Lessons from the Asian Financial Crisis

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The Asian Miracle Is Alive

The Asian financial crisis may have finally put to rest the myth that the region's success has come about as a result of a unique system of capitalism rooted in Asian values—a system immune to the depressions and other troubles that economies in the West have to endure. Now, however, this claim is being replaced with a skepticism that is equally wrongheaded: a perception that the so-called Asian miracle had no substance, that it was a house of cards destined to collapse under the weight of cronyism and corruption.

The fact remains that real per capita incomes in the Asian economies have grown at an average rate of 4 to 6 percent per annum since the 1960s. This is not some national income accounting anomaly but, rather, a reflection of the high and rising rates of consumption that anyone who has lived or traveled in the region can easily observe. It is also reflected in the vast improvements in health, life expectancy, and education of the Asian people. Even if the present crisis stopped all economic growth for the next five years, these economies would have performed well above the world average for some three decades.

Asia's success has not been built on the discovery of a new form of capitalism, advocated by Singapore's Lee Kuan Yew and Malaysia's Mahathir Mohamad and promoted quietly by Japan's faceless bureaucrats. Rather, its success has been due to a tried and true formula, the vital ingredients of which include a hard-working, well-educated and trained labor force, and a vigorous entrepreneurial class that invests in plants and equipment. Asian nations spend more on human capital than do the vast majority of nations with comparable levels of per capita income and appreciate the importance of the market economy. They have promoted economic freedom by lowering taxes and

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reducing barriers and restrictions in markets for goods and services and in labor and capital. Moreover, the physical infrastructure—the highways, office towers, and factories that these countries built at breakneck pace—is still in place. None of these vital ingredients have been fundamentally altered as a consequence of the Asian crisis.

What Went Wrong?

The issue of what went wrong can be usefully examined from a historical perspective. If we take into account the historical development of the Asian crisis, we will be more likely to succeed at any future attempts to build new institutions and reshape the global financial system.

The causes of Asia's crisis were quietly developing as far back as the late 1980s. Many factors played a role in its unfolding:

- Banks in Japan and Europe were glad to lend overseas because of the economic recession at home and were also tempted by the high profit margins of Southeast Asia.
- The long-standing economic boom and low interest rates in the U.S. markets released a torrent of funds seeking higher yields in emerging markets.
- The emergence of China as a major exporting nation in the region contributed to the worsening current account balance of some Southeast Asian economies.
- The confidence of many Asian leaders eager to push their development plans without regard for economic fundamentals and to grow instant international financial centers by liberalizing financial markets prematurely, often supported by a chorus of international agencies, bankers, and investors.
- Corrupt practices, outdated banking rules, and weak supervision left many Asian nations totally unprepared to handle a flood of foreign funds in a global capital market.

The overwhelming confidence of some Asian leaders and central bankers in their ability to successfully defend their currencies against speculative attacks finally led to total collapse and bankruptcy.

The 1987 Plaza Accord brought down the value of the U.S. dollar and ushered in a new era of the appreciating Yen. This led to a six-year cycle of Japanese investment in Asia that transformed and expanded the industrial base for Malaysia, Indonesia, and Thailand. Japanese capital outflows reflected that nation's domestic problems. Japan's leaders refused to write off mounting bad debts in the banking system after the asset bubble burst. Japan pursued a low interest rate policy to keep the banks solvent. The banks in turn took unusual risks by lending to many Asian economies in search of high yields in a bid to resolve their own domestic debt problems.

Foreign banks and other institutional investors from Europe and later the United States, all flush with funds, soon discovered Asia's emerging markets, where interest rates were high and risk was very low because currencies were pegged to the U.S. dollar. This environment led to a five-year boom in Asian equities. As the Asian economies grew, infrastructure bottlenecks became apparent. The World Bank's high-profile claim that Asia needs $1 trillion worth of investment in infrastructure and bond markets soon captured the public's imagination. Japanese, European, and to a lesser extent U.S. banks were soon providing short-term foreign currency loans at low interest rates to finance long-term infrastructure and real estate projects in Malaysia, Indonesia, and Thailand. In Korea, the same short-term loans were used to support investments in projects favored by government industrial policy.

In addition to effecting currency and maturity mismatches, these banks often extended loans without adequately assessing credit risks. Indeed, the current obsession with the lack of transparency and the accusation of Asian crony capitalism were hardly mentioned then, as foreign investors and lenders ingratiated themselves with the powerful and influential and envied each other for their special and privileged access to the power elite. The lack of transparency in Asian business transactions that is much lamented today was viewed then as an opportunity for making huge profits that warranted taking large risks. These stories were well known among bankers, and they are now finding their way to the press as accounts of failures surface.

