

# **The Asian Financial Crisis and the Lessons for Globalization**

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## **I. Introduction**

The Asian financial crisis is neither the first nor last of its kind; in the past decade alone, the world has already seen several financial or currency crises. In 1992, a currency crisis occurred that almost collapsed the European Exchange Rate Mechanism. Mexico was severely hit by a currency and financial crisis in 1994, which soon afterwards made trouble for Argentina and Brazil. The financial crisis which hit many of Asia's miracle economies was sudden, triggered by an unexpected currency crisis in Thailand. Russia and Brazil are the current victims of its spillover effect, and its lingering effects are still felt in Asia today.

Although the Asian financial crisis is only one of many recent crises, it was particularly shocking because it happened at a time when most nations in this region were doing well. Growth rates were high, inflation was low, and government deficits were minimal. Just prior to the crisis, at the peak of euphoria around the early 1990s, many in the region were talking about the arrival of the Pacific Century. Though some signals were ominous, including bubbles in real estate markets and rising trade deficits, these signs were generally dismissed as either unimportant or manageable. All nations have

ups and downs, and these miracle economies were apparently invincible, judging from their amazing past performance. Few predicted that a currency crisis could trigger a regional financial crisis, which then escalated into both an economic crisis and a political crisis.

One explanation of the Asian crisis is that it was fundamentally demand-driven, based on a bubble of optimistic projections. Rapid growth led to capital inflows from foreign investors who wished to profit from future growth, increased borrowing by domestic firms who believed their investments would continue to be profitable, and rising imports for domestic consumers who believed their rapid income growth would continue indefinitely. The mere slowing of this growth in 1996 led to the sudden slowing of capital inflows in countries where central banks tried to maintain one-sided pegged exchange rates against their major trading partners. As a result, surpluses in the balance of payments suddenly turned to deficits, and though central banks tried to create the illusion of stability, speculators quickly figured out that they were running out of foreign currency reserves, forcing catastrophic devaluations that burst the bubble. Afterwards, repayment problems, capital flight, and higher import costs pushed many firms towards insolvency and forced banks to tighten credit.

An alternative explanation is based on the inefficiency of the financial system in these countries. With high domestic savings rates and easy access to foreign capital, there was little incentive to invest wisely. Banks lent because of firm connections or government pressure, not on the basis of a prudent examination of project payoff. Growth was extensive, not intensive, and thus was not sustainable. Like all pyramid schemes, it ultimately collapsed, taking many naïve foreign investors with it.

Various hypotheses have been proposed to rationalize this financial crisis. Some of more attractive hypotheses include moral hazard problems, the inherent instability of capital markets as a result of herd behavior, multiple equilibria in the foreign exchange market, failure of Asian values or the Asian model, et cetera. All these hypotheses have some truth, but none of them alone can fully explain the specific timing of the crisis, its geographical concentration, its severity, and the specific form of expression it took.

For example, the moral hazard hypothesis cannot explain the particular timing of the Asian financial crisis and its geographical concentration. Moral hazard is a universal problem. It is not clear why suddenly it chose East and Southeast Asia and the year 1997 as its target unless we assume that moral hazard suddenly became particularly rampant in this place, at this time. The hypothesis of the inherent instability in capital markets also has trouble in explaining the collapse of South Korea. If some of the Southeast Asian nations are small enough to be victims of herd behavior, it is hard to understand why South Korea, as the 11<sup>th</sup> largest economy in the world, was so fragile that it fell to the attack of international speculators. The hypothesis of multiple equilibria in the foreign exchange market also cannot explain the particular timing and geographical concentration of the crisis, while citing the failure of the Asian model or of Asian values can only explain the geographical concentration of the crisis, but not its timing. Ironically, in the decades when these nations were outstanding performers, many used the same hypotheses to rationalize why they were so successful in maintain high growth rates for such a long period of time; thus, it is neither clear nor convincing why suddenly the same model or set of values became the culprit.

What we need to explain, then, is what happened that made the Asian model, once so effective in accelerating the growth rate in this region for so long, more of a liability than an asset in the changing context. In what follows, we will discuss the role of the current round of globalization in triggering the Asian financial crisis. Section II discusses the main characteristics of globalization. Section III discusses why the globalization could be a trigger of the Asian financial crisis. Section IV concludes this article by drawing some lessons from the Asian financial crisis for better understanding the globalization.

