

# The East Asian Financial Crisis 1997-1998

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# East Asia



8 countries involved :

Hong Kong  
Indonesia  
Korea (South)  
Malaysia  
Philippines  
Singapore  
Taiwan  
Thailand

# Outline

1. Before the crisis
  - 1.1 Before the crisis: Asia
  - 1.2 Before the crisis: East Asia
2. The crisis 1997-1998
3. Causes of the crisis
4. Conclusion
5. To go further

# 1. Before the crisis

# 1.1 Asia

1.1 Before the crisis:

# Strengths of the Asian economies

# 1.1 Before the crisis

- \* In the 1990s, before the financial crisis broke out in 1997, Asia was the fastest growing region in the world.
- \* Output growth took place in a stable macroeconomic environment: decreasing inflation and sound fiscal policies.
- \* High growth and macroeconomic stability contributed to attracting private foreign capital in Asia.
- \* Before the crisis, all the East Asian currencies were pegged to the US dollar (« soft » pegs) to provide macroeconomic stability. As most of these countries were debtor countries, their currencies appeared to be overvalued in the 1990s.

# 1.1 Before the crisis: annual average GDP growth (1989-1996)

|                                    | 1989-1996   |
|------------------------------------|-------------|
| <b>Developing Asia</b>             | <b>8.1%</b> |
| <b>ASEAN - 5</b>                   | <b>7.4%</b> |
| Emerging and developing economies  | 3.6%        |
| World                              | 2.9%        |
| Advanced economies                 | 2.5%        |
| Central and Eastern Europe         | 1.3%        |
| Commonwealth of Independent States | -8.2%       |
| Latin America and the Caribbean    | 3.1%        |
| Middle East and North Africa       | 4.6%        |
| Sub-Saharan Africa                 | 1.9%        |

Source: IMF

# 1.1 Before the crisis: disinflation

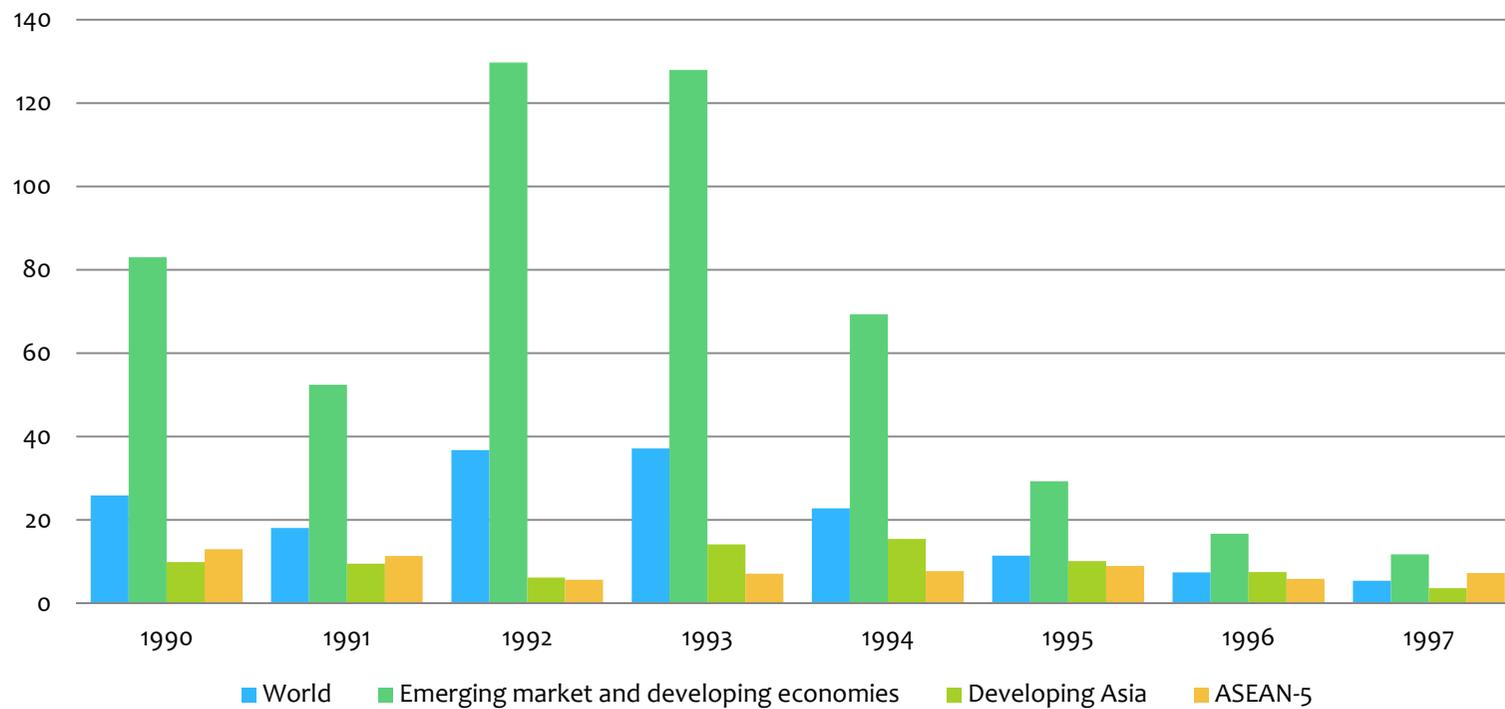
\* After high inflation in the 1970s and the debt crisis in the 1980s in developing countries, some countries in the 1990s, in particular in Asia, started to conduct a disinflation policy based on :

- 1) Sound fiscal policy to prevent indebtedness
- 2) And ruling out of monetization of public debt

This policy was successful particularly in Asia.

