Asian Financial Crisis Essay, Research Paper

The Asian Financial Crisis:

Causes & Consequences

Few financial events have so rocked the world economic order as the Asian financial crisis of 1997-98. Beginning with the collapse of the Thai currency in early July of 1997 and extending through the near meltdown of the South Korean economy in December 1997 through January 1998, the financial crisis toppled one “tiger” after another. The chaos that resulted even challenged the solvency and stability of the once seemingly invincible Asian economic hegemon and the commonly accepted model of Asian economic development and prosperity: Japan. The interconnectedness of world capital and financial markets has made it difficult to isolate a national economy from the volatility in international currency markets and from the disasters that can result. This paper will be about how economic variables are interconnected, both domestically and internationally, and how poor performance in one sector can have a domino effect throughout the world economy.

The Asian financial crisis was caused by a number of different, but interrelated factors ranging from domestic, regional, and international sources. Each factor carries different weight in each country. The major factors summed up are as follows:

1) Macroeconomic weaknesses related to current account deficits and mishandling of currency devaluations. 2) Panic behavior by investors and lenders after the initial shock. 3) Disgraceful lending practices of international banks. 5) Significant weaknesses in the banking and financial sector. 4) Weaknesses in the so-called Asian development model and too-cozy business-government relations and misguided government initiatives.

Probably the best word to describe the initial response to the Asian economic crisis is “surprise.” Gerardo R. Ungson, in his analysis on the crisis, said:

Perhaps what was most surprising about the Asian financial crisis is that it caught most of us by surprise. Except for a disquieting article by MIT economist Paul Krugman, who even then simply took issue with the sustainability of Asia’s breathtaking pace of growth, commentators continued to laud the success of this region and predicted the next millennium as belonging to Asia (Ungson 321).

International management analysts were by no means the only ones caught by surprise. In the path of the crisis,

neither the international financial “forecasters” and rating agencies (e.g., Moody’s, Standard and Poor, etc.) or the financial “watchdogs” at the International Monetary Fund could legitimately claim they had seen the crisis coming.

Although few people predicted the crisis, many soon rushed to establish its cause(s). While most analysts stressed that the Asian financial crisis was caused by a complex mix of factors (domestic and international), some analysts took pains to emphasize the overwhelming importance of one causal factor over the others. At polar opposites were those who fixed the blame to the malfunctioning of international financial markets. More specifically, the irresponsible actions of foreign lenders and currency speculators-and those who gave blame to domestic factors like the Asian model of economic development and the prevalence of “crony capitalism”. Summarizing the first viewpoint was Malaysia’s Prime Minister Mahathir, who went so far as to claim that the Asian financial crisis was the result of a western conspiracy to impoverish the emerging Asian economies (Woodall 9). Epitomizing the second viewpoint was an extensive spectrum of Western analysts, who, often in

contradiction used the same arguments (focusing on the power of “Asian values”) to explain the Asian collapse they had used to explain the previous three decades of sustained economic.

The suddenness of the crisis is of particular concern for economists because the Asian model of development had been seen by many in the West as the possible successor to a highly individualistic American model that was having trouble producing the extraordinary gains in efficiency seen in the region. This “economic miracle” that had been producing phenomenal gains in GDP growth since the sixties was suddenly insolvent. Two explanations for this exist. First, in can be interpreted that these economies were structurally deficient in their financial structure, particularly in corporation’s high debt-to-equity ratio, was a cause of bank insolvency once currency valuations fell too low. Secondly, it could be interpreted that these vast financial transactions can affect the health of any economy and that Asia was simply the victim du jour.

While some factors were certainly more important in some of the Asian countries then in others (e.g. loans on inflated land values was not a significant issue in South Korea), commonalties could be seen across the region. In

early February of 1998, an analyst for the Far Eastern Economic Review summed up what had at the time become the general consensus on these commonalties:

In country after country the story was remarkably similar. Corruption and crony capitalism had weakened solid economies built on years of hard work and prudent investment. Lax, outdated banking rules had left nations unprepared to handle a flood of foreign funds. In short, a potent mix of globalization, poor governance and greed brought about the crisis that now engulfs the region (Chanda 46).