## **II. Friction between Productive and Financial Globalization**

One of the most outstanding characteristics of modern market economy is its ever-deepening division of labor. China's market-oriented economic reform since the early 1980s and the unexpected collapse of the former Soviet bloc have provided a golden opportunity for market economic institutions to expand into almost every nation in the world. The world is no longer divided along lines of ideology and fundamentally different economic institutions. Globalization, a process that has been interrupted many times in the past, suddenly resumed its full momentum. In addition to the dramatic changes in the world's political landscape, this new cycle of globalization has received strong impetus from the sweeping advances in communication and computer technology. While economic globalization is clearly the triumph of market institutions and the principle of free trade over those of the central planning system and autarky, it faces its own problems, including the friction between financial globalization and productive globalization.

Financial globalization is reflected in the fact that more and more nations are liberalizing their financial system by allowing capital account convertibility and deregulating capital market and banking system since the late 1980s. Now significant funds flow freely overnight between major world financial centers as a result of global computerization. There has also been a conspicuous acceleration in long term capital flows into developing nations. Table 1 shows that in 1997, capital flows into developing nations were more than three times that of 1990. Although official financing has declined during this period, it is more than offset by the sharp increase in total private financing. Total private flows in 1997 were more than six times that of 1990. Of the private financing during the period, portfolio equity increases much faster (more than 10 times) than foreign direct investment (more than 5 times). This development implies that the international financial system has been increasingly more market-oriented, and more motivated by profit seeking and dividends seeking.

Productive globalization is reflected in the accelerated widening and deepening of the division of labor among nations and the rapid expansion of world trade. Nations increasingly realize the benefit of productive globalization, which enables even small nations to reap economies of scale if they abandon self-sufficiency and accept the role of producing only the goods in which they have a comparative advantage. The fact that the world trade has been growing at a much faster rate than world GDP shows that more nations realize that specialization and trade is the path leading to higher living standards. In the 1990s, the trade elasticity, defined as percentage growth in trade in response to one percentage of output growth, was much higher than in the 1970s or in the 1980s (see Table 2).

However, the ever-deepening and widening specialization implies that society faces the task of better coordinating global production through the world market system and the international financial framework. Specialization and division of labor can be supported only by comparative advantages in skills, technology and factor endowments. However, as a result of changing factor prices and the constant addition of new trading partners, comparative advantages are shifting constantly across nations. Accordingly, the pattern of division of labor has had to change across nations relatively quickly. Unfortunately, a conspicuous asymmetry is that the productive globalization is lagging far behind the financial globalization. Billions of dollars can now flow overnight out of the developed nations in pursuit of low-cost labor and land in developing nations. However, dying industries can linger around for decades without being final swept away because of industrial policy, protectionism and national pride (see Figure 1).

The friction caused by the rapidly-proceeding financial globalization and the lagging productive globalization will not go away for the following reasons.:

1. Financial globalization makes it relatively easy to add new production capacity anywhere in the world, but due to high adjustment costs it is slow and difficult to get rid of old production capacity that should be phased out after it lost its comparative advantage;
2. In those economies where the government or government-owned banks have the final say in picking winners and losers, it sometimes takes decades to phase out production capacity, even though many of these investments were never financially viable;

3. In economies where some production capacity has been financed primarily by foreign savings, a sudden loss of confidence among foreign investors or lenders may prematurely destroy production capacity even if its long-term prospects were positive;
4. As more and more nations become convinced that an export-promotion strategy is more effective in raising growth rates, more nations will join in expanding their trade. As competition escalates among nations, the shift of comparative advantages among nations will accelerate, making it harder to predict whether a new project is sustainable in the future, or an existing plant will still be viable in a few years to come;
4. Less than a decade after the end of the cold war, there still exists an outdated division of labor among nations. This is a serious challenge not only to domestic governments but also to the rest of the world, as the relocation of industries and workers must take place to yield room for a new, globally-viable division of labor. This is particularly problematic in places such as the former Soviet Union, China, India, and other third world nations that once followed policies of self-sufficiency;
5. As globalization deepens and widens, local decisions often have global consequences. Because of imperfect and costly information, however, those who make decisions are increasingly not those who will ultimately bear the consequences;
6. Advances in transportation, communication, especially in information are becoming ever-penetrating, making many indigenous institutions increasingly less stable, and people everywhere more susceptible to external influence and international norms. Many developing nations is now facing the formidable choice between first building

sophisticated political institutions in an relatively backward economic environment or facing social disorder and institutional collapse.

