Financial development in East Asia after the 1997 Crisis

SHAN Zhongdong
ZHANG Shengping
QI Jianhong

Institute of the Chinese Economy and WTO Studies, Peking University
Peking, 100871, China
Email: wto@gsm.pku.edu.cn

ABSTRACT: Six years after the Asian financial crisis in 1997, financial development in East Asia has been an important topic which draws the attention from both economists and politician around the globe. Some argue that another financial crisis might occur in East Asia. In this paper, we firstly review the financial development in those countries that had been suffered most from the last crisis, with an attempt to find out if there are further signs of financial crisis in these countries. Secondly, we will examine the main reasons for the improved financial situation in East Asia. Finally, we discuss the prospect of financial cooperation and financial openness in East Asian countries.

Key Words: financial crisis; Asian economy; financial cooperation; financial openness.

I. Introduction

Six years after the Eastern Asian financial crisis in 1997, financial development in East Asia has been an important topic which draws the attention from both economists and politician around the globe. Some warn that there are some signs of another financial crisis in the Eastern Asia. Others, however, argue that Asia has fully recovered from its last financial crisis.

We believe that the recovery in Asia and the signs of any possible financial crisis depend on many economic variables in these countries such as GDP growth rates, exports, stock markets and exchange rates. Other related indicators are equally important, and they include the stock market movement, nonperforming assets in the banking systems, the levels of external debt and fiscal deficit, unemployment and potential inflation level. Therefore, it is not only important for these countries to deal with the above-mentioned issues and problems, but is also necessary to recognize the omens and causes of financial recovery after the crisis and to examine the prospect of financial development in East Asia.

In this paper, we firstly review the financial development in those countries that had been suffered most from the last crisis, with an attempt to find out if there are further signs of financial crisis in these countries. Secondly, we will examine the main reasons for the improved financial situation in East Asia. Finally, we discuss financial cooperation and financial openness in East Asian countries.

II. Financial Development in East Asia after the Crisis

(i). Economic Growth and Financial Development

Table 1 presents some indicators for Eastern Asian countries. It clearly shows that many countries have recovered from the crisis. Although some Eastern Asian countries (eg. Thailand, Malaysia, Indonesia, South Korea and Philippines) had once fallen in their GDP growth rates, as USA, Japan and European countries, who are major export market for Asian countries, had slowed down and even experienced negative growth in 2001, these Asian countries had recovered after the valley floor experiencing in 1998. In addition, "the economic growth rate of every Eastern Asian economic entity will reach 6.6 percent for the improvement of external surroundings and the internal strong demand" [1] The ADB's study points out that some uncertain signs

[1] *Asian Economic Monitor*, Asian Development Bank, 2000.

indicate that the five countries mostly harmed by the Asian financial crisis, especially Thailand, finally had shown the trend of recovery after long-term investment low ebb of private sectors.

However, it is important to point out that economic growth in all Eastern Asian countries that are badly hurt by the crisis, has never surpassed the pre-crisis level. This indicates that there still exist some factors that may resist further economic growth in those countries. These factors might be the sequel of the past financial crisis, or the hidden danger of future financial crisis.

Table 1: GDP Growth Rates of the Eastern Asian Nations after the Crisis

	1998	1999	2000	2001	2002	2003(Anticipated)
Thailand	-10.5%	4.4%	4.6%	1.8%	5.2%	6.0%
Malaysia	-7.4%	6.1%	8.3%	0.4%	4.2%	4.6%
Indonesia	-13.1%	0.8%	4.8%	3.3%	-	3.8%
Korea	-6.7%	10.9%	9.3%	3.0%	6.1%	2.7%
Philippines	-0.6%	3.4%	4.0%	3.4%	5.2%	3.7%

Data source: The data of 1998-2001 come from *International Statistical Yearbook* 2002, China statistic Press; The data of 2002 come from http://www.iapscass.cn; the data of 2003 come from *People's Daily*, Dec.13, 2003, Ed.5.

