Asian currencies that caused a loss of competitiveness and widened the current account deficits. The real appreciation in Asian currencies was partly the consequence of the choice of the exchange rate regime in these countries which essentially peg their currencies to the US dollar. The US currency rapidly appreciated in nominal and real terms since the middle of 1995.

Table 1 presents data on the real exchange rate of the relevant Asian countries. Taking 1990 as the base year, by March 1997 the real exchange rate had appreciated by 19% in Malaysia, 23% in the Philippines, 12% in Thailand, 8% in Indonesia, 18% in Singapore, 30% in Hong Kong. In Korea, the currency had depreciated in real terms by 14% while in Taiwan there was a 10% real depreciation. This suggests that, with the exception of Korea, all the currencies that crashed in 1997 had experienced a significant amount of real appreciation. A large part of the real appreciation occurred after 1995 in the period in which the dollar (to which these currencies were pegged) was becoming stronger.

The misalignment of the regional currencies was exacerbated by a number of other factors. First, the long period of stagnation of the Japanese economy in the 1990s led to a significant slowdown of the growth of exports of the Asian countries to Japan. Second, the 50% nominal devaluation of the Chinese currency in 1994 led to a significant loss of competitiveness for the rest of the Asian countries. Third, some sector specific shocks such as the fall in the demand for semi-conductors in 1996 caused a significant slowdown in export growth in 1996-1997.

4.2.2 *Large current account deficits*

Countries with more overvalued currencies were generally experiencing a larger worsening of the current account. Historically, most episodes of unsustainable imbalances translating into a currency crisis have occurred when the current account deficits were large relative to GDP. According to Lawrence Summers, US. Deputy Treasury Secretary in an article in *The Economist* on the anniversary of the Mexican financial crisis, **"close attention should be paid to any current-account deficit in excess of 5% of GDP, particularly if it is financed in a way that could lead to rapid reversals"**.

By this standard, many of the Asian economies provided ample reason for concern. As shown in Table 2, many of the Asian countries whose currencies collapsed in 1997 had experienced large and increasing current account imbalances in the 1990s. The two countries with the largest and most persistent current account imbalances were Thailand and Malaysia, which experienced very large deficits for over a decade. The current account in Thailand averaged over 8% of GDP in 1995 and 1996. Similarly large numbers are observed in Malaysia where the deficit was above 8% of GDP in 1995, while falling to 5.2% of GDP in 1996.

4.2.3 Moral Hazard

The following analysis of the role of excessive lending driven by moral hazard incentives in the banking system was presented by Jeffrey Sachs in the Financial Times in August 1997:

“ Throughout Latin America, central Europe and South East Asia, banks have been deregulated and privatised in recent years, allowing them much greater latitude to borrow from abroad. Banks and near banks - such as Thailand’s now notorious financial trusts- become intermediaries for channeling foreign capital into the domestic economy. The trouble is the newly liberalised banks and near banks often operate under highly distorted incentives. Under-capitalised banks have incentives to borrow abroad and invest domestically with reckless abandon. If the lending works out, the bankers make money. If the lending fails, the depositors and creditors stand to lose money but the bank’s owners bear little risk themselves because they have little capital tied up with the bank. Even the depositors and the creditors may be secure from risk, if the government bails them out in the case of bank failure “

The logic of moral hazard is illustrated below with a numerical example. Imagine the owner of a financial intermediary who has raised \$100 million from guaranteed creditors. We assume that he is not required to put up any capital of his own and can walk away from the institution at no personal cost if it goes bankrupt. Assume that there are two alternative investments available. One yields a known present value of \$107 million. The other alternative will yield \$120 million if conditions are favourable but only \$80 million if they are not. Suppose that the good outcome, i.e \$120 million and the bad outcome, i.e \$80 million in the second alternative investment are equally as likely to happen, so that the expected return on this riskier investment is \$100 million, which is lower than the first alternative. A risk neutral investor would prefer the first alternative.