By 1995, the era of the strong yen was being replaced by the era of the strong U.S. dollar, and a number of Asian economies were slowing down and experiencing current account deficits. Nevertheless, capital inflows continued to accelerate. Thailand was the country whose exports were most obviously affected by China's entry into the world market, but South Korea, the Philippines, Indonesia, and Malaysia were all slowing down for a variety of different reasons. China was trying to engineer a soft landing after earlier excesses had led to intolerably high inflation rates. Hong Kong also experienced a slowdown as the government acted to restrain the credit growth that had occurred as a result of rising asset prices.

At the end of the day, Asian economies became vulnerable as markets became increasingly aware of the excesses that had been built up as a result of the poor investment decisions that had been made in an attempt to employ the huge increases in portfolios for investment.

In some cases, excesses were fed by unsound real estate and other lending activity that undermined the soundness of the financial systems of the affected Asian economies. These excesses were reflected in overvalued exchange rates, growing current account deficits, and highly inflated asset values.

The excesses of Asian governments, financial institutions, and nonfinancial firms would not have been possible without the availability of cheap credit. The international banks and other foreign lenders made it possible for these excesses to take on disastrous proportions. The availability of cheap foreign currency-denominated credit that was extended almost indiscriminately set the stage for the Asian crisis. Foreign lenders were no doubt encouraged by the willingness or perceived willingness of international agencies and the U.S. government to bail out bankrupt countries, as they had in the case of Latin America in the 1980s and Mexico in 1994–95. There is little doubt that the actions of the International Monetary Fund in bailing out countries had created a serious moral hazard problem in international lending.

The moral hazard problem in international lending is a serious one that has to be properly addressed in any future design of the global financial system. Greater transparency and better surveillance systems are necessary, but the effectiveness and value of those changes are difficult to assess. The outcome would depend on how the new information is used and, hence, on the incentives confronting decisionmakers.

A novel suggestion proposed by Charles Calomiris (1998) to invite banks to police each other is worth serious consideration, especially if it could be implemented. Part of the solution would be to reduce our dependence on banks as suppliers of capital to industry, partly by shrinking the banking industry itself, but, even more importantly, by steadily expanding the number and variety of market alternatives to bank loans. Here, as so often in economic life, we must rely on decentralization and diversification—in this case, diversification of financing alternatives—and not on the presumed superior judgments of large banks and their regulators for directing capital to its most productive uses.

Unlike their Latin American counterparts, Asian entrepreneurs generally trusted their governments to enact sound economic policies. Although that trust may have been misplaced, it was genuine. Against such a background, advocates of Asian values found a willing audience. But their failure to sense the dangers of borrowing short in foreign currency and investing in long-term projects with earnings denominated in local currency was disastrous. The World Bank's 1993 study, *The East Asian Miracle,* also failed to recognize the danger inherent in the attempt of governments to achieve national and developmental goals by domination of credit markets. The ambitions of Asia's political leaders in the newly emerging market economies were seldom challenged.

The excessive confidence of Asian leaders and central bankers blinded them to the severity of the economic and financial problems that were emerging. During the Mexican crisis, speculators attacked a number of Asian currencies, which alerted governments to the dangers inherent in short-term capital outflows. It also led Asian leaders to view such speculative activity as purely opportunistic and unjustified by economic fundamentals. How could speculators justify attacking Asian currencies? Actually, the real problem was halfway around the world in Mexico, an economy whose ties to Asia are very limited.

This episode nevertheless prompted most Asian central bankers to devise "repo agreements" to defend their currencies against speculative attacks. Hong Kong authorities had another reason to be concerned about the prospect of a speculative attack against the Hong Kong dollar—namely, the handover of the territory in 1997 to China. They were determined to maintain the rigid link to the U.S. dollar.

This mindset was first put to the test in Thailand. The Bank of Thailand fought back hard against the speculators, but eventually it ran out of foreign reserves and devalued the baht in July 1997. Once the peg to the U.S. dollar was abandoned, the baht lost more than 50 percent of its value. The Bank of Thailand's first mistake was to try to fight off the speculators by raising interest rates and tightening market liquidity. Raising interest rates did little to discourage the speculators, and ended up actually enriching those who had sold the baht short in the forward exchange market. The higher interest rates also inflicted terrible damage on the Thai people, many of whom were borrowing short and lending long.

The most damaging mistake, however, was the Bank of Thailand's attempt to conceal the true state of its foreign exchange holdings. The bank deceived the public and foreign investors by overstating the amount of foreign reserves it had for fighting off speculators and maintaining the value of the baht.

When the bank finally admitted that its foreign reserves were mostly gone, there was a massive run against the baht, which quickly swamped the additional liquidity that the IMF had brought in and changed the terms of the battle from one of countering speculators to one of stemming widespread capital flight by the Thai people themselves. With the deception by even the trusted Bank of Thailand revealed, the remaining Thai institutions, financial and political, could not withstand the loss of confidence. What might otherwise have been a minor realignment of 10 or 15 percent turned into a major disaster.