(ii). Stock Market and Financial Development

The stock markets of the Eastern Asian countries have recovered significantly since the 1997 crisis, and they all have exceeded the lowest point when the crisis had occurred. But they are still not stable enough; further, the stock markets in Malaysia and Philippines have not recovered to the pre-crisis level. In 2001, many stock markets in the Eastern Asian countries were in depression due to many internal and external factors; these factors reduced the investor's confidence and increase the difficulties for business to raise capital. Philippines, for instance, had seen some 30percent decline in its stock market in 2001. It's estimated by the IMF in October 2001 that about 4.5 billon dollars investment in securities floated from these 5 countries mostly harmed by the crisis in 2001; at the same time, some 6.9 billion dollars investment in securities flowed into these countries in 2000. The ups-and-downs in stock markets during the 2000 and 2001 period are beyond what people can imagine. But stock markets in the Eastern Asian countries, led by the main stock indexes of America and European countries, have climbed up the valley one after another and have achieved powerful growth since 2003. According to the *International Financial Market Research Report* produced by Merrill Lynch Co., the Seoul stock market rose by 29.10 percent, followed by Thailand stock market (up by 23.07 percent), Indonesia (rose by 22.89 percent), Philippine (rose by 20.16 percent).

Table 2: Stock Market of the Eastern Asian Nations before and after the Crisis

	Pre-crisis Level (July 1,1997)	The lowest point during the crisis (Time is different in such countries)	Current level after the crisis
Bangkok	527.28	204.59	772.15[Notes] (Dec. 31, 2003)
Kuala Lumpur	1078.90	261.33	628.00 (Mar. 20, 2003)
Jakarta	731.62	255.46	337.48 (Aug. 20, 2003)
Seoul	758.03	277.37	796.18 (Dec. 20, 2003)
Philippines	2815.54	1075.32	1319.42 (Nov. 27, 2003)

Notes: This is the highest level in Thailand since January 31,1997.

Data Source: Qin Xiao, On Asian financial crisis and its recovery after crisis from the aspect of structure and system, *Journal of World Economy*, vol.3, 2000.

(iii). Exchange Rates and Financial Stability

Eastern Asian nations were forced to abandon their exchange rate system pegged to US dollars when the 1997 financial crisis had occurred. Most of Asian stock markets had lost half of their value by the end of 1998, among which the Jakarta stock market had declined by 88 percent. Total capitalization of the market was only 12.44 billion dollars, that is to say, it was merely 1/6 of the Hong Kong and Shanghai Bank value; In Malaysia its stock market capitalization had declined by 74 percent, with only 75.28 billion dollars remained as its total assets; At the same time, the Seoul stock market had declined by 71 percent with only 45.67 billion dollars remained as its assets; In Thailand, its stock market had declined by 53 percent. The Eastern Asian areas lost 400 billion dollars in only one year after the crisis, reported by the World Bank. If we put this figure into the scope of the whole world, we'll find that the wealth lost is nearly twice as large as the private capital that flowed into the developing countries of the whole world. The currencies of all the Eastern Asian countries appreciated after the crisis and its premium was mostly above 10 percent (see Table 3).

Table 3 Level of Exchange Rates of the Eastern Countries before and after the Crisis

	Pre-crisis Level (July 1 of 1997)	Lowest point during the crisis (Time is different in such countries)	Current level after the crisis
Thailand	24.35	56.50	1$=43 Baht (Average price of 2002)
Malaysia	2.52	4.88	1$=3.8 Ringgit (Fixed exchange rate)
Indonesia	2.43	16.80	1$=9316shield (Average price of 2002)
South Korea	886	1995	1$=1275.90KRM (Nov.4, 2002)

Philippines	26.35	46.30	1$＝55.9 peso	(Nov. 27, 2003)

Data source：Partly from Qin Xiao, On Asian financial crisis and its recovery after crisis from the aspect of structure and system, *Journal of World Economy*, vol.3, 2000,and partly from http://www.iapscass.cn.