# 1.1 Before the crisis: inflation

Annual Inflation Rate in % (end of year)



Source: IMF

1.1 Before the crisis:

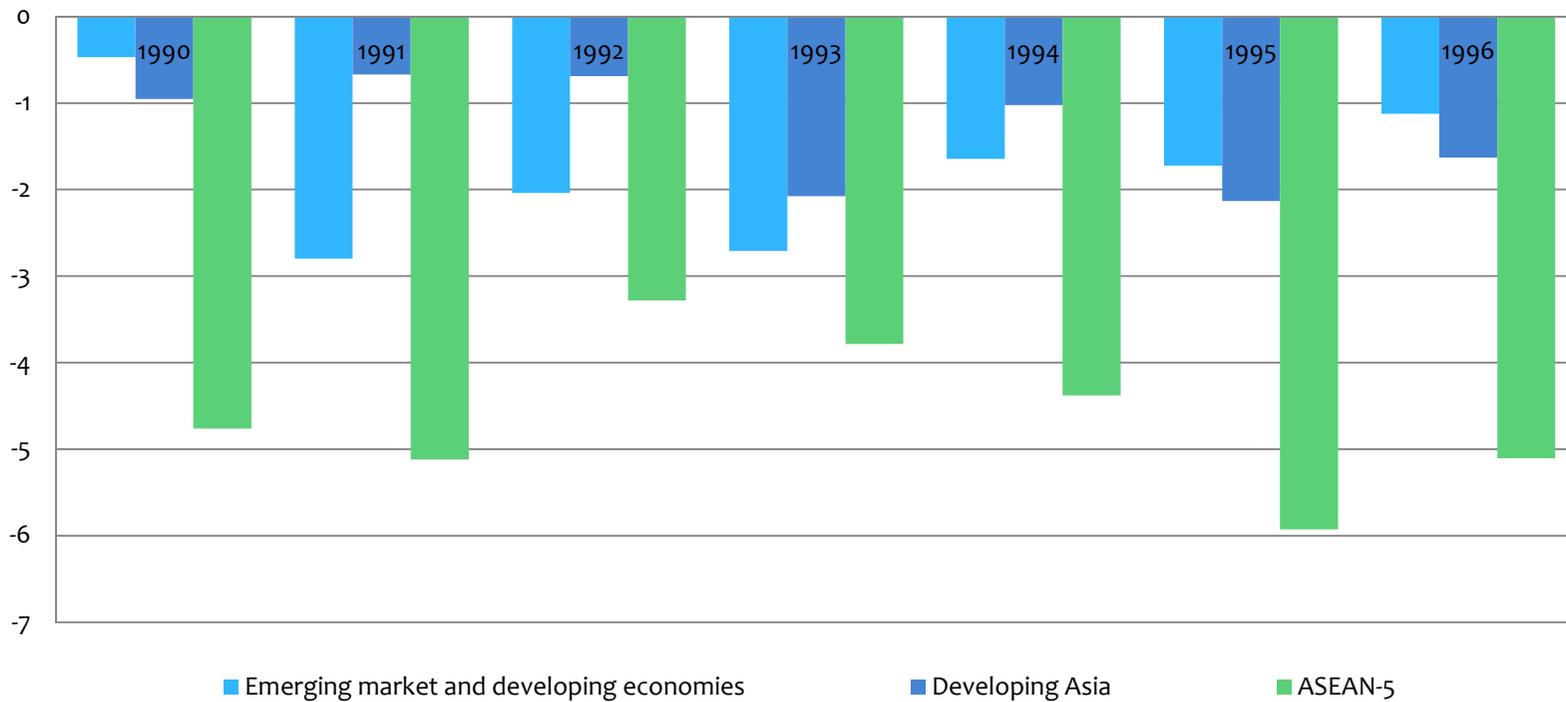
# Weaknesses of the Asian economies

# 1.1 Before the crisis: weaknesses

- \* Asian countries recorded current account deficits between 1990 and 1996 in line with the neoclassical theory: fast-growing countries tend to record faster dynamics of imports than exports.
- \* The corollary is the accumulation of external debt.
- \* The external debt became more of short-term maturity over time and increasingly held by private creditors. Consequence: higher volatility of foreign capital flows.

# 1.1 Before the crisis: current account deficits

Current Account Deficit as a % of GDP (1990-1996)



Source: IMF

# 1.1 Before the crisis: External debt

- \* The external debt to GDP ratio has remained stable in Asia between 1990 and 1997, around 30% of GDP.
- \* The share of Asia in the external debt of developing countries has increased a lot in line with the increase in its share in the GDP of developing countries.
- \* The share of short-term external debt has increased between 1990 and 1997.
- \* The Asian external debt was increasingly held by private creditors between 1990 and 1997.

# 1.1 Before the crisis: External debt to GDP ratio (%)

|                                  | 1990 | 1996 |
|----------------------------------|------|------|
| Developing countries             | 37.3 | 33.4 |
| Asia                             | 31.0 | 27.9 |
| Asia (excluding China and India) | 46.3 | 40.0 |
| Africa                           | 59.3 | 58.0 |
| Sub-Saharan                      | 61.6 | 56.2 |
| Middle East and Europe           | 29.1 | 30.0 |
| Western hemisphere               | 40.2 | 34.4 |

Source: IMF World Economic Outlook, October 1998

# 1.1 Before the crisis: short-term external debt

## Share of short-term instruments in total external debt (%)

|                        | 1990 | 1996 |
|------------------------|------|------|
| Developing countries   | 13.4 | 17.7 |
| Africa                 | 10.1 | 13.8 |
| Asia                   | 10.9 | 18.8 |
| Middle East and Europe | 23.3 | 22.9 |
| Western hemisphere     | 13.1 | 16.8 |

Source: IMF World Economic Outlook, October 1998

# 1.1 Before the crisis: external debt held by private creditors

## Share of creditors in total external debt (%)

|                         | Developing countries |      | Asia |      |
|-------------------------|----------------------|------|------|------|
|                         | 1990                 | 1996 | 1990 | 1996 |
| Official                | 48.0                 | 43.3 | 51.6 | 41.2 |
| Banks                   | 32.1                 | 26.4 | 29.9 | 32.1 |
| Other Private creditors | 19.9                 | 30.3 | 18.5 | 26.7 |

Source: IMF World Economic Outlook, October 1998

# 1.2 Before the crisis

## East Asia

## 1.2 Before the crisis: East Asia

- \* Excellent macroeconomic fundamentals: high growth, moderate inflation, low public debt, high and stable saving and investment rates.
- \* the Achille's heel of these countries:  
Large current account deficits associated with « soft » pegs to the US dollar and a banking sector too dependent of short-term foreign borrowing.