However, the owner of the financial intermediary knows that while he can capture the excess returns in the good state, he can walk away from the losses in the bad state. So if he chooses the safe investment, i.e the first alternative, he gains a sure 7 million but if he chooses the riskier investment, i.e the second alternative, he gains 20 million in the good state, loses nothing in the bad state, for an expected gain of 10 million. Thus, his incentive is to choose the riskier investment, even though it has a lower expected return.

The empirical data on the rate of credit growth to the private sector by banks in the 1990s as presented in Table 3 and the ratio of private sector lending to GDP contained in Table 4 lends some support to the hypothesis of moral hazard and over-investment. The data shows very large rates of growth of borrowing by the private sector which was well in excess of nominal GDP growth throughout the 1990s. As a consequence, the ratio of private sector lending to GDP increased in all Asian countries in the 1990s. The above measure gave an indication of the quantity of lending.

The quality of lending can be observed by reviewing the proportion of non-performing loans. One of the serious problems faced by the Asian countries is that many of the loans made by banks and non-banks were of low quality and dubious profitability, such as speculative investments in financial assets rather than new investment projects. Data on non-performing loans in Table 5 provides some indication on the quality of loans made. The estimate of the non-performing loans at the onset of the crisis as a share of total loans is 19% for Thailand, 17% for Indonesia, 16% for Korea, 16% for Malaysia, 14% for The Phillipines and 4% for Singapore.

4.3 Financial Panic Hypothesis

4.3.1 According to this hypothesis there is no fundamental reason for the Asian crisis except financial panic itself which was triggered by currency speculators. The following account illustrates the role of currency speculators in the crisis.

4.3.2 From May of 1997, international banks and money traders began to speculate that Asian currencies would have to devalue in order to revive exports and reduce current account deficits. Focusing first on Thailand, they sold massive amounts of Thai baht -- often selling it forward, that is concluding a sale today but promising to deliver the currency in the future. They were betting that when the date came, they would be able to buy the baht they needed for much less than they had already sold them for, making an instant profit.

Asian governments tried to resist, knowing that devaluation would cripple firms which had borrowed huge sums in dollars and would now have to earn much more in local currency to pay back the loans. When the traders sold the local

currency and bought dollars, the Asian central banks bought the local currency and sold dollars. But even central banks run out of dollars and had to give up the fight and allowed their currencies to devalue. The speculators won. Stock markets plunged because it was clear that many companies would have problems repaying dollar loans.

Only Hong Kong had enough reserves of US dollars to fight off the speculators, and even there the stock market crashed because it was clear that the cost of keeping the Hong Kong dollar pegged to the US dollar would be high. Hong Kong exports would be uncompetitive and interest rates would have to be kept high to make the Hong Kong dollar attractive, so businesses would slump.

As asset and stock prices fall, what had been good loans become bad loans. Adequate collateral becomes inadequate collateral and loans with inadequate collateral get called for payment. Fearful of defaults or short of liquidity themselves, banks don't renew short-term loans that normally would be automatically rolled over. Working capital dries up. Suppliers who are fearful of not being paid demand cash before delivery instead of being willing to wait the normal ninety days for payment.

Even financially sound firms find that they cannot pay their bills since they are suddenly and unexpectedly asked to repay loans and pre-pay suppliers. Business firms that cannot finance themselves go broke. Worried about preserving their wealth, insiders and outsiders convert their holdings to currencies that are not expected to depreciate. Vast amounts of money leave the affected countries. Credit markets freeze up. A business crisis becomes a crisis for the country.

