The Asian Meltdown

ALTHOUGH 1997'S ASIAN financial market explosions received much press coverage, a full explanation has not—and with good reason. The economic literature involves long-standing and ongoing debates about what really determines sudden movements in asset prices: fundamentals or unexplainable "animal spirits."

This article outlines the trajectory of capital market turmoil as it moved from Thailand in July to Indonesia, Malaysia, the Philippines and Hong Kong by October and then to Korea in November. As the contradictory elements of the current literature on asset prices suggest, there is plenty to wonder about. Regardless of what triggered this turmoil, one artifact it uncovered was the insufficiency of Asian financial systems to maintain corporate governance.

Despite their own high savings rates, many Asian countries received large inflows of foreign capital during the present decade. According to some analysts, low rates of return in Japan and, to some extent, Europe motivated capital to seek higher returns elsewhere.

Chart 1 depicts the rapidly rising loan-to-GDP ratios of four Asian countries. The ratios are consistent with a story one often hears about high levels of lending: too much money chasing too few good investments—or too many bad ones. Large surges in lending do seem to reduce bankers' vigilance over asset quality. In Asia, some of the investment booms began to be followed by asset quality busts.

When suspicions of a banking crisis materialize, who knows if there is really a commitment to resolve the problems quickly, and, if there is, how they will be resolved. Will the government inflate its way out of the difficulties? Will there be fiscal problems? Questions like these can make foreign investors nervous. In late 1996 they started to pull their funds from Thailand, the site of Asia's first 1997 financial crisis.

As foreigners took their money out of Thailand, they exchanged their Thai currency (baht) for dollars or other non-Thai currency, thereby lowering the demand for baht and putting downward pressure on the Thai exchange rate. To hold the exchange rate within the band established for it, the Thai central bank began to spend its foreign currency reserves to purchase baht, which created a demand that no longer existed in the private sector. To encourage foreign capital to stay, the Thais also raised interest rates. In July, seeing the ineffectiveness of their efforts, the Thais let the baht devalue.

Financial difficulties in Thailand may have sensitized investors to other developing Asian markets and to the likelihood of other Asian devaluations. Worries about mounting problem loans, rising excess capacity and slow demand, as well as concerns that these problems would continue may have been what motivated investors to move their money out of Indonesia, Malaysia and the Philippines. However, the issues of problem loans and excess capacity appear not to have been consistent across countries where capital outflows occurred. The Philippines suffered much exchange rate pressure, but with what appeared to be less structural foundation than Indonesia, for example. The results of the outflows, however, were major devaluations for all three countries from July—when Thailand devalued—through October (*Chart 2*).

By October the round of financial problems and devaluations across south Asia made some investors worry that Hong Kong, one of the region's important bankers, might be ripe for the same. Hong Kong real estate prices had risen markedly over the past year amidst one more of the various Asian construction euphorias. Meanwhile, market concerns were said to be accumulating that the takeover by the People's Republic of China might ultimately abridge the covenants that had made Hong Kong so financially attractive. Some investors believed that Hong Kong might also suffer because its markets are highly integrated with those of other Southeast Asian countries.

Because Hong Kong's huge foreign currency reserves allowed a strong defense of its dollar, the speculative currency attacks were ultimately ineffective. But perhaps another reason for their ineffectiveness was less evidence of loan quality problems in Hong Kong than in such markets as Thailand and Indonesia. Nevertheless, the quality of Hong Kong's assets proved insufficient to prevent a serious run on Hong Kong's securities market.

In November, the market began to

Chart 1
Loan-to-GDP Ratios

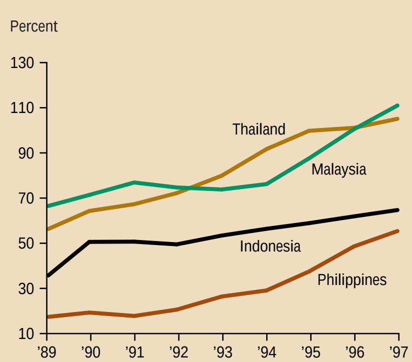
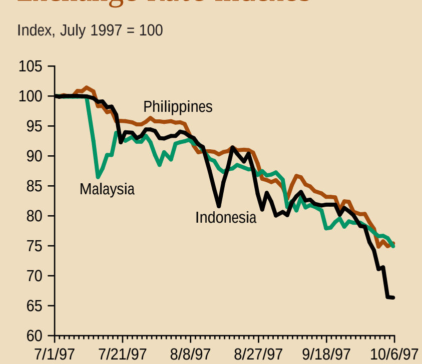


