

**Globalization, emerging market economies and currency crisis in Asia:
Implications on economic reform and development**

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Abstract

Recent experiences in Latin America and Asia provide ample evidence that countries in the process of integration are increasingly exposed to internal and external economic shocks. More importantly, this growing vulnerability of particularly developing economies has the potential of undermining decades of development efforts. The Asian crisis clearly demonstrates that we are increasingly unable to predict the triggers of such crises, and certainly lack the institutional arrangements to contain them. This translates into the fact that our ability to manage the interaction between domestic and international economic forces is limited or undermined by certain factors. This practical outcome has the potential to delay the process of globalization and integration of developing economies into the world economy.

Introduction

Emerging economies of Asia and Latin America have experienced a phenomenal growth throughout the 1980s and 1990s. Much of the credit has been attributed to increasing liberalization and growing integration of these economies to triad economies of North America, Europe and Japan. Alleged integration progressed in two separate yet interrelated fronts: in real sectors of these economies through trade and foreign direct investments and in financial sectors through portfolio investments. Asian strategies involving a governed market created impressive economic growth in the last twenty years.

Mexico experienced the first severe currency crisis in the post-liberalization period in December 1994, and contagion effects were quickly felt in the region (particularly in Argentina). The second crisis started in Thailand in the summer 1997, and contagion took effect immediately bringing a large number of Asian economies to the brink of a collapse. Since then, other countries have followed like Russia and more recently Brazil. A number of Latin American countries are even considering replacing their national currencies with the U.S. dollar.

By analyzing the globalization of the world economy, this paper will shed light on the causes of Asia's currency crisis. Finally, some concluding remarks on the challenges faced by emerging nations will be presented.

Asian currency crisis 1997-1998

The Asian crisis has quickly attracted the attention of the academic community and financial press due to its widespread implication on the global economy. Economists and analysts presented a range of competitive and/or complimentary perspectives on the crisis. These explanations can be grouped in four categories. The first perspective stresses deterioration of the macroeconomic conditions in the region. A particular emphasis is placed on the external sectors and growing current account deficit as a percentage of GDP. The second perspective focuses on the fundamentals of Asia's economic model and questions the effectiveness of the governed market approach in the long run. The third perspective attracts attention to the destabilizing nature of capital flows and potential power of global financial markets in inflicting damage on fundamentally sound economies. And finally the fourth

perspective questions the efficiency of financial markets and describes the working of a panic in financial markets with reference to the Asian contagion.

Deterioration in Macroeconomic Fundamentals

A quick review of macro economic indicators in Malaysia, South Korea, Indonesia and even Thailand does not lend immediate support to macroeconomic decay or weakness arguments. Although some governments in the region had committed to ambitious infrastructure investment programs, public sector balances did not point to rampant fiscal imprudence. Even though higher than industrialized country averages, inflation rates were moderate, and did not concern investors or analysts.

On the other hand analysis of private sector balances indicated that investments in excess of domestic savings created a fundamental imbalance. This gap between private investments and the private savings also explains the current account deficit. Although this savings deficit was progressively financed by external capital flows, it was not perceived to be an alarming sign of deterioration because of two reasons: First this deficit that was fully attributable to the private sectors and was not perceived to be a major macroeconomic problem. In other words, it should have been the result of optimal allocation decisions made by the economic agents. Second, the source of private sector deficit was not due to declining savings (or increasing consumption), but due to higher levels of investment.

Economists argue that a current account deficit resulting from higher investments should be more sustainable, since these investments may create productive capacities that generate export revenues to pay back for the external debt used to finance the current account deficit. In other words as long as these investments were channeled into export oriented manufacturing projects, they were safe. The legacy of three decades of export oriented development strategies in Asia led the investors and analysts to believe that this was the case. However, investment patterns started to deviate from this traditional pattern in early 1990s and increasingly channeled into local service sectors and lucrative property markets particularly in Thailand, and to some extent in Malaysia and Indonesia. The only exception to this was South Korea, where investments continued to concentrate in manufacturing. Cosetti, Pesenti and Roubini (1998) also present a convincing case of declining productivity and profitability of investments by using Incremental Capital Output Ratio (ICOR). The main

argument is that Asian investments generated less and less growth per unit investment in their economies. They also point to sharp declines in corporate profitability by using a sample of South Korean companies.