## 1.2 Before the crisis: East Asian countries

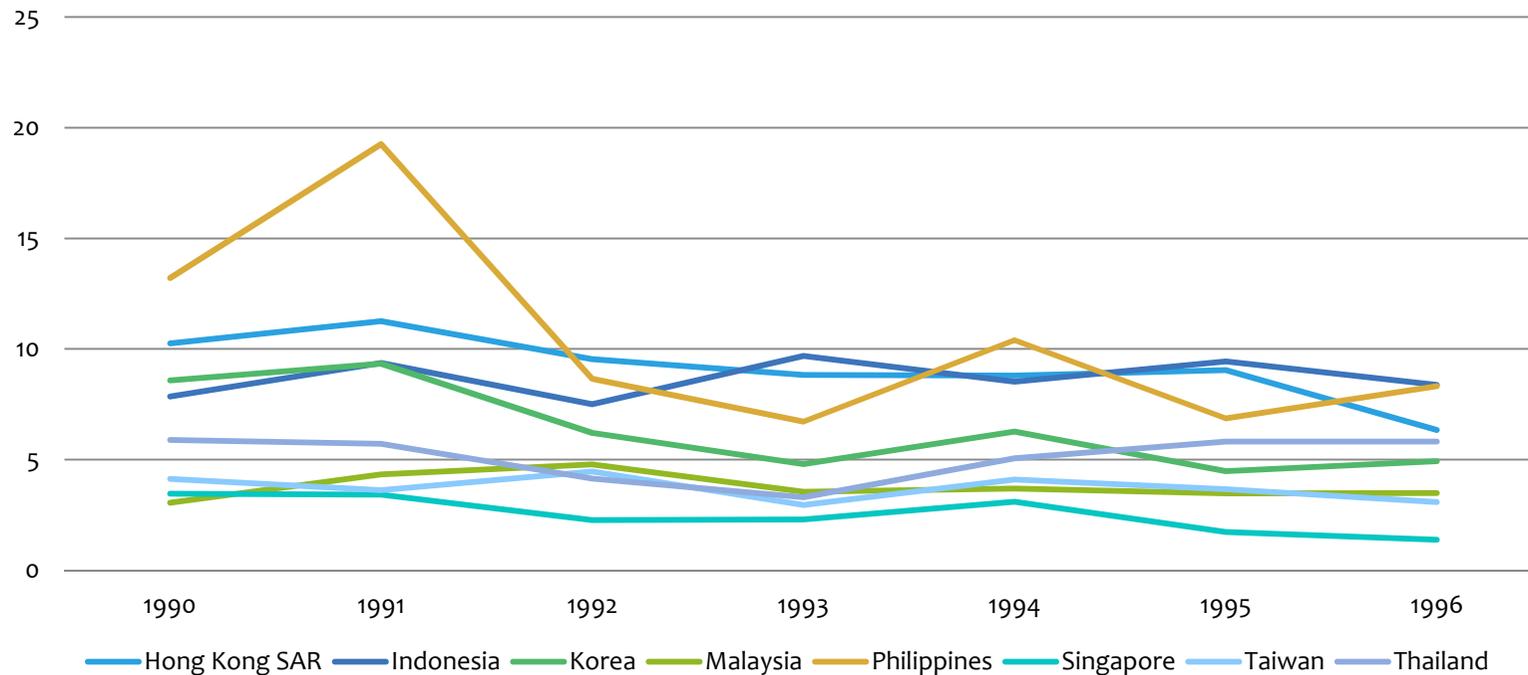
|             | Annual average growth rate in % (1989-1996) | Current account balance in 1996 (% of GDP) |
|-------------|---|--|
| Hong Kong   | 4.9   | -2.5                                       |
| Indonesia   | 7.5   | -3.2                                       |
| Malaysia    | 9.5   | -4.4                                       |
| Philippines | 2.8   | -4.2                                       |
| Singapore   | 8.7   | 14.8                                       |
| South Korea | 8.0   | -4.0                                       |
| Taiwan      | 6.9   | 3.8  |
| Thailand    | 8.6   | -7.9                                       |

Source: IMF

In red: creditor countries; in black: debtor countries.

# 1.2 Before the crisis: inflation in East Asian countries

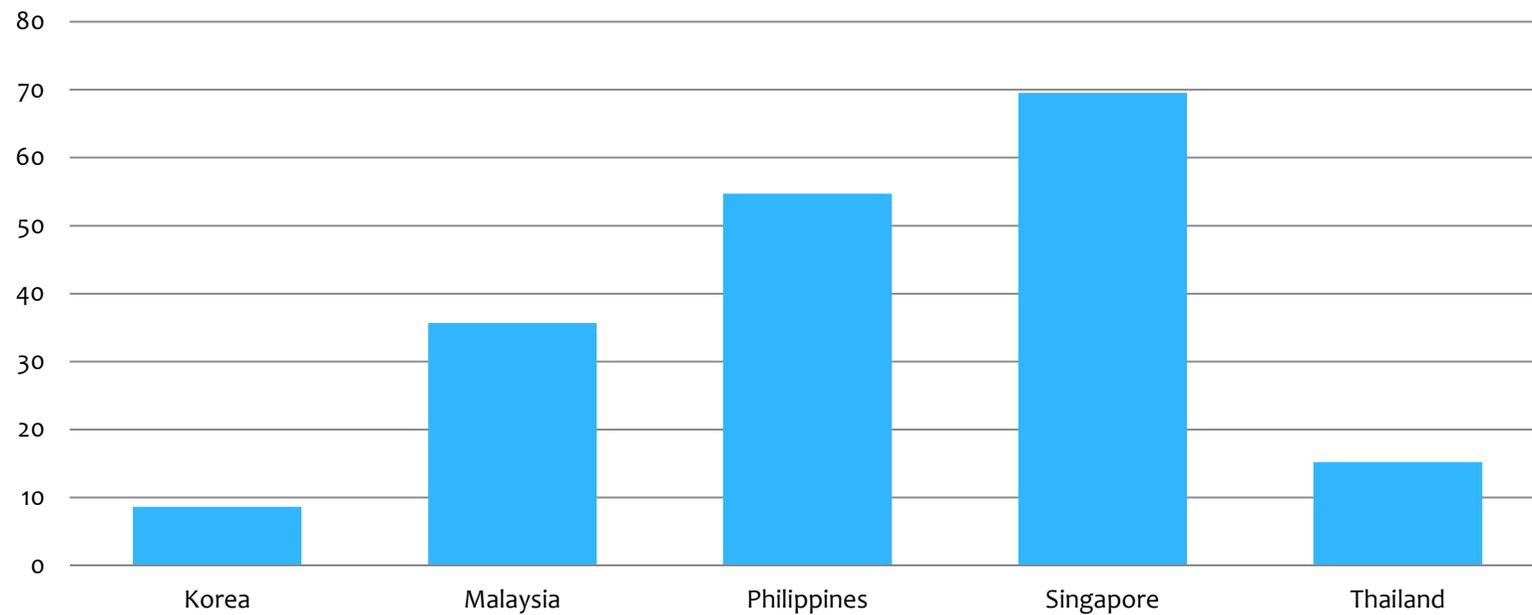
Inflation rate (%) in East Asian countries 1990-1996