The speculators were probably encouraged by the willingness of Asian nations to support their currencies, despite the vulnerabilities of their economies and their ineptitude at defending themselves successfully against such attacks. With the baht down so dramatically, the speculative attack quickly spread to Thailand's neighbors and competitors—Malaysia, Indonesia, the Philippines, and South Korea. Singapore and Taiwan were also affected, but their currencies suffered only minor devaluations. Hong Kong was able to avoid devaluation altogether, largely because of its currency board system, the relative transparency of its monetary and banking system, and the fact that the people of Hong Kong did not lose confidence in their government and its promise to maintain the value of the currency.

I am not convinced that the rapid spread of these events throughout Asia is the result of some contagion effect. The fact that they happened more or less simultaneously can be attributed to the fact that many of these economies are remarkably similar in the fundamental nature of their problems and became vulnerable at around the same time. Their plights were to a large extent the culmination of the same global market forces that had been in operation for about a decade before the crisis emerged. Moreover, their responses to speculative attacks were very similar, even though the final outcomes varied depending on the relative strength and soundness of their monetary and financial systems.

The Asian economies were due for a major adjustment after a decade of rapid and excessive growth. But the total collapse of the monetary and financial systems in some of these countries was unnecessary and could have been avoided if better policies had been adopted to manage the speculative attacks on the currency. The implementation of such policies would have been followed by a period of painful adjustment, but the current plight of the economies in Thailand, South Korea, and especially Indonesia could have been avoided as a result.

The IMF's attempt to help these economies was largely unproductive. While the evidence is not yet conclusive, there is a growing suspicion that the IMF acted as the unwitting handmaiden to broker a bailout of lenders and a bailin of borrowers at the expense of the public. The bailout package the IMF put together was too little, too late. And its effort was focused initially on austerity measures that pushed the economies into depression when the most immediate issue at stake was a collapse of the credit system that had adversely affected many otherwise sound companies. To be fair, it is not evident that, on this most urgent issue, there was much the IMF could have done quickly, given its own limitations to perform the role of international lender of last resort.

Should an international lender of last resort be created to deal with a crisis situation after it has happened? That question is receiving substantial attention. The purpose of such a facility would be to lend freely, to banks that are distressed but solvent, against collateral, and at a penalty rate of interest. That arrangement would let insolvent banks fail but help sound banks facing a temporary liquidity crisis. In practice, however, the moral hazard problem is unlikely to be easily or fully mitigated, and any lender of last resort flush with funds is likely to invent a new role for itself from time to time.

Recovery and Lessons

As I mentioned at the outset, none of the vital ingredients of the success of the Asian miracle have been fundamentally altered as a consequence of the Asian crisis. Moreover, if there is anything remaining of the term ''Asian values'' that still applies to the population there today, it is their untainted record of relying on self-help, hard work, and entrepreneurship. Before long those positive attributes will renew the Asian miracle.

A new era of prosperity is possible as these nations rebuild their banking and financial systems. We may even have reason to hope that some of the flaws in their economic and political systems, and the much too cozy relationship between government and business conglomerates, will be corrected, creating more open and transparent systems. Such institutional reforms would encourage new business activity and attract an inflow of capital from abroad.

The Asian crisis has once again revealed that currency crises are a result of the compromise between monetary unification (the only true fixed-rate regime) and a freely floating exchange rate. The performance of Hong Kong's currency board system, despite its flaws, has presented itself as a viable option for many open economies. There is much to be said for its transparency, its single-minded policy objective, and its discipline on domestic macroeconomic policies. Indeed, a further step toward monetary unification would be to dollarize the economy—that is, eliminate the Hong Kong dollar and replace it with the U.S. dollar. Dollarization would remove any doubt about the possibility of either devaluation or revaluation.

The Asian crisis no doubt will lead to a growing demand for capital controls, transaction taxes, or other market-inhibiting initiatives to limit international capital flows. Such policies would have large and adverse unintended consequences. In a global system, suppressed markets in one area would be rapidly displaced by others outside the reach of government controls and taxes. Furthermore, risk-taking would be curbed, to the detriment of rising living standards.

It is worth noting that the global financial system is not an end in itself, but an institutional structure that has responded to and facilitated the production and distribution of goods and services. There are bound to be incongruities between the institutional requirements of a global financial system and the prevailing institutions in an emerging market. This is part of the problem some Asian economies faced when they began to partly liberalize their financial systems. They each lost sight of the purpose and objectives of financial liberalization and became enamored with the ambition and grandiosity of developing an international financial center for their own country.

The Asian financial crisis may well be a blessing in disguise for the region. It has provided an opportunity to review things in a fundamental way. And, intellectually, it has put to rest the idea that there are new laws of economic growth that have been uncovered by the Asian miracle.

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