### **III. Globalization as a Triggering Factor of the Asian Financial Crisis**

From the discussion above we can see that as a result of accelerated globalization and worldwide integration, competition for export markets has become much fiercer since the 1990s. We expect to see large scale of adjustment as relocation of industries and workers become necessary for the emergence of new pattern of worldwide division of labor. The rapidly globalizing international finance system is conducive for this purpose. However, to phase out some existing industries that have lost comparative advantages remains to be a serious challenge to all nations. If a nation's domestic financial system is more market-oriented and more sensitive to external changes, it will facilitate the channeling of funds, both of international source and domestic source, into more promising industries from dying ones. The booming economy that we are now witnessing in the U. S. is not accidental. Its sound financial system helped its economy undertake a painful but successful sectoral restructuring in 1980s. If a nation's financial system is less market-oriented, or if the government acts out of national pride or of concerns for social repercussions, it may respond to the external pressure in a wrong way by instead trying to rescue those industries that should be phased out. In sharp contrast to the U. S., Japan in 1990s has exactly done the opposite to what the U. S. did in the 1980s by postponing a necessary restructuring in its financial system and corporate governance.

Japan's financial system has a history of being more or less controlled by the government, and Japanese firms are more reliant on bank loans than equity capital. The

government has used its leverage over the banking system to implement its industrial policies and promote exports. The success of this system worked when Japan was catching up to other nations and had a more or less well-defined target to imitate. The Japanese model greatly inspired other Pacific Asian nations, and many of their financial systems were designed along similar lines. This model worked well for these nations in the 1970s and 1980s, when most nations were still following an import-substitution strategy and thus not competing with the Pacific nations in export markets. Meanwhile, many developed nations were not yet demanding reciprocal opening of Asian markets to competition, but were willing to unilaterally open their markets for products from these nations, in order to further political and strategic goals during the cold war.

However, the collapse of former Soviet Union and the East Block in the late 1980s and early 1990s abruptly changed the situation, and suddenly accelerated a new round of globalization. The main concerns among developed nations shifted to securing a more reciprocal treatment in trade and investment. Since the early 1990s, they vigorously encouraged the liberalization of trade, the deregulation of financial systems, and capital account convertibility.

There is nothing wrong in identifying these as main targets of trade and financial reform. But it is more debatable about in what sequence they should be carried out. For example, before thoroughly cleaning up their financial system, most Pacific Asian nations rushed to open their capital accounts. Now many believe that the capital convertibility should among the last to implement in financial reforms (Stiglitz 1998, Krugman 1999).

The fundamental cause of Asian financial crisis lies in the deficiency of their financial institutions and corporate governance, as Miller pointed out (1995). Having followed an export-promotion strategy for decades, many Pacific nations suddenly became more exposed to an increasingly competitive global environment, and have been forced by events to become more sensitive and responsive to external changes. These external changes include changes in other nations' foreign exchange rates, changes in their competitiveness relative to that of other nations in a particular product or a particular factor price, changes in other nation's policies on FDI, trade, capital markets, et cetera. As globalization goes wider and deeper, domestic events often have global implications, especially to nations with more openness. Thus, because the exposure of Vietnam, Laos and China is less than Thailand, these nations are less affected by the financial crisis.

This sudden accelerated globalization explains the timing of the Asian financial crisis. The institutional deficiency of the financial systems in the Pacific Asian nations is not new, but was never a dominant factor until the early 1990s. Before the 1990s, the merits of the Asian financial system seemed to far outweigh its demerits, as these nations performed so well during 1970s and 1980s. The institutional deficiency alone cannot fully explain why in mid-1997 the Asian financial crisis occurred, unless we turn to this sudden acceleration in globalization. This fundamentally changed the rules of the game for the Asian nations, creating two sources of pressure -- one from developed nations demanding more liberalization and reciprocity, the other from other developing nations joining the world competition for exports markets.

China is one of these newly-arrived heavyweight players in the global export competition. China suddenly exhibited an explosive export capacity after ten years of economic reform and decentralization, and it also devalued its currency in 1995, further improving its export edge over other nations. The other Pacific Asian nations were complacent in their success, however, and were slow to realize how dramatically their world was changing. Had their financial systems and corporate governance been flexible and sensitive enough, less controlled by governments but more responsive to changes in the world markets, then these nations might have swiftly escalated their export composition by restructuring their industries, and gradually adjusted their exchange rates in response to changes in their foreign currency reserves. But instead, they followed a dollar-pegging policy, and responded to external changes slowly in upgrading their exports. The worsening foreign reserves eventually alarmed the prospective foreign investors, and attracted speculators who realized that the situation was not sustainable.