III. Financial Reforms in Eastern Asian Nations

Paul Krugman considered the implying (hidden) government guarantee enjoyed by the banks of the Eastern Asian countries as the root of the financial crisis. "The root of southeast Asian financial crisis is the ill banking systems rather than the disorder of exchange rate", once pointed out by Paul Krugman.

Jerry Caprio, Director of Strategy and Policy Bureau of Financial Department of the Word Bank , had also suggested, "If the finance is fragile, the banking industry would be the weakest link ……The developing countries are to face the financial fragility induced (caused) by many factors." Although the Eastern Asian countries dealt with the 1997 crisis in many different ways, they shared many common policy measures to deal with the crisis such as financial institution restructure. One important measure is to close the financial institutions that had been unable to pay their debts.

(i). the Banking Reform and the "Bad Assets" issue

Korea had closed or sold the banks which had severe problems in order to dissolve the instability of Korean financial institutions and to restore its intermediary functions. For example, Korea First Bank was allowed to be sold to Newbridge Capital Consortium of America; further, another 487 financial institutions had been closed by September 2000.

At the same time, the Korean government continued to invest public funds into the pool of banking department. Until the end of 1999, the government had expended 64 trillion KRW, with 20.5 trillion used as abundant banking funds, 21 trillion used to disburse the deposit, 20.5 trillion used to handle the nonperforming assets and the other 2 trillion used in some other ways. In Thailand, the government had closed 56 financial corporations running bad and carried out many measures such as government takeover and foreign M&A to save the banks. The central bank had provided guarantee for its native banks to issue bonds, which was till alive and in operation, and had established the central asset management institutions. They also entrusted two asset management corporations to deal with the dead account of the state-banks and private banks respectively.

Similar methods were taken even in Japan even it was affected by the crisis on a mild scale. In September 1998, Japan established a fiscal supporting policy scheme of 60 trillion Japanese Yuan, of which 18 trillion was used to deal with the dead account of banks, 25 trillion was used as investment in banking systems, and 17 trillion was used to pay back the deposit as the last resort for the depositors. The government in Japan has invested more than 7,000 billons to the pool of banks since 1998. Until the end of August 2000, the free capital rate of 134 Japanese banks was 9.2 percent, which had risen by 0.7 percent than 1999, but the average rate in the 16 largest banks was 11.3 percent, decreasing by 0.6percent than last year, which was mainly because the inspection and delectation of the dead account was strengthened. Besides, the Japanese government launched a tremendous movement of bank nationalization and merged Japanese Long-term Credit Bank and Japanese Obligation Right Bank which were on the edge of bankruptcy.

As far as the effects of this policy measure are concerned, some positive results had been seen: firstly, the ratio of bad credit in those five countries (had become descending or stable; the earnings of banks had increased gradually, and the debt restructure of the asset management corporations had made some further progress, according to “Asian Economic Inspection” published by the Asian Development Bank in 2003.

However, we should also realize that there are still some urgent issues to deal with. First, the attempt to protect other banks by closing some non-performing banking institutions had not reached its goal. For example, the depositors withdrew their money from banks that they thought was insecure, and put them into the much bigger and securer ones or simply changed their savings from local currency into foreign currency deposit. In Indonesia, the government’s financial measures were lack of credit because the government didn’t provide sound guarantee to depositors. Second, the huge amount of bad debts owed by those non-performing companies and banks will be a big obstacle for the recovery in Asia. The bad account rates of the commercial banks in Indonesia, Korea, Malaysia and Thailand are as high as 55.2 percent, 19.2 percent, 16.6 percent and 25.1 percent respectively. And the dead account rate of banks takes on an up-trend in some special countries. For example, the dead account rate of the commercial banking system in Philippines rose from 15 percent in end of 2000 to 18 percent in August 2003. For the obstacle of politics, law and technology, the Asian banking reform makes little progress ,the credit culture does not obviously get better, the bad loan rate is still quite high, the problem of credit deflation still exists, and the fragile banking system is still the hidden troubles for the recovery and further development of the Asian economy.