The deviation of investments from traditional patterns of tradable sectors to non-tradable sectors and lower productivity of these investments infused a range of problems in Asian economies. One of these problems was the asset inflation that was fueled by uncontrolled domestic credit growth. This has created significant problems in the financial sectors, which increasingly intermediated domestic and foreign funds into less productive use. Financial institutions in Thailand, Malaysia and Indonesia were progressively exposed to booming property sectors. In addition to this, it is claimed that financial institutions also provided financing for investments in the stock markets (secondary), and extended property or stock collateralized loans. This growing exposure to speculative investments created an enormous vulnerability in the financial systems of particularly Thailand and Indonesia and to a lesser extent in Malaysia.

An even more concerning dimension of these vulnerabilities was the source of financing used by the financial institutions. Financial institutions exploited a very profitable opportunity by borrowing in international markets in foreign currency and converting them into high interest domestic loans. Growing optimism in international financial markets about emerging markets led to a significant decline in spreads attached to emerging market loans and created a conducive environment for large syndications. The result was a highly exposed financial sector, which started to show some early signs of weakness in Thailand in 1996 and in Malaysia and Indonesia in 1997. On the other hand, there was great deal of ambiguity about the extent of the problem in countries other than Thailand.

As it was discussed above the progression of the external sectors also did not send strong crisis signals with the exception of Thailand and Malaysia. Although there were indications of deterioration in the current account balances of the regional economies, their export capabilities and offsetting capital inflows to the region did not won) most observers. An analysis of trends in current account deficit over 1990-1996 reveals fluctuations in the deficit. It was below 5% of GDP in South Korea despite a surge from 1.81% of GDP to 4.76% of GDP. In Indonesia it ranged between 0.82% to 4.40%, but it improved to 3.41% in 1996. In Philippines it was stabilized between 5 and 6% in 1995 and 1996. Malaysia which is

the most open economy among the Asian-5, experienced a surge in current account deficit between 1993-1995, but brought it sharply down to 5.2% of GDP in 1996. In midst of optimism about the growth performance of the region, these indicators were not perceived to be clear signals of trouble.

Real exchange rate appreciation was pointed out as a factor that contributed to the deterioration in trade accounts. The impact of this factor was not very clear either. The pegged currencies of the region, notably the Thai Baht, experienced devaluation as the US dollar depreciated against major currencies between 1991 and 1995. However JP Morgan data indicated that it appreciated in real terms during this period. Malaysia's Ringgit also experienced a sharp appreciation until 1993, and depreciation in 1994. Indonesia's Rupiah experienced a real appreciation between 1990 and 1993, and slight depreciations until 1995. South Korea's Won depreciated in real terms until 1994 and experienced a slight appreciation in 1995. All Asian five, and Singapore and Hong Kong experienced a real appreciation in 1996 with respect to 1990 and 1995 with the exception of South Korea.

It is not clear that, if these real appreciations were justified with productivity increases in the region. It is easier to assess these revaluations ex-post in light of evidence about the productivity of investments during the 1990-1997 period, which leads us to the conclusion that productivity increases were not significant, therefore revaluations were not justified. On the other hand, during the event window of 1997, there were few concerns about the impact of real exchange rate appreciation. In the final analysis, the so called macroeconomic weaknesses that were identified in the aftermath of the crisis and discussed above, were neither typical "crisis signals", nor ex-ante perceived to be serious problems in the midst of fairly optimistic expectations about the region's future economic performance.

Failure of the Asian model

Much praised Asian economic development model was widely debated among economists after the publication of a World Bank report entitled "East Asian Miracle". Young (1992), Rodrik (1994), and Krugman (1994) among others, disagreed with the label "miracle" and attributed the sustained growth in East Asia to unusually high physical capacity increases. Their fundamental disagreement with the report was on the issue of total factor productivity (TFP), which contained information regarding the contribution of

technology and innovation to the productivity increases. They argued that the gains in the TFP in the East Asian setting were insignificant, and Asian growth was destined to slow down once the physical investment limits were reached. Critics of the Asian model also questioned the efficiency of resource allocation process through governed markets and argued that sustained deviations from market mechanisms bound to impose severe limitations in more advanced stages of development. The accumulation of problems in the financial systems and corporate sectors were linked to these early critical analyses of the Asian model and increasingly identified with the label “Crony Capitalism” which apparently were used to stress the deviations from Anglo-Saxon capitalism. This perspective emphasizes the favoritism, insufficient supervision and regulation and rampant inefficiencies in allocation of resources as the root factors of the crises. It is argued that intertwined government and large corporate conglomerations increased the moral hazard in the financial systems, and fueled careless capital allocations without any regard to risk. Although the core of the arguments developed in this perspective has some validity, it fails to capture the significance of other factors and undermines the sustained progress in the region for over three decades.