Source: IMF

## 1.2 Before the crisis: public debt in East Asian countries

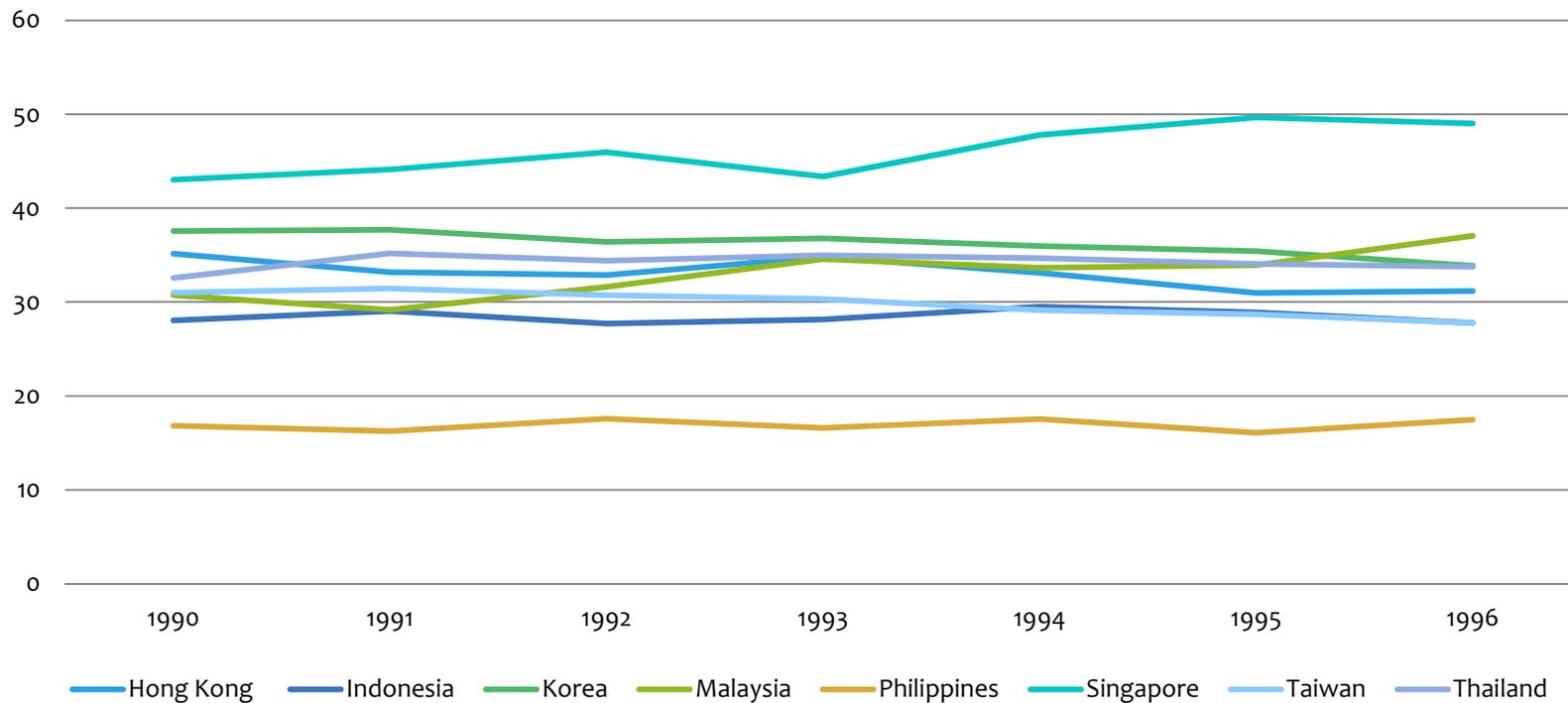
**Gross public debt as a % of GDP in 1996 in a few East Asian countries**



Source: IMF

# 1.2 Before the crisis: national saving in East Asia

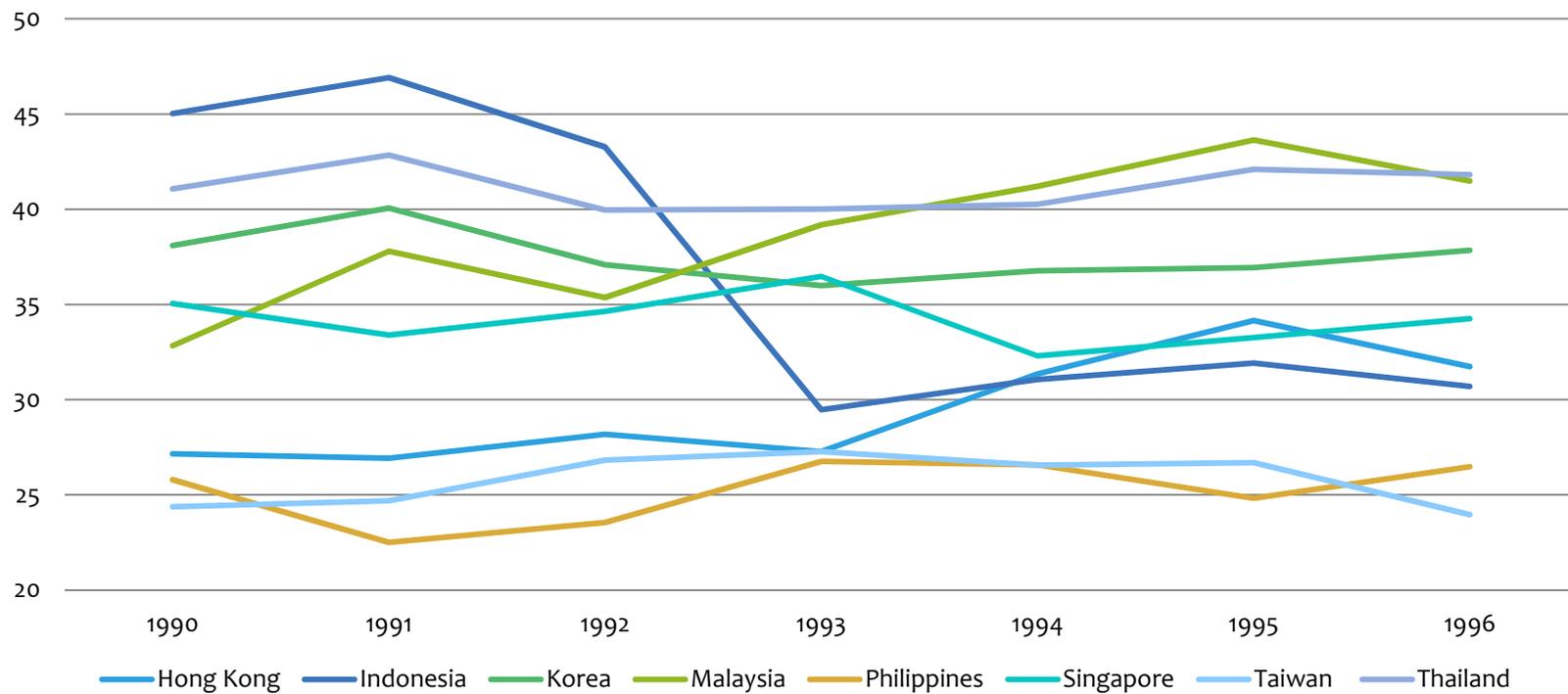
Gross national saving as a % of GDP in East Asia