(ii). Liberalization of Capital Markets

In 1998, the Korean government opened the long-term bonds market, and allowed foreign banks and security institutions to establish their branches in Korea, Further, it had sold the non-performing credit institutions to foreign companies. In Thailand the big depreciation of its currency paralyzed the Thai economy. A lot of banks and financial corporations went bankruptcy, and even many large consortiums and company got trapped in debt were compelled to close.

The Thai government had to take some fierce reform measures to comply with the terms of loan in order to secure a 1,702 billon dollars loan, which was lead by the World Bank, to deal with its financial crisis. At the same time, a series of more favorable policies to attract foreign investors were issued. In Indonesia, the IMF had transmitted the last 505 million dollars of the comprehensive aiding plan amounting to 5.3 billon dollars to the Indonesian government on the 20th of December, which had symbolized that the IMF completed the supply of all the aiding account to Indonesian government after the 1997 crisis. By that time, Indonesia had entered the era of "post IMF aiding and inspecting ages". In Philippines, the government thought that it was "just influenced by the crisis" or "the victim of the crisis-transmitting system" and it didn't need to launch a fierce reform. But for its own interest, it still relaxed the restriction to foreign investment and adopted many flexible monetary politics and some other important protecting measures in order to increase the channels of raising money and prevent the Asian crisis from deepening and bringing more loss to Philippines.

(iii). Financial Supervision

One of the lessons people had learnt from the 1997 financial crisis is that attention must be paid to the law framework, supervising ability and the market rules will make the financial supervisory institutions of the host countries disable to inspect the foreign banks; The disordered capital movements between them and foreign countries will place their financial systems in a state of high risk, while a lot of bankruptcy was the concentrating manifest. Because the bad account rate was relatively high, even the banks whose economy didn' t worsen had to use their limited profits to cope with all the events going along with the financial instability, such as squeeze, breach of contract, large scope of bad account and so on. After the crisis the Eastern Asian countries improved their financial control and supervision framework one after another in order to lay a firm base for the financial system to run sound in the future. Otherwise, if it's only limited to solve the accumulating problems of the capital structure of banks and ignored the system defect causing these problems, the success would be just temporary.

In the light of this view, soon after the problem of deposit flight was somewhat under control, the countries in East Asia had started to strength the supervision of loan-inspecting, sufficient capital rate and the exposure of foreign exchange risk, and they also tried to establish a supervisory criterion conforming to Basle Agreement. At the same time, they also took measures to improve the accounting criterion in order to increase the quality of the information issued by the financial institutions. For example, Thailand improved the operating quality of the financial institutions and amended some laws and rules to make them close to the international standard. Implemented much stricter standard of bad account reserve fund and limited the highest loan rate of the commercial banks. Korea increased the efficiency of financial supervisory policy and the transparency of financial information, adjusted the capital structure of all the financial institutions, including banks, securities, insurance, comprehensive financial corporations and so on, opened its financial market and strived to make it internationalized.

IV. The Future of Financial Development in East Asia

In the era of economic globalization, it has been the commonsense that financial cooperation and financial openness be the direction of financial development in the world in (for) the future. However, the 1997 financial crisis teaches us a good lesson to reexamine the depth and range of the financial cooperation and openness.