Destabilizing Capital Flows

Traditionally high domestic savings rates in East Asian countries reduced the dependence on external capital during the high growth periods until late 1980s. However sustained high rate of growth and surge in domestic investments created the need for external capital flows. The surge in private investments was the primary source of growing need for external capital in most of these countries. This need became increasingly visible as current account deficits increased.

While a growing need for external capital emerged, there was no shortage of investors and creditors to the region. Net capital inflows to five Asian countries (South Korea, Indonesia, Malaysia, Thailand, and the Philippines) were \$47.4bn, \$80.9bn and \$90.8bn respectively in 1994, 1995 and 1996. These flows were more than offsetting current account deficits and led to increases in foreign exchange reserves. During the 1990-1996 period, growth in foreign exchange reserves ranged between 127% and 183% (935% in Philippines).

Foreign direct investments, the most stable component of capital flows, financed a considerable portion of the current account deficit. Since high growth in the manufacturing

and service sectors created a significant demand for credit in the banking system, this demand driven increase in interest rates presented an attractive profit potential for large and credible domestic banks. They channeled the funds borrowed in the international capital markets in dollar or Yen terms to domestic currency denominated loans in local markets. The declining spreads in syndication loans, and accessibility to international markets created significant profit margins for the domestic banks. However allocation of these funds to inefficient diversified conglomerates which kept creating over-capacity in their industries, and highly lucrative real estate deals which created the asset bubble problem, created an explosive exposure for the regional financial institutions.

Although capital inflows to Asia does not seemed to create some of the problems experienced in other developing countries such as an inflationary pressure, it gradually contributed to an exchange rate overvaluation, monetary expansion through increased domestic lending, asset inflation and a build up in short term liabilities. This combination obviously prepared the grounds for a crisis that can be triggered by a domestic or external shock, or a panic in financial markets. The Asian crisis clearly demonstrates the increasing sophistication of determination of appropriate level and mix of capital flows in a global economy. The urge to reconsider the role and stage of capital account liberalization in the economic reform process is not baseless under the light of the current evidence.

Financial Panic

The combination of financial deregulation, contagion and erratic behavior suggests that financial markets are not a symbol of market perfection. This is even more pronounced in international financial markets where a Debreu-Arrow type of efficiency is not possible due to vast informational asymmetries (Wyplocz, 1998). In other words, agent's access to information set, and their ability to incorporate information to prices is quite limited in the international context. An expected outcome of this is the occasional malfunction of the financial markets, which create dramatic impact on the real sectors in terms of output and employment.

A fundamental distortion to market efficiency comes from informational asymmetry in international financial markets. By definition lenders know less about the borrowers about

the latter (Wyplocz, 1998). This leads to moral hazard and adverse selection. Since lenders have limited information about the borrowers, they either prefer not to lend or to charge high-risk premiums to compensate for the risk. This inherently creates high loan prices in international markets. Borrowers with good credit tend to not to borrow at these rates. In other words, there is no interest rate that would bring good borrowers and lenders together.

This leads to adverse selection, and credit intermediation leans towards risky parties in international markets. Also lenders look for implicit guarantees such as borrowers good relationships with governments, market power etc. Lenders often ration credit, and limit their exposure to risky borrowers. However, when the economic climate is optimistic they relax their credit rationing and increase their exposure to risky borrowers, particularly to those who can provide implicit guaranties. On the other hand, when economic outlooks take a pessimistic turn, lenders immediately invoke credit rationing, and borrowers are denied new loans. The rush to collect the previous balances may quickly turn into a panic, and the borrowers who are denied new loans face a liquidity crunch. If the funds dry out in domestic and international markets, liquidity problem transforms itself to an insolvency problem. The panic becomes a systemic problem, and quickly spreads into real sectors.

Another channel where the financial panic is triggered is the case of multiple equilibria. Multiple equilibria implies that the actions based on expectations of a particular outcome, can deliver that outcome. In other words the expectations that are ex-ante unjustified are validated by the outcome that provoked. In financial markets, a perceived weakness in an economy may easily create the expectation that the markets will collapse at some point. Although the fundamentals at the time may not justify this expectation, actions of the agents triggered by this expectation may lead to a crisis in currency, debt or equity markets. In other words, multiple equilibria could trigger self-fulfilling crises.

Financial panic is more likely to develop in environments where capital mobility is high and financial market supervision is inadequate. In such environments, any weakness in the financial system and macroeconomic fundamentals may quickly evolve to a crisis.

The Asian case lends strong support to adverse selection and moral hazard in the sense that was explained above and multiple equilibria where self-fulfilling crises develop quickly. As it was mentioned above, although there were macroeconomic weaknesses in the Asian economies, they were not as significant as to justify the scale of the collapse. However,

expectations that the markets would collapse, brought the outcome that was not justified ex-ante.

