

During the 1990s, it seems clear that financial economy has gradually become the predominant consideration in the mainstream of the world economy. As a result of general economic liberalization and internationalization, controls on capital movement and non-tariff barriers to trade have both been greatly reduced. This move towards free capital movement and trade transfers results in all the countries within a region becoming closely related and reliant upon each other, thus, a financial crisis in one country can quickly spread to neighboring countries. Furthermore, capital flow and trade flow, are also closely linked together.

It should be noted that as a result of the liberalization of capital movement, international funds have formed a powerful stream, exerting great influence over a country's exchange and stock markets. In any country where the market was comparatively small, the international funds would have the potential for dominance and control of its stock market. When huge amounts of capital flowed in, stock prices would soar; when capital of such magnitude flowed out, the stock market would collapse, virtually overnight. This phenomenon has led to the question: what kind of financial mechanism for an individual country would be able to face the challenge of a financial crisis? Needless to say, so far, no definite answer has been provided. This is why many governments still prefer to maintain some measure of control over their capital movement, and tend to be somewhat reluctant to open up their capital account completely.

However, since financial conditions have become more dynamic, more uncertain and more complicated than ever before, it has become necessary to consider the possibility of setting up a series of financial indicators that will reflect the signals of impending financial crisis, while providing a coherent approach for effectively preventing contagion from external financial crises.

3. VARIOUS EXPLANATIONS OF THE CAUSES OF THE FINANCIAL CRISIS

Since the 1960s, the four so-called 'Asian Dragons', Taiwan, Hong Kong, Singapore and Korea, have all achieved high economic growth, largely

propelled by the expansion of their exports and investment, and from the late 1980s onwards, the four so-called ‘Asian Tigers’, Thailand, Malaysia, Indonesia and the Philippines have also enjoyed rapid economic growth. Their amazing achievements have been described as an “economic miracle”, suggesting that they are “making the impossible possible”. However, sometimes “miracle” is more an indicator of “good fortune”.

When many people in East Asia were removed from poverty and began to become infatuated with the so-called “economic miracle”, Professor Paul Krugman’s argument seemed to be to “pour a bucket of cold water over their heads”. According to Krugman, all of the output growth in Asia could be attributed to the growth of factor inputs, such as labor and capital. In other words, the Asian miracle was more a result of perspiration, rather than inspiration and there was nothing really miraculous about the high growth in Asia at all.¹

Lewis T. Preston, President of the World Bank also holds a similar argument suggesting that: “the research shows that most of East Asian’s extraordinary growth is due to superior accumulation of physical and human capital”². Put simply, the suggestion is that if there were no continuing accumulation of sufficient capital and available labor, the miracle would simply become a bubble. Is it surprising then that the East Asian financial crisis actually occurred, or should we conclude that the crisis is a reflection of the bursting of the Asian bubble economy?

There have been many attempts at explaining the causes of the financial crisis in East Asia, some of which are unreasonable and excessively emotional, and some of which are incomprehensive and lack impartiality. However, all of these arguments are helpful in providing many perspectives for consideration of the cause-and-effect relationship of the financial crisis.

3.1 Sinister Tactics

From this perspective, in view of the rapid development of the East Asian economy over the past twenty years, there would have been a

¹ See Yasuhiro Maehara, “Financial Stability in Southeast Asia”.

² See ‘foreword’ in the *East Asian Miracle: Economic Growth and Public Policy*.

presupposition amongst western nations that the East Asian nations could become a great threat to their dominant position in the world economy. In order to eliminate the threat, these rich economies took advantage of the situation by initially investing in the East Asian economy, and then later withdrawing their investments. Once the East Asian countries lacked the operating capital, their economies would become gloomy and even lose their competitiveness in the world market.

3.2 International Speculation

Many international speculators have recently become interested in indirect investment in the newly emerging economies, and through the effective use of valuable information and their huge funds, they are able to penetrate particular capital markets. Since most of these countries have adopted fixed exchange rate mechanisms, or have otherwise linked their exchange rate to the U.S. dollar, the speculators can make short-term investments in their stock markets through such kinds of exchange rate systems. First of all, they create successive rises in the stock prices within these countries, then, as soon as the stocks reach suitably high levels, the speculators sell out all of their stockholdings, creating a sudden drop in prices, and a bursting of the bubble.