Source: IMF

# 1.2 Before the crisis: national saving in East Asia

## Total investment as a % of GDP in East Asia



Source: IMF

## **2. The Crisis 1997-1998**

## 2. The crisis: countries involved and spared

| Countries involved | Countries spared |
|--------------------|------------------|
| Thailand           | China            |
| Philippines        | India            |
| Hong Kong          | Japan            |
| Taiwan             | Vietnam          |
| Singapore          |                  |
| South Korea        |                  |
| Malaysia           |                  |
| Indonesia          |                  |

## 2. The Crisis

- \* The East Asian financial crisis started in 1997 in Thailand, the country of the region with the largest current account deficit (see slide 18). Moreover, the country faced at that time a budget deficit for the first time in a decade.
- \* In May 1997, the Thai baht was under speculative attacks. The Thai Central bank raised interest rates and spent billions of its foreign reserves to defend the baht.
- \* On July 2<sup>nd</sup> 1997, the Thai baht was forced to float. The Central bank instituted a « managed float » with larger bands of fluctuation, i.e. accepted a devaluation of the currency. The baht dropped by 20%.
- \* The magnitude of the panic, unexpected, spread to other countries. Within a week the dominoes began to fall...

## 2. The Crisis

- \* The second and third largest current account deficit of the region in 1996 were found in Malaysia and Philippines respectively.
- \* The announcement of the baht devaluation caused other regional currencies to experience pressure.
- \* On July 8<sup>th</sup> 1997, the Malaysian Central bank defends its currency (the ringgit) which is under speculative attacks.
- \* On July 11<sup>th</sup> 1997, after defending its currency for a few days, the Philippine Central bank decided to let the peso float. On the same day, the Indonesian Central bank widened its intervention band for the rupiah.
- \* On July 14<sup>th</sup> 1997, the Malaysian ringgit was forced to float. This led Singapore to let its currency depreciate.
- \* On August 14<sup>th</sup> 1997, the Indonesian rupiah was also forced to float.
- \* On August 20<sup>th</sup> 1997, The IMF announced a rescue plan for Thailand, which eventually calmed down financial markets.

## 2. The Crisis

- \* On October 8<sup>th</sup> 1997, Indonesia asks the IMF and the World Bank for financial assistance. This triggered a renewal of attacks against currencies more in the North.
- \* On October 17<sup>th</sup> 1997, despite being a creditor country, Taiwan is forced to let the New Taiwan dollar float.
- \* On October 22<sup>th</sup> 1997, South Korea nationalised Kia Motors, which led Standard and Poor's to downgrade the South Korean foreign debt.
- \* On the same day, the Hong Kong Central bank raised interest rates from 7 to 300% to defend its currency. The stock market crashed by 10% that day and by 25% after three days.
- \* For the first time, European and US financial markets feel the tornado. On October 27<sup>th</sup>, the Dow Jones fell by 7% (« mini crash »).
- \* On November 17<sup>th</sup> 1997, the South Korean won was forced to float.

## 2. The Crisis

- \* On November 21<sup>th</sup> 1997, South Korea requested IMF aid.
- \* On December 4<sup>th</sup> 1997, after Thailand and Indonesia, South Korea obtained a \$57 billion aid package and, thank to an agreement with big foreign banks, avoided defaulting on its \$100 billion short-term debt.

## 2. The Crisis in East Asia: short-lived but severe

- \* Severe recession in 1998 but income growth resumed in 1999 at a high pace.
- \* The current account turned positive in most countries and remained so years after.
- \* The saving rate, on average, remained stable.
- \* The investment rate, on average, decreased but remained stable.

## 2. The crisis: GDP growth rate

|                          | 1997 | 1998  | 1999 | 2000 | Average (1997-2000) |
|--------------------------|------|-------|------|------|---------------------|
| Hong Kong SAR            | 5.1  | -6.0  | 2.6  | 8.0  | 2.4                 |
| Indonesia                | 4.7  | -13.1 | 0.8  | 4.2  | -0.9                |
| Korea                    | 5.8  | -5.7  | 10.7 | 8.8  | 4.9                 |
| Malaysia                 | 7.3  | -7.4  | 6.1  | 8.7  | 3.7                 |
| Philippines              | 5.2  | -0.6  | 3.1  | 4.4  | 3.0                 |
| Singapore                | 8.5  | -2.2  | 6.2  | 9.0  | 5.4                 |
| Taiwan Province of China | 5.5  | 3.5   | 6.0  | 5.8  | 5.2                 |
| Thailand                 | -1.4 | -10.5 | 4.4  | 4.8  | -0.7                |
| China                    | 9.3  | 7.8   | 7.6  | 8.4  | 8.3                 |
| India                    | 4.6  | 6.0   | 6.9  | 5.7  | 5.8                 |
| Vietnam                  | 8.2  | 5.8   | 4.8  | 6.8  | 6.4                 |