By early 1998 it had become fashionable to ascribe the Asian crisis to crony capitalism and weak banking systems (Wood S2). More cautious analysts, however, while acknowledging the contributions of too cozy business-government relations as casual factors in the crisis, began to tone down the emphasis on the “crony capitalism” argument. After all, what was now being maligned as “crony capitalism” was once shown as devotion to Asian “alliance capitalism” (Wade 20). In the shift away from the focus on “crony capitalism” and a stereotyped model of Asian economic development, it became to consider the cause of the crisis in terms of broad domestic and international financial interactions. For example, a former US Federal

Reserve Board chairman Paul Vocker argued that the crises was caused by a combination of volatile capital flows and

huge shifts in the dollar-yen exchange rate during 1996 and early 1997 (Wood S2).

While Western analysts had initially reacted with anger at Dr. Mahathir’s accusation that the Asian financial crisis was the outcome of a foreign investor, most well-considered research of the causes of the Asian crisis now acknowledge that the behavior of Western investors was a contributing factor, if not a direct initiation of the crisis.

Although the initial impact of currency devaluations was large, it could have been contained had it not been for dynamic escalating dynamics, such as herd behavior, boom-to-bust panic activities, and self-fulfilling prophesies that precipitated the crisis

(Ungson 323).

While analysts have not abandoned the well-grounded charge that the Asian banks participated in disastrous lending practices often under the protective shield of their governments, they also criticized the lending practices of foreign banks (Nayan, Stiglitz, Wade). Foreign banks frequently lent blindly, with little or no due diligence. Foreign investors were providing funds to Asian firms with

debt ratios and long-term alliance relationship that would have been unacceptable in the West. When the crisis hit, the violence of the outflow owed much to the realization

that much of the capital should not have been committed in the first place, according to western prudential standards (Wade 20).

Each of these causes had consequences. The most immediate and obvious consequence of the Asian financial crisis was that the Asian economies plunged into a deep recession. After decades of economic growth, real GDP growth turned negative. The impact of the crisis has been evident across every macroeconomic and fiscal policy-unemployment rates soared, interest rates soared, inflation rates soared, devalued currencies, collapsing stock markets, investment dried up, reductions in public spending, etc. Moreover, while analysts had at first been optimistic about the idea that the Asian economies would bounce back from the crisis, by mid-1998, most analysts, with officials at the IMF, were admitting that the crisis was worse then they expected (Lee 4).

What was disappointing was the magnitude of the crisis. Early on, it seemed it would hurt to suggest that the currency crisis in Thailand would spread like a disease

throughout Southeast Asia or north to South Korea. Looking back, however, it is now understood that contagion was inevitable because of the interdependency of the Asian

markets and the weaknesses in the Japanese economic system and financial structure (Goldstein, Lee, Wade, Woodall). The fact that the disease was not contained within Asia is a reflection of the globalization of the world financial systems and the flaws in the Japanese economy. The possibility of global a impact was evident around October 1997, when the Hong Kong stock market collapse sent shock waves through New York, London, and Japanese exchanges. Concrete evidence that the crisis had become global appeared in spring of 1998, when falling demand in Asia quickly caused a collapse in world commodity prices (Wood S2).

Looking back, the Asian financial crisis was a case study in global economic interdependence. The disease that spread throughout Thailand and the rest of Southeast

Asia could not be quarantined within the affected Asian economies. While some say that a financially sound and economically strong Japan could have better absorbed the shocks and withheld the impact to Asia, the collapse of the Russian economy and the reverberations through US and

European markets make a much stronger case for the inevitable situation that became a global crisis.

We live in an era not only of super power states, but also super-empowered individuals, who can move their influence and capital across borders almost instantly. The economy of the future must be prepared to deal with these gigantic capital flows and the destabilizing effect they can have on international macroeconomics.

In addition to the need for global financial infrastructure, the Asian crisis can serve as a reminder that it is impossible to separate politics from economics. Secure financial systems can reduce the problems of corruption and “crony capitalism”, but they are unlikely to remove political influences from financial decision-making. The Asian financial crisis taught the global economy a lesson: careful analysis of creditworthiness is essential and in the future, both direct investors and lenders must conduct more careful assessment, and demand greater accountability.