(i). Financial Cooperation

The 1997 financial crisis has caused significant damages to the economy and politics in the Eastern Asian countries, and they indicate that these countries had failed to coordinate their economic policy and resist the crisis through joint efforts. It is thus realized that there is an importance and urgency for regional economic cooperation and integration in East Asia. This financial crisis was unique in the world because of its large scope, great disaster, fast translation, and ferocious violent oncoming force. In other words, a single country or area could never resist it by itself and have no choice but to endure the bitter damages. The only method to resist the financial crisis is to reinforce the regional economic and financial cooperation and make full use of the entire financial strength. Thus, the intention and idea of financial cooperation of the Eastern Asian countries even the whole Asia comes to being.

In April 1999, the 10 nations of ASEAN together with China, Japan and South Korea had issued a “Joint Declaration of Eastern Asian Cooperation”, and had agreed to strengthen the dialogue, cooperation and coordination of fiscal and monetary policy.

In May 2000, the finance department ministries of 13 countries reached an agreement in the annual meeting of Asian Development Bank. They promised to aid each other in case of another round of financial crisis. According to this agreement, these countries agreed to strengthen the data and information exchange about capital movements, establish an aid network in this region and strengthen the current cooperating framework of every country's currency bureau. In August 2000, the central banks of these 13 countries enlarged the scope of currency exchange from 200 million dollars to 1,000 million dollars.

Despite the above good signs of financial cooperation among the Eastern Asian countries, the future of financial cooperation in this region is still far way to go, in particular, the process of monetary integration will be winding and endless. There are mainly two reasons. Firstly, economic development in this region is unbalanced. According to the optimum currency area theory and the practice of monetary integration in European Unions, the similarities of the level of economy, economic style and structure, political and social mechanism, economic mechanism and policy, history and culture are the basic prerequisites for the monetary integration.

However, there exist huge divergences among the economy of different countries. Take the GNP per capital for example, Japan is on the first level, the Asian four dragons are on the second level, China and the Asian four tigers are on the third and the others are on the fourth level, between which the differences are tremendous (Yu Yongding, etal., 2002). According to World Bank, the GDP per capital of Japan is 124 times larger than that of the most undeveloped country --- Cambodia in this region and that of Singapore is 116 times larger than that of Cambodia as well. But in comparison, the divergence between the most developed and most undeveloped countries in Europe, England and Uzbekistan, is only 20 times and that between America and Mexico is below 8 times (Li Fuyou, 2003). Unbalanced economy determines that the financial cooperation of the Eastern Asian countries is still at the stage of theory researching and dialogue consulting. The actual cooperating hasn't been carried out but nonsystematic cooperation is at the leading status. Secondly, shortage of impetus for financial cooperation. In the current Eastern Asian financial cooperation, insurmountable contradictions still exist between the large countries, which want to monopolize their economic advantage, and the small countries, which strive for equal opportunities for economic development (Li Fuyou, 2003). Motivated by 'opportunism ', large countries wouldn't like to take actions firstly, while small ones have the intention of free-ride for the problems in their economy. Therefore, the Eastern Asian financial cooperation is lack of long-term cooperating goals and cooperating procedures in every stage. What every Eastern Asian country must be confronted to be how to establish feasible strategic goal and magnificent guideline assisted with detailed measures in every stage. Therefore, a bright beginning of financial cooperation sprung out and will be undertaken in all Eastern Asian countries, but there’s still a long way to go to develop the depth and range of financial cooperation.

(ii). Financial openness

Before the Asian financial crisis occurred, the financial openness optimism had dominated the on-going view, and they reckoned that a more opened capital account will guarantee a high economic growth; it is prevailed in the western academia to judge the economic condition of developing countries by the openness of the capital account.

However, this thought was broken out by the crisis and its consequence. It’s because that the influence of the crisis to the Eastern Asian countries was relative with the level of their economy and financial openness. Singapore and Hong Kong, whose economy and financial openness are both at a high level, kept their currency relatively stable; the countries, whose economy and financial openness are both at a low level, such as China and India, successfully resisted the financial crisis. The financial crisis often takes place in the countries whose economy is relatively laggard while the level of their financial openness is relatively high, namely the above five countries most harmed by the crisis (Zhou Yu, 2002). Therefore, it’s quite necessary to open the financial industry, but the real problem is how to open, how fast the openness is, what policies could reduce the transition cost and hidden risk, and what kind of proceeds to the economic development could be brought out by different levels of openness.