Source: IMF

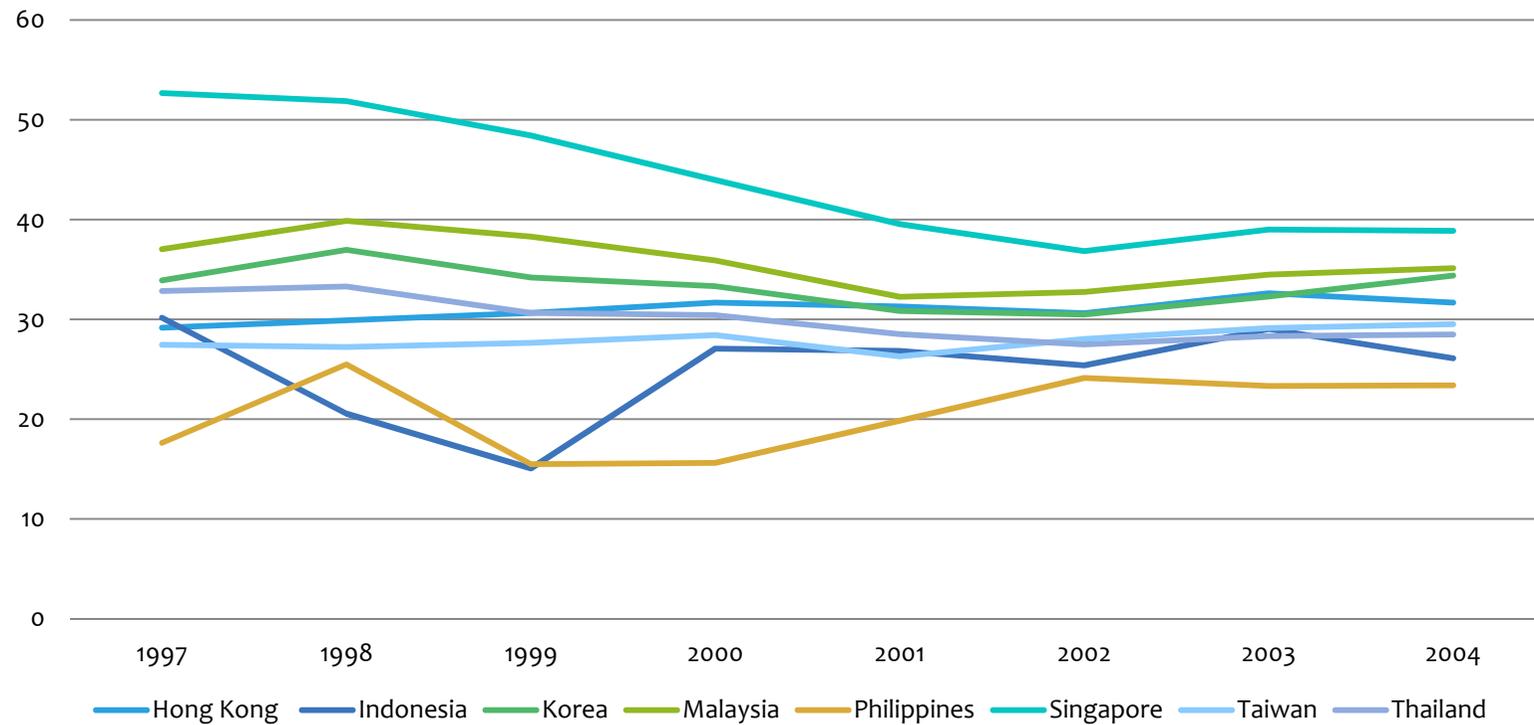
## 2. The crisis: current accounts

|             | 1997 | 1998 | 1999 | 2000 |
|-------------|------|------|------|------|
| Hong Kong   | -1.3 | -0.9 | -1.0 | -0.6 |
| Indonesia   | -1.8 | 4.2  | 4.1  | 4.8  |
| Korea       | -1.5 | 11.9 | 5.3  | 2.8  |
| Malaysia    | -5.9 | 13.2 | 15.9 | 9.0  |
| Philippines | -4.7 | 2.1  | -3.5 | -2.8 |
| Singapore   | -1.5 | -1.8 | -0.5 | -0.1 |
| Taiwan      | 2.4  | 1.2  | 2.7  | 2.7  |
| Thailand    | -2.1 | 12.8 | 10.2 | 7.6  |
| China       | 3.9  | 3.1  | 1.4  | 1.7  |
| India       | -1.3 | -0.9 | -1.0 | -0.6 |
| Vietnam     | -5.7 | -5.0 | 4.1  | 2.7  |

Source: IMF

## 2. The crisis: saving in East Asia

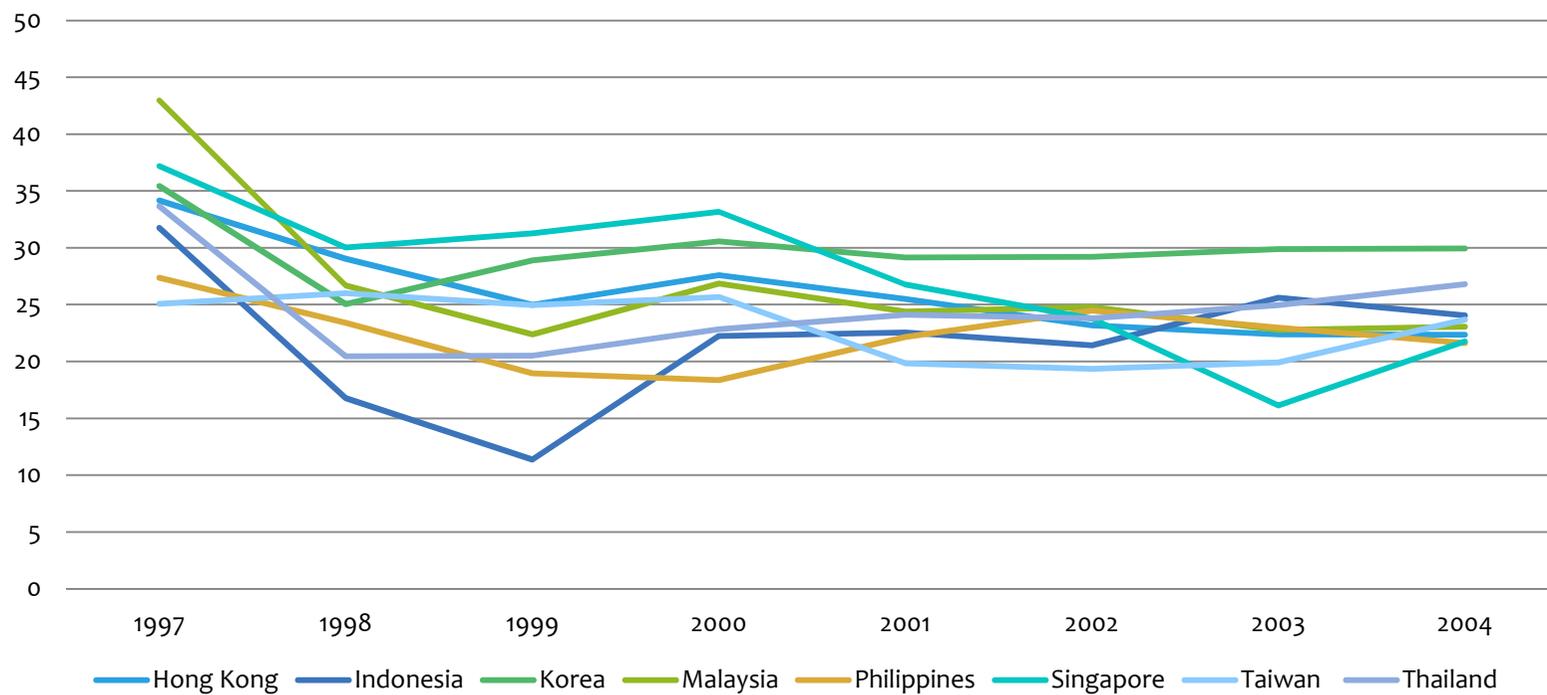
Gross national saving as a % of GDP in East Asia 1997-2004



