The Japanese Economic Review

The Journal of the Japanese Economic Association

Vol. 52 No. 4 December 2001

Articles:

The Japanese Economic Review
Vol. 52, No. 4, December 2001

SYMPOSIUM ON THE ASIAN CRISIS, 1997: INTRODUCTION

By KAR-YIU WONG
University of Washington

The Asian crisis that shocked the world began officially on 2 July 1997 when Thailand stopped defending the baht. This occurred after a long period during which the country had been hit by capital flight and speculative attacks. Soon after the event, many neighbouring countries felt similar pressure, and many Asian economies, with the primary exceptions of Hong Kong and China, were forced to give up their long policy of pegging their domestic currency to foreign currencies. Since then, many of them have experienced continuing external and internal problems, and three countries—Thailand, Indonesia and South Korea—have received assistance from the International Monetary Fund.[1]

This crisis caught many people by surprise, in part because of (a) the large number of countries affected, (b) the speed with which the crisis spread from one country to another, and (c) the fact that before the crisis most of these economies had been growing and performing quite well, with solid fundamentals. The growth experience of these countries prior to the crisis had been very impressive, and had even been termed "miracles". Moreover, the governments of most of these countries had been fairly responsible fiscally and had achieved good growth rates without running up large budget deficits. Very few forecasters had sensed any big trouble for these economies, or anticipated that they would go through a crisis of this magnitude.

Since the crisis broke, many people, myself included, have been trying to piece together what had happened. To learn more about this crisis and help others learn more about it, I organized a study group at the University of Washington, consisting of around a dozen graduate and undergraduate economics students. They collected information and data for various Asian countries, wrote country reports, and presented them at the Economics Department of the University of Washington.[2]

In addition to the study group, I helped organize two conferences on the Asian crisis held at the University of Washington, the first in December 1998 and the second in January 2000.[3] Altogether about forty papers were presented, covering many aspects, from the causes and effects of the crisis, and domestic troubles in these countries to policy recommendations, and how countries in other regions might have been affected.

This Special Issue presents eight of these papers, most of which were read at the second Seattle conference on the Asian crisis in January 2000.[4] The papers are put together so that

[1] For a good account of what happened in 1997, see e.g. Wong (1998), or visit the Asian home page at http://faculty.washington.edu/karyiu, which contains a chronology of the events, country reports and a reference list.

[2] The reports can be downloaded at the above web site.

[3] The above-mentioned web site gives information about these conferences and access to all papers presented at the conferences. A third conference on the crisis was held on the campus of Tokyo University in July 2001.

[4] The conference was jointly sponsored by City University of Hong Kong Faculty of Business, University of Washington College of Arts and Sciences, and University of Washington Center for International Business Education and Research. Thanks are due to these units for generous financial support.

Published by Blackwell Publishers, 108 Cowley Road, Oxford OX4 1JF, UK.

readers can gain a comprehensive idea of how certain features of the crisis have been analysed. Roughly speaking, three papers examine the causes of the crisis and suggest theories to explain its occurrence; two discuss some of the features of the crisis, while the remaining three focus more on the effects of the crisis and on post-crisis adjustment.

The papers by Wan and Wong, Wong, and Choi discuss possible causes of the crisis. By taking different approaches to the crisis and analysing it from different angles, they come up with different theories. However, they have one element in common, which sets them apart from many of the other papers. Although the crisis brought troubles to the financial markets of many countries, leading many people to call it the Asian Financial Crisis, these three papers focus instead on the "real" economies, and examine how some real variables might have led to such a disastrous financial crisis.

The paper by Wan and Wong investigates how a country with solid fundamentals may be affected by a crisis in another country. The authors note that crises occurred in many countries within a short period of time: it might have started in the Czech Republic, and then moved to Thailand, Malaysia, Indonesia, Korea, Brazil and finally Russia. They noted further that the financial markets in London, New York and Tokyo were, however, left intact. The crises in these countries could have been coincidental, but many people seek to explain the sequential occurrence of the crisis in terms of the Contagion theory. According to such a theory, those countries that were affected must belong to the same network, and there must be direct or indirect links (through third parties) between them.

Wan and Wong suggest an alternative theory, which they call the Inductance theory. They argue that a crisis in one country can spill over to other countries even if these other countries do not belong to the same network, and even if there are no links between them and the originating country. According to this theory, inductance can occur in a world of uncertainty and imperfect information. When it is known that an investment has gone sour, but is not known which countries or firms going to be affected by the failure, banks and creditors in other countries may become conservative and reduce their lending. As a result, debtors in the latter countries could be hurt by the reduction of credits and a crisis could occur even if the fundamentals of these countries are still sound. According to this theory, transmission of the crisis from one country to another does not require the affected firms to be in the same network.