4.3.3 Advocates of the financial panic hypothesis views Asia's economic fundamentals as basically sound since budgets are generally in balance or surplus, inflation is low and private saving rates are high. This hypothesis views Asia as reeling not so much from a crisis of fundamentals but from a self-fulfilling withdrawal of short-term loans, one that is fuelled by each investor's recognition that all other investors are withdrawing their claims. Since short-term debts exceed foreign exchange reserves, it is rational for each investor to join in the panic

4.3.4 "In a matter of just a few months, the ASEAN economies went from being the darlings of the investment community to being virtual pariahs. Much of the panic is a self-feeding frenzy: even if the economies were fundamentally healthy at the start of the panic, nobody wants to be the last one out when currencies are weakening and banks are tottering because of the rapid drain of foreign loans. It is somehow comforting, as in a good morality tale to blame corruption and mismanagement for the crisis. Yes, they exist and they weaken economic life. But the crisis itself is more pedestrian: no economy can easily weather a panicked withdrawal of confidence, especially if the money was flooding in just months before...The currency crisis is not the result of Asian government profligacy. This is a crisis made mainly in the private, albeit under-regulated, financial markets...", wrote Jeffrey Sachs of the Harvard Institute of International Development in an article in the New York Times of 3 November 1997.

4.4 The paper end this section on the origins of the Asian crisis with the following remarks made by Prof Paul Krugman in Hong Kong in March 1998:

" Anyone who claims to fully understand the economic disaster that has overtaken Asia proves, by that very certainty, that he doesn't know what he is talking about... The truth is that we have never seen anything quite like this. Of

course the country doctors at the IMF and the US Treasury Department are obliged, by the nature of their position, to adopt a reassuring bedside manner as they prescribe their bitter economic medicine. But we all know that in reality they are pretending a confidence they do not at all feel, that even as they lay down the law to their clients they are groping frantically for models and metaphors to make sense of this thing. In fact, the best thing I can say about the people running the show in this case - who happen to be people I know rather well - is that they are smart enough, and also personally secure enough, to know and admit to themselves that they are making it up as they go along."

5. Malaysian Government's policy response to the currency crisis

A review of the policy measures instituted by the Malaysian government in response to the crisis reveals three distinct phases which correlates to the interpretations of key members of the Malaysian policy elite on the origins and causes of the currency crisis.

5.1 The first phase of Malaysia's policy response is the period between 2 July 1997 and 4 December 1997. This period was characterised by the belief that the crisis is only a short-term phenomenon and is externally induced (caused by currency speculators). It was also believed that the temporary shock which would be self-correcting and that Malaysia would not suffer Thailand's fate since domestic economic fundamentals were sound. As a result, minor adjustment measures were subsequently instituted. The high growth strategy remained essentially unchanged. Unfortunately, the slide in both the Ringgit and the KLSE continued.

Adjustment strategies instituted during this period are as follows

- Increase oil production by 50,000 barrels per day to 680,000 bpd to help ease the current account position
- Across-the-board 2% cut in public expenditure.
- Corporate tax rate reduced to 28% from 30%.
- Interest rate to be held steady.
- Estimated 1997 credit growth of 29% to be trimmed to 20 % by the end of 1998. Credit to be directed to productive sectors - manufacturing, small and medium-scale industries, and low-cost housing
- Credit ceiling for loans to purchase passenger cars reduced to 70% from 75%.
- Import tariff increased on consumer durables that are produced in Malaysia. Import tariffs raised on luxury items

5.2 From 5 December 1997, the adjustment response shifted into the second phase when various austerity measures were instituted by former Deputy Prime Minister Datuk Seri Anwar Ibrahim. The former DPM was of the view that domestic weaknesses had contributed to the crisis in Malaysia. During this phase, interest rates were allowed to rise fairly rapidly to support the currency.

Austerity measures were instituted as follows

- All large-scale infrastructure projects to be deferred
- Outward investments by Malaysians to be deferred.
- Increase in interest rates
- Credit growth for 1998 revised downwards to 15% from previous target of 20%. Priority sectors in manufacturing, agriculture and services sectors to be provided credit. Restrain credit allocation to unproductive sectors, notably property sector and for consumption.