Source: IMF

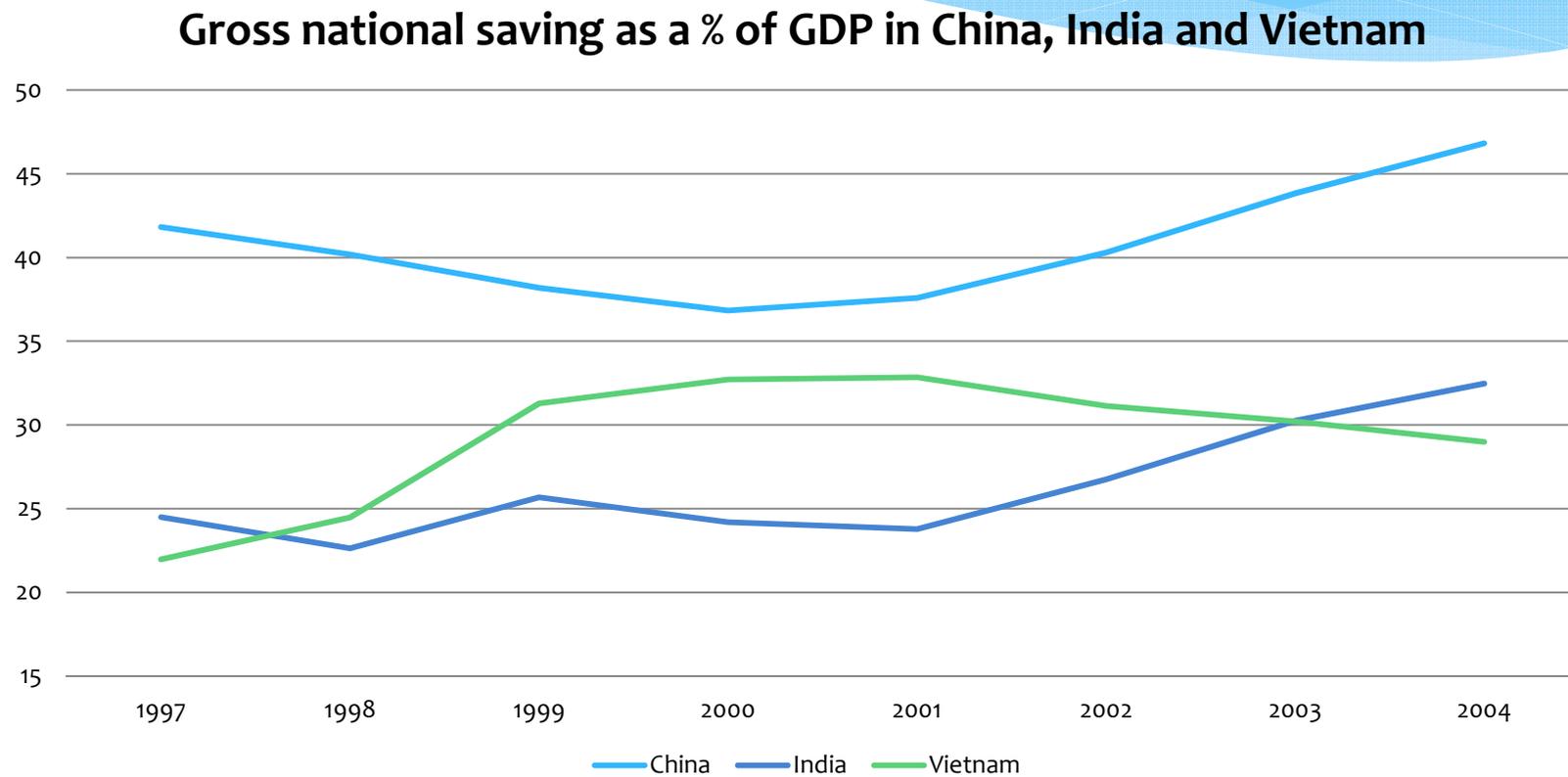
## 2. The crisis: investment in East Asia