Wan and Wong's theory has important policy implications. While the Contagion theory recommends better compartmentalization of risks through the setting up of "firewalls", the Induction theory puts more emphasis on the need for stricter financial supervision and a higher degree of "transparency". With more perfect information, creditors would not be over-conservative, and would not be needlessly affected by an investment failure in another country.

Wong puts forward another theory. The crisis begins with a sufficiently large sector such as the housing market in Thailand, the first Asian country to cease defending of its currency against speculative attacks. This market had been experiencing over-optimism, over-investment and over-borrowing before the crisis, causing "bubbles". The loans to Thai firms were made by local financial institutions, which in turn had borrowed heavily from abroad, usually short-term because of the more favourable rates; and most of the foreign debts were denominated in foreign currencies, because of the confidence in the domestic exchange rate under the pegged exchange rate regime. Soon the "bubbles" in the market burst and the market collapsed, causing widespread bankruptcy and defaults. The problems in the housing market dragged down the whole Thai economy.

To explain what happened, Wong proposes a theory that is based on the following pre-

crisis experiences of these Asian countries: (a) high growth rates before the crisis; (b) large amounts of foreign debt, most of it short-term in nature; (c) "bubbles" in many sectors of the economy. The nearly unprecedented high growth rates of the affected countries were partly fuelled by foreign capital inflow in the form of direct investment, portfolio investment and foreign loans, and the signs were that these countries were becoming over-reliant on foreign loans to finance domestic investment in sectors such as the housing market. As long as the economies remained healthy, domestic firms would have no problem in repaying their debts; but if a sufficient number of firms failed during an economic downturn, the ensuing bankruptcies, bad loans and defaults could mean that local financial institutions would be unable to repay the foreign debts they had incurred earlier.

Wong's theory indicates one cost of growth: when an economy grows rapidly for a long time, people can get over-optimistic, and such feelings, together with herding behaviour, can lead to over-investment and over-borrowing from abroad. This increases the risks that the market and the economy face: over-investment means a bigger loss should an economic downturn occur.

Another theory about the cause of the crisis is proposed by Choi. He observes that China opened its door to foreign investment and foreign trade in the late 1970s. In the 1980s and 1990s, China greatly improved the competitiveness of its exports by increasing production efficiency, promoting domestic capital formation, improving the quality of its labour, easing trade and domestic restrictions and devaluating its currency. There have been arguments that, as many of China's exports are now close substitutes of those of many other Asian countries, and are competing intensely in the same markets, the emergence of China as an economic giant in Asia could have had adverse effects on other Asian countries.

The China factor is analysed theoretically by Choi. Using a simple Heckscher–Ohlin-type model, he shows how population change and trade liberalization of a large labour-abundant country may affect the trade performance of other labour-abundant countries, and the income and welfare levels of the rest of the world. He argues that rapid trade liberalization of a country like China could cause income divergence between trading countries, and could worsen the terms of trade for other labour-abundant countries while benefiting the industrial countries.

As Choi's paper is only theoretical, his results cannot be used simply to imply that China *is* an important factor of the Asian crisis. Yet his paper does raise researchers' interest in the possible impacts of China on the income, welfare and trade performance of other Asian countries.

Two other papers, one by Aizenman and the other by Hamada and Takeda, examine the adjustment of the exchange rates of some Asian countries during the crisis. It has been observed that the crisis caused a sudden and sharp depreciation of domestic currencies of most countries. In addition to this change in the exchange rate, many countries also experienced foreign reserve depletion, capital flight and speculative attacks. Different countries responded to the pressure with different policies. For example, Thailand, Indonesia and South Korea allowed their currencies to float, resulting in an immediate devaluation. Hong Kong has long had an established and credible currency board, which pegs its currency to the dollar; China, partly to help defend the Hong Kong dollar, refused to allow its own currency to adjust. Malaysia, on the other hand, permitted a significant depreciation of its currency but imposed restrictive capital control.

The papers by Aizenman and by Hamada and Takeda examine this feature of the crisis, using different approaches. Both papers attempt to determine how capital control (or the liberalization of capital control) might affect exchange rate adjustment and welfare of the economy.