Chart 2
Exchange Rate Indexes



notice Korea. Close and incautious relations between the nation's large corporations, banks and the government had resulted in lending for projects whose principal contribution to Korea was industrial overcapacity. Government-authorized bank liberalizations had greatly eased access to foreign capital but had not beefed up bank supervision to avoid injudicious lending. The ongoing weakness in Japan, softness among the rest of Korea's Asian customers, Korean difficulties in identifying the extent of short-term outstanding debt and a reluctance to resolve banking problems initially contributed to much market uncertainty, runs on currency and the securities markets, and deep devaluation.

What's Behind the Turmoil?

Although it is difficult to know why all of the Asian financial markets went into turmoil exactly when they did, some possible reasons for their respective plunges have emerged.

Financial Inflexibility and State Paternalism. Asian countries tend to follow the Japanese model in which banks, large corporations and governments operate in the same close relationship year after year. The discipline of hostile takeovers, shareholder revolts and bond vigilantes plays a far smaller role in this environment, even though the Asian countries do have securities markets. New ideas and technology can certainly make it through this "old boy" network, but the flexibility that allows the sudden rise and efficiencies of a Dell or a Microsoft, or the equally sudden decline of a Commodore or Wang, is much rarer in a region where government decides what and who will grow.

Trade and Technology Advances. The enormous increase in the importance of trade in most countries has meant much greater competition and, therefore, far more pressure for the technology advances and cost improvements we often get from those same little companies that rise so suddenly. Since the corporate governance imposed by active stock and bond markets turns out to be particularly useful in high-tech industries, these competitive pressures may explain why an Asian-style bank-centered financial system that was very serviceable is now less so.

Financial Liberalization and Weak Supervision. In the 1990s, Asian countries began to allow banks and other lenders much greater access to foreign capital and to loosen the restrictions that had made it hard for banks to attract deposits or to lend profitably. These changes occurred in a world in which financial markets were becoming much more globalized anyway. The results were large increases in bank deposits and other liabilities, as well as a rush of lending, but not enough financial supervision and regulation to keep up with it. Similarly, a lack of transparency in the equities markets meant that when those markets got jittery, they got very jittery indeed.

Pegged and Problematic Exchange Rates. Asian countries typically pegged their exchange rates. That is, they intervened in the markets for their currency so as to maintain exchange rates within certain bounds. The result has been that when pressure builds on an exchange rate and a country finally stops defending it, the consequent exchange rate plunge creates much uncertainty about its future trajectory. It is not unusual for an exchange rate, once it becomes shaky, to remain shaky for a while. While this pattern reflects uncertainty, it also contributes to it.

Conclusion

There is in fact much that is known about the Asian financial meltdown, up to a point. Indeed, financial problems in the Asian countries were heavily covered in the financial press well before the turmoil began in July 1997. Nevertheless, much remains to be explained. We don't know fully why Hong Kong suffered such market turmoil. Why did the Philippines, lacking the banking problems and nontradable asset price bubbles of Indonesia and Thailand, suffer an exchange rate attack at about the same time as those countries? Furthermore, the standard explanations do not shed much light on timing. They tell us little, for example, about why Korea's financial turmoil occurred so much later than Thailand's.

Despite what actually sent Asia's 1997 financial tumult in the peculiar sequence that it followed, it's now clear that an essential problem in these countries was inadequate corporate governance—the discipline financial markets are supposed to impose on the issuers of debt or equity when markets are efficient. In the Asian situation, neither financial supervision and regulation nor covenants established by the private sector were effective in governing what businesses did with what they borrowed or in preventing certain businesses from receiving funding for shaky projects. It is for this reason that increased transparency of financial behavior and of financial instruments is among the conditions of the bailout lending programs for these countries, where the results of nontransparency now seem so clear.

—William C. Gruben

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