“We must measure the income and cost from financial openness to solve the problem of the financial openness degree”, pointed out by Zhang Jikang and Yin Wei(2001). Generally speaking, the proceeds of openness includes: (1) International financing channels, especial the commercial financing channels, will become smooth, so it’s easy to obtain international capital. (2) Urge the domestic financial service to improve efficiency through embittering competition of international financial service. (3) Help the government to increase the efficiency of financial inspection and the perfection of the framework of law and policy. The cost of the openness includes: (1) the risk cost and the loss of profits, that is, the various risk faced by the domestic financial institutions and financial system for the imperfection of the financial system in the host countries. (2) Discriminative supervisory cost, that is, the distinction of supervision, which not only makes the super national treatment enjoyed by the foreign banks a shelter to escape from inspection, but also causes them to pay less than local banks to deal with the financial inspection. (3) Macroeconomic cost, that’ s to say, it will increase the hardship for monetary policy to operate and the financial security of the host countries will be affected, and so on.

In terms of the above analysis, although in view of the measures and background of the whole financial reform, most countries will incline to constructing the framework of financial openness for their economic recovery, this is only a kind of long-term goals rather than short-term measures for quick recovery and reconstruction after the crisis. The 1997 crisis reveals that the institutional framework of financial system would not be get done at one time and that the internalization of financial systems and financial openness must be well coordinated. The adjustment of the Eastern Asian financial mechanisms and financial governments after the crisis should be regarded as a modification to the disharmony between finance deepening and the internalization of financial systems. As for the Eastern Asian countries, they must realize that profits are accompanied by risks. Fast financial openness may bring out fast economic growth but the risk of too much exposure of their native financial system may also cause them to undergo the cost of mechanism and policy adjustments sooner or later; while relatively slower financial openness may cause them to lose some good opportunities for a faster growth of their native economy, but their financial systems might endure a much more lighter burden of risks. Thus, when trying to open their financial systems more quickly, the Eastern Asian countries must correctly grasp the ability of the government to regulate markets and the adaptability of private sectors to participate in financial markets, and take prudent measures in light of certain situations.

V. Conclusion

This paper has examined the financial development in East Asia after the 1997 financial crisis. It has also discussed the lessons and implications learnt from the crisis, and have pointed out the future directions for Asian financial development.

We argue that financial openness and cooperation in Asian countries are important to maintain the current recovery in East Asia and to avoid possible financial crisis in the future. That is, the only method to resist the financial crisis is to reinforce the regional economic and financial cooperation and make full use of the entire financial strength. At the same time, the adjustment of the Eastern Asian financial mechanisms and financial governments should be regarded as a modification to the disharmony between finance deepening and the internalization of financial systems in the course of financial openness.

Bibliography:

[1] Yu Yongding, He Fan and Li Jing, 2002. “Asian financial cooperation: background, recent development and prospective”, *Journal of International Finance Study*, Vol.2.

[2] Zhou Yu, 2002. “Asian financial crisis and financial openness”, 2002. *Journal of World Economy Study*, Vol.2.

[3] Zhang Jikang and Yin Wei, 2001.“Openness and regulation of Asian finance: realities, benefits and losses”, *Journal of World Economy*, Vol.4.

[4] Qin Zhen,2001. “APEC and cure of Asian finance”, *Banker*, Vol.11.

[5] Qin Xiao, 2000. “On Asian financial crisis and its recovery after crisis from the aspect of structure and system”, *Journal of World Economy*, Vol.3.

[6] Shen Hongfang,2001. “Asian financial crisis: activator for transformation of Eastern Asian Style”, *Journal of World Economy*, Vol.10.