Aizenman notes that Korea relaxed its restrictions on foreign capital inflow after the crisis, and the resulting capital inflow has helped ease the depreciation pressure on the currency, thus diminishing the extent of overshooting of the currency. However, Aizenman is quite sceptical of how this policy may improve domestic welfare, because domestic equities were sold at a discount. He argues that, even if the net gain is significant, using temporary capital controls to prevent capital flight, as Malaysia did, could lead to similar welfare effects for the domestic economy.

Hamada and Takeda examine the following questions: why did different countries choose different policy responses and can these policies be compared and ranked? They pay special attention to three policy regimes: flexible exchange rates, a currency board and capital control. In analysing these regimes, they start with the traditional proposition of the "impossible trinity": a country must give up one of the three objectives of exchange rate stability, monetary independence and capital mobility: it cannot achieve all three. Therefore each of these three policy regimes can attain at most two of the above three objectives.

Hamada and Takeda compare these policies in terms of the critieria of the degree of overshooting, the change in country risk, the degree of strength in the monetary contraction, and the severity and duration of the recovery process. They investigate the experience of Indonesia, South Korea and Thailand, and compare their experience with that of Argentina, Brazil, Chile and Mexico. One conclusion the authors draw is that no single regime dominates the other two. They also note some important features of the adjustment of these economies after the financial shock: for example, the rigidity of the domestic price levels right after the crisis; the smooth adjustments of economies such as South Korea and Thailand; the relatively smooth transition of the Malaysian and Chilean economies after the imposition of capital control; the problems of the currency board in Argentina; and finally the wide range of adjustment costs arising among the countries switching from a fixed to a flexible exchange rate regime.

The other papers in this issue focus more on the adjustment of various economies after the crisis. Ahn examines the adjustment of the Korean economy, which has attracted a good deal of analysis, in part because the crisis arose so suddenly and in part because the economy recovered so well thereafter.[5] Ahn attributes the crisis to the difficulties in Korea's corporate and financial sectors. The paper begins with a careful description and analysis of the economy immediately before and after the crisis. It then turns to the restructuring of the financial and corporate sectors. The work done in these sectors and their subsequent performance are described. However, despite the efforts made by firms in these sectors and the government, and despite the rapid recovery of the economy in 1999, Ahn concludes that Korea has yet to complete the reforms it has committed itself to for the IMF and the global community. Thus, more reform and work are called for. The paper makes several recommendations for the further restructuring of the sectors, which should not be taken lightly by government policy-makers who want to ensure a healthy recovery of the economy and to minimize the chance of confronting similar crises in the future.

The paper by McKibbin, Wang and Coyle investigates how the crisis may affect global economic adjustment and the US agricultural trade using a multi-country, multi-sector dynamic intertemporal general equilibrium model. This study is important not only to

[5] See Wong (2000) for a theoretical analysis of the crisis in Korea and for more references.

government planners, but also to those who have been following the foreign trade performance of the US economy. Over the previous years, the comparative advantage of the United States in agriculture has been rising, and Asia has been a reliable and growing market for US agricultural products. While agricultural exports currently account for about 20% of the US total agricultural production, about 40% of the US agriculture and food exports go to Asia.

The simulation carried out by the authors suggests that the Asian crisis, taken as exogenously given, has reduced US exports, domestic interest rates and the cost of intermediate inputs of production. The change in domestic interest rates and in the cost of intermediate inputs are favourable to domestic economic activities in interest-sensitive sectors and to the demand for agricultural products. However, the impact on domestic production is ambiguous, depending on whether the stimulus of domestic demand can offset the negative impact of declining exports.

Yang and Tyers, on the other hand, examine the relative contributions of external and internal shocks in China during the Asian crisis. Noting that China experienced a surge in the domestic saving rate before the crisis, the authors investigate how the crisis, which came from outside, and the surge in saving rate, which came from inside, might have contributed to the country's slowdown in 1998. They also try to determine the consequences of China's pegging its currency, and to learn how the surge in the domestic saving rate might have encouraged capital outflow during the crisis.

Yang and Tyers construct a global general equilibrium model to estimate the impacts of the external and internal shocks, and they consider three scenarios: the reference scenario, the "passive China" scenario with no domestic shocks, and the flexible exchange rate scenario. A comparison between the results of these three scenarios reveals the impacts of these shocks. For example, the crisis and the rising saving rate had a dampening effect on the domestic GDP and contributed to capital outflow. Perhaps a more surprising result they find that the rising saving rate had a contractionary effect on the domestic economy.

Final version accepted 29 December 2000.

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