#### **IV. Conclusion**

In this paper, we do not attempt to disprove any of the many hypotheses suggested for the Asian financial crisis, but instead argue that this crisis can best be understood as the result of a sudden acceleration in globalization and pressures for market liberalization that followed the end of the cold war. The Asian economies had a record of success that made it difficult for their governments to realize how fundamentally competition was changing the international division of labor. The success from the initial restructuring, however, created political incentives to protect established firms, institutions, and policies. Their economic success was due to international trade

and specialization in the first place, but as others followed their lead they found themselves pressured to make restructure further. Their failure to recognize this and respond quickly made the ultimate adjustment much more dramatic.

To some extent, the argument posited here is Schumpeterian in nature. The expansion of international trade and investment forces trading nations to rapidly change their division of labor and productive specialization. Governments are often loathe to allow existing industries to be dismantled, particularly those with past records of success. Efforts to protect them, however, put increasing amounts of bank capital at risk, slow the rate of economic growth, and may be doomed to ultimate (and catastrophic) failure unless countries are willing to withdraw from trade.

Thus, a nation which chooses to be open to the outside world, in order to take advantage of the growth engine that trade provides, will be increasingly forced to make its financial system and corporate governance compatible with a fully competitive world market. If countries instead follow no-failure policies, then they are trying to prevent creative destruction and will instead end up propping up inefficient firms or industries. Then when a strong wind blows, the whole house caves in because new structures were built on top of the deteriorating earlier construction.

**Table 1: Net Long-term Capital Flows to Developing Economies,<sup>(a,b)</sup> 1990-97**

(US \$billions)

| <b>Type of Flow</b>               | <b>1990</b> | <b>1992</b>  | <b>1994</b>  | <b>1996</b>  | <b>1997<sup>c</sup></b> |
|-----------------------------------|-------------|--------------|--------------|--------------|-------------------------|
| <b><u>Total Private Flows</u></b> | 41.9        | 90.1         | 160.6        | 246.9        | 256.0                   |
| Debts                             | 15.0        | 33.8         | 41.1         | 82.2         | 103.2                   |
| Commercial Bank Loans             | 3.8         | 13.1         | 8.9          | 34.2         | 41.1                    |
| Bonds                             | 0.1         | 8.3          | 27.5         | 45.7         | 53.8                    |
| FDI                               | 11.1        | 12.4         | 4.7          | 2.3          | 8.3                     |
| Portfolio Equity                  | 23.7        | 45.3         | 86.9         | 119.0        | 120.4                   |
| <b><u>Official Financing</u></b>  | 56.4        | 53.8         | 45.5         | 34.7         | 44.2                    |
| Grants                            | 29.2        | 30.5         | 32.7         | 29.2         | 25.2                    |
| Loans                             | 27.2        | 23.3         | 12.9         | 5.4          | 19.2                    |
| Bilateral                         | 11.6        | 11.1         | 2.5          | -7.2         | 1.8                     |
| Multilateral                      | 15.6        | 12.2         | 10.4         | 12.6         | 17.4                    |
| <b><u>Total Capital Flows</u></b> | <b>98.3</b> | <b>143.9</b> | <b>206.2</b> | <b>281.6</b> | <b>300.3</b>            |

Notes: a. Excludes short-term flows or asset transactions like changes in foreign deposits held by developing country residents

b. Developing countries defined as low- and middle-income economies with 1995 per capita incomes less than US\$765 and US\$9385 respectively

c. Preliminary

Source: World Bank (1998), Global Development Finance 1998: Analysis and Summary Tables, New York: Oxford University Press. (Taken from Rajan 1998)

**Table 2: World Trade and Output Growth, 1971-96**

|                    | (Annual Average in %) |                |                |                |
|--------------------|-----------------------|----------------|----------------|----------------|
|                    | <b>1971-85</b>        | <b>1986-90</b> | <b>1991-93</b> | <b>1994-96</b> |
| Trade Growth*      | 3.7                   | 6.1            | 4.1            | 8.7            |
| Output Growth      | 3.2                   | 3.3            | 1.1            | 2.9            |
| Trade Elasticity** | 1.2                   | 1.8            | 3.7            | 3.0            |

\*Refers to merchandise export plus imports

\*\*trade elasticity = trade growth/output growth

Source: S. Otsubo (1996), taken from R. S. Rajan (1998).

**Figure 1**