Total investment as a % of GDP in East Asia 1997-2004



Source: IMF

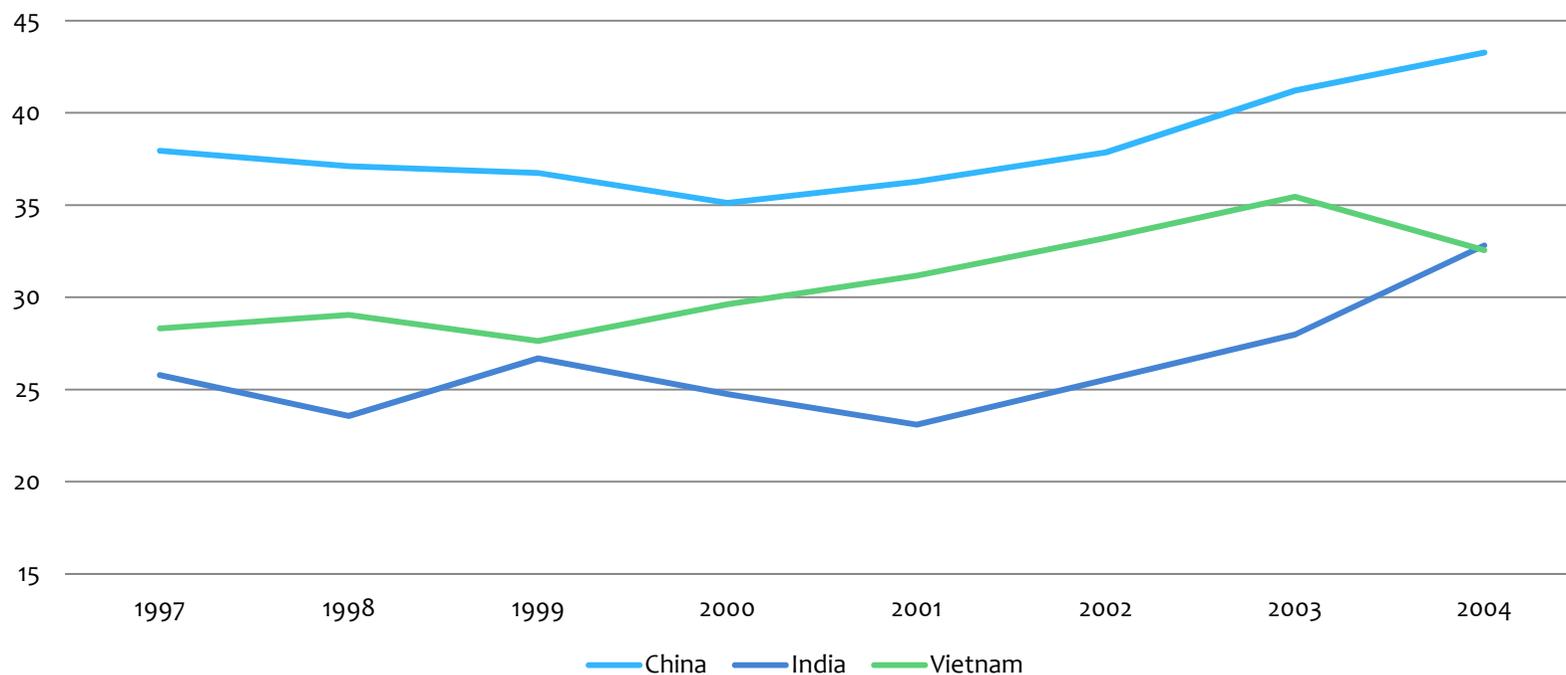
## 2. The crisis: saving in China, India and Vietnam (1997-2004)



Source: IMF

## 2. The crisis: investment in China, India and Vietnam (1997-2004)

Total investment as a % of GDP in China, India and Vietnam



Source: IMF

# 3. Causes of the crisis

# 3. Causes of the crisis: international finance

- \* The East Asian financial crisis is both a currency and banking crisis.
- \* The high growth rates and the sound macroeconomic results of East Asian countries attracted, before the crisis, a lot of short-term (often unhedged) and long-term (foreign direct investment) capital from foreign countries, especially from developed countries. These capital inflows gave rise both to large current account deficits and inflows of foreign currency reserves.
- \* These capital inflows created real estate and asset bubbles. When some of these bubbles started to burst in 1995-1996, investors started to change their portfolio positions, hence, reducing short-term capital inflows to these countries. The resulting downward pressure on their currencies sparked off a flight to quality to Western financial markets. Short-term capital inflows suddenly dried off leading to a currency crisis in these economies.

# 3. Causes of the crisis: international finance

- \* This currency crisis led to a banking crisis.
- \* In emerging and developing countries, investment finance generally depends heavily on bank loans. Despite structural problems in the banking sector in these countries, there were two specific characteristics of the banking sector, which made things worse:
  1. Maturity mismatch: the traditional maturity mismatch of the banking sector (borrowing short and lending long) was particularly acute in these countries as banks used a lot of short-term interbank liquidity.
  2. Currency mismatch: banks borrowed in foreign currencies (dollars), taking advantage of cheap foreign capital inflows, and lent to domestic borrowers in domestic currency.

### 3. Causes of the crisis: international finance

- \* When investors' mood reversed, the maturity mismatch worsened creating a liquidity crisis for the banking sector.
- \* The flight to quality caused the depreciation of East-Asian currencies leading to a much higher value (in domestic currency) of dollar-denominated debts of the banking sector. This created a solvency crisis for the banking sector.
- \* These two problems led to a turmoil in the banking sector calling for a rescue from the governments and the IMF.
- \* The deterioration of the banking sector's balance sheet further deepened the currency crisis, spreading the panic on the Asian financial markets.

## 3. Causes of the crisis: international finance

- \* Although the inefficiency of the East Asian banking sector was certainly a weakness, the excess of the booming years (too much domestic lending and too much foreign short-term borrowing) coupled with severe currency and maturity mismatch in the banking sector account for the sudden stop of economic activity in these countries.
- \* Credit crunch + sudden change in the consumers' and investors' mood led to a short-lived but very strong recession.
- \* However, capital outflows, fiscal and monetary policy helped a lot in containing the crisis by turning the current accounts into surpluses and, hence, by stabilizing currencies.

# 4. Conclusion

# 4. Conclusion

- \* The East Asian financial crisis contaminated other emerging countries such as Russia, Brazil and other Latin American countries.
- \* The East Asian financial crisis emphasized the volatility and the fragility of the international financial markets.
- \* This crisis has had a tremendous impact on the way economic policies are monitored by governments in emerging and developing countries. More developed domestic financial markets and current account surpluses are now considered as essential in development strategies of an emerging economy.

# 5. To go further

## 5. To go further

- \* Bank for International Settlements (1999) *69th BIS Annual Report*, BIS, Basel.
- \* Radelet, Steven and Jeffrey Sachs (1998) « The Onset of the East Asian Financial Crisis », NBER WP 6680.
- \* Sachs, Jeffrey and Wing Thye Woo (1999) « The Asian Financial Crisis: What Happened, And What Is To Be Done », WDI Working Paper 253.
- \* Yoshimoti, Masaru and Sayuri Shirai (2001) « Designing a Financial Market Structure in Post-Crisis Asia », Asian Development Bank Institute, WP 15.