3.3 Excessive Devaluation of the Chinese Currency (RMB)

In 1994, due to hyperinflation and over-investment, the government in Mainland China adopted the strategy of “adjustment and control of the macro-economy” taking devaluation measures in the foreign exchange system. Many foreign economists considered that, as a result, the RMB had been over-devalued. This was helpful for the Mainland Chinese economy, since it led to an increase in exports, but harmful for many of the Southeast Asian countries, where continued economic growth relied heavily upon the expansion of exports.³

³ This is not supported by the export statistics of the ASEAN countries, refer to Table 1.3.

3.4 The Rapid Depreciation of the Japanese Yen

The relationship between Japan and other East Asian countries is closely linked to trade and capital flows. Many East Asian countries import large quantities of intermediate products and machinery equipment from Japan, whilst producing less goods for export to Japan. Consequently, they generate massive trade deficits with Japan. As the Japanese Yen appreciates against the U.S. dollar, the East Asian economies become prosperous; as the Japanese Yen depreciates against the U.S. dollar, their economies can rapidly decline into recession. Ever since late-1995, there has been a tendency for continuous depreciation of the Japanese Yen against the U.S. dollar, making it increasingly difficult for the East Asian countries to expand exports to the United States, and subsequently leading to economic recession.

3.5 The Collapse of the 'Bubble Economies' of East Asia

Over the past decade, many East Asian economies have been characterized as 'bubbles' in the context of soaring stock prices and sharp rises in the price of real estate. When the level of prices reaches beyond the purchasing power of the middle-income classes, many real estates become inventory, which presents not only an enormous burden upon construction investors, but also results in a rapid rise in bad debts amongst the financial institutions as the real estate companies loans remain unpaid.

3.6 Short-Term Capital Used for Long-Term Investment

In most of the East Asian countries, enterprises have relied upon the various financial institutions to provide them with short-term capital, lending that must be repaid within one year. However, many of these enterprises have subsequently gone on to utilize these funds as long-term investment capital. Clearly, however, once these loans mature, if the debtors do not have sufficient readily available funds to meet repayment of the loans, this will lead them into bankruptcy.

3.7 The Nepotism Between Politicians and Enterprises

In many East Asian countries, very close relationships exist between politicians and enterprises. Engaging in this sort of nepotism provides the enterprises in question with substantial preferential treatment being offered by the government. In concrete terms, the enterprises may be provided with mortgage-free loans from the state-owned financial institutions at preferential interest rates. If the enterprises fail in their investment of these funds, and fall into financial difficulties, the relevant institutions would inevitably find themselves becoming part of the subsequent financial crisis.

These arguments seem plausible, but they cannot provide the whole picture of the Asian financial crisis, either completely or systematically. In some sense, they seem to be consistent with an old Chinese saying, “the blind who touches an elephant”, meaning that their impression of the financial crisis is merely partial, incomplete. Nevertheless, no one explanation can provide the answers to the underlying causes of the financial crisis in East Asia.

4. THE IMPACTS OF THE FINANCIAL CRISIS IN EAST ASIA

4.1 The Initial Impacts of the Financial Crisis on Financial Markets

There are two important indicators, which reflect the initial impacts of the financial crisis on East Asian economies during the period June 30, 1997 to December 31, 1997. One is the change in exchange rates and the other the change in stock prices. Table 1.1 shows that among the ten countries, Thailand, Indonesia, Malaysia, the Philippines, Singapore, Hong Kong, China, Taiwan, Korea and Japan, the worst reactions in each of these indicators were demonstrated by just four of them, Indonesia, Korea, Thailand and Malaysia. In terms of depreciation of currency against the U.S. dollar, in Indonesia the depreciation was 52.3%, in Korea 47.8%, in Thailand 46.1%, in Malaysia 34.9%, and in the Philippines 34.3%. Regarding the change in