Economic development and lessons from currency crises

The damage created in the real sectors of the economies hit by currency crises has the potential to dictate a new set of priorities in the economic development process. The classical currency crisis scenarios were invariably linked to large public sector deficits caused by government profligacy, high inflation, rampant real exchange rate appreciation and a growing current account balances (Krugman, 1998). Policy recommendations developed by multilateral development agencies were quick to emphasize prudent macroeconomic management with balanced public sector budgets. The Mexican experience proved the inadequacy of this condition and directed the attention to the dangers of accumulation of short-term debt by governments. Another lesson learned from the Mexican crisis of 1994 was the incredible power of the international financial system. Although there were traces of financial panic and imperfections in the international financial system, this power was interpreted as international financial market's ability to punish governments committing undesired policies by the global investors.

The Asian crisis has made it clear that triggers of crisis are becoming increasingly difficult to predict. The potent message is that macroeconomic prudence and stability, a prerequisite to growth, are not sufficient conditions to immunize an economy to external shocks, unless a range of collateral factors accompanies them.

The most important of these collateral factors is the development of a sound financial system. The key characteristics of a sound financial system are effective and efficient intermediation of funds, a sound institutional infrastructure, regulation and supervision. The current development paradigm emphasizes macroeconomic stability and liberalization of current and capital account without any particular reference to the financial system. The current episode of currency crisis indicates that development of the sound financial sectors should take precedence to capital account liberalization. Although most emerging economies have introduced financial market reforms, these reforms focused on the effectiveness of fund allocations. As capital account liberalization facilitated access to international capital markets, the volume of funds intermediated by these institutions reached to significant levels.

However, as it was evident in Incremental Capital Output Ratio, growing inefficiency of the fund allocations and moral hazard motivated by lack of regulation and supervision, as well as implicit and explicit guarantees in the financial systems, created the grounds for a financial crisis with potent implications in the real sectors.

The Asian crisis raises legitimate concerns for developing economies in the process of reforming their economies through privatization, deregulation and liberalization. It exposes the difficulties of macroeconomic management in an increasingly integrated world economy. Although it is not expected to change the course of liberalization of developing countries including the ones struck by the crisis, it will lead to a search for a new development paradigm with revised priorities in the reform process. In this process development of a comprehensive institutional infrastructure including laws and regulations governing intermediation practices of financial institutions should be an absolute priority, and any deregulation in the financial system should be designed and monitored very carefully. Liberalization of capital account should only then be considered.

Development of sound financial systems is a prerequisite for the development of competitive industries and individual companies in these industries. The impact of financial crises on the real sectors creates significant systematic risks for developing country companies that increases the cost of investment capital and creates a significant impediment for further development and growth. Particularly, for companies that are striving to make a transition from low-technology/labor intensive industries to high technology-proprietary product markets, the systematic risk factor imposes a significant barrier for the transition.

Asian crisis is loaded with lessons for progressive companies operating in relatively protected emerging markets. It has shown that strategies designed without regard to global demand and supply dynamics bound to fail. It has also proven that substitution of markets by technocratic guidance systems gets progressively ineffective at higher levels of economic development. Building well functioning contestable markets with adequate business and legal infrastructure should be incorporated in economic development programs.

Concluding remarks

Even though the benefits from integration are undeniable for both developed and developing economies, recent experiences in Latin America and Asia provide ample

evidence that countries in the process of integration are increasingly exposed to internal and external economic shocks. More importantly, this growing vulnerability of particularly developing economies has the potential of undermining decades of development efforts. The Asian crisis clearly demonstrates that we are increasingly unable to predict the triggers of such crises, and certainly lack the institutional arrangements to contain them. This translates into the fact that our ability to manage the interaction between domestic and international economic forces is limited or undermined by certain factors. This practical outcome has the potential to delay the process of globalization and integration of developing economies into the world economy.

While integration of national financial markets culminating to a global financial market offers vast opportunities for individual countries and companies operating in these environments, it presents a set of very serious challenges. Liberalization and deregulation of national financial markets in the process of integration should follow development of sound financial systems furnished with a very comprehensive legal infrastructure, adequate regulation and supervision, that would reduce the possibility of system-wide exposures and collapses. An important dimension of the sound financial system is increasing transparency that would naturally reduce informational asymmetries in international markets. Another important dimension is the National and Supranational coordination of the supervision. Development of new supranational bodies or improvement of the existing ones such as the IMF and BIS is essential to reduce the systemic risks.

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