

extremely vulnerable to financial crisis. When these banks go bankrupt, the government will usually use special measures to rescue them, which causes the problem of “moral hazard”.

7. A MODEL USED TO EXPLAIN THE FINANCIAL CRISIS

Returning to the causes of the financial crisis, as already mentioned, many explanations have been provided. Here, we present a further explanation: the marriage of internal excess investment and external excess

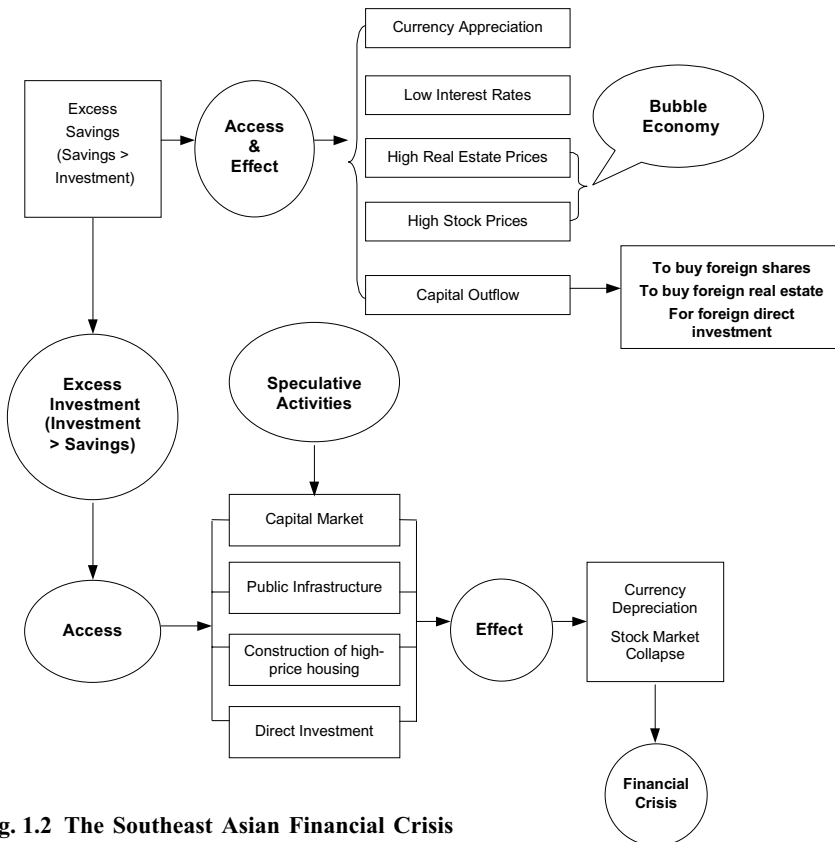


Fig. 1.2 The Southeast Asian Financial Crisis
(An Explanatory Model)

savings, which is considered to be the main cause of the financial crisis in East Asia, since most of the East Asian countries' excess investments have been financed through excessive external savings. Either of these conditions, excess investment or excess saving, provides a condition for economic disequilibrium. Excess investment would raise inflation and increase employment, while excess savings would produce a bubble economy resulting in unemployment later. In order to increase an understanding of this, a diagram may be helpful.

7.1 Excess Investment

When investments are larger than savings, the result is excess investment. Here savings comprise of domestic savings, and inflow of foreign capital and loans, and loans include both domestic and foreign loans, which in turn, consist of short-term and long-term loans. All the sources of investment can be used in both direct and indirect investment. The former is used for producing goods and services, of which, a large part is used for domestic demand, while the remainder is used for exports. The latter is channeled to the money market, capital market or real estate market.

In the case of any one of the following, financial problems would ensue.

- a. Exports continue to decline because of weak competitiveness. This would influence the exporters' repayments to the financial institutions and produce bad debts and subsequent troubles for the financial institutions.
- b. Short-term loans are used for long-term investment. It becomes very difficult for the enterprise to adjust its financial account, and again, this would cause financial difficulties.
- c. International speculators with huge amounts of capital penetrate the stock market and dominate the change in stock prices. Once the stock prices rise to a high level, the speculator immediately withdraws all of his capital from the market, causing the collapse of the stock market.
- d. Investments are channeled to the real estate market causing real estate prices to rise too high, beyond the purchasing power of the middle-income class. It would become very difficult for real estate

owners to sell out and, therefore, if the owners have substantial loans from financial institutions, the financial institution themselves would face financial difficulties and go bankrupt.

7.2 Excess Savings

When savings are larger than investment, the result is excess savings. If excess savings were too large, this would create a bubble economy. The examples of Taiwan and Japan can be used here to illustrate this phenomenon.

In the late-1980s, Taiwan enjoyed huge trade surpluses and abundant foreign exchange reserves. Since such huge savings had no inappropriate excesses to absorb, it was natural to use these funds for indirect investment in the stock market and real estate market. Consequently, the stock market soared and real estate prices rose sharply. Many speculators made use of the money earned from the stock market to purchase real estate, further pushing up the price of real estate up until early-1990, when stock prices suddenly dropped, and the bubble burst!

Simultaneously, Japan was also enjoying huge trade surpluses and foreign exchange reserves, which caused both the stock and real estate markets to soar; prior to 1990, Tokyo house prices were the highest in the world, and the stock market was booming. However, by the end of 1990, both of these markets had collapsed.

7.3 A Marriage

As stated earlier, the East Asian countries most affected by the financial crisis were Indonesia, Korea, Thailand and Malaysia. Among these four countries, over the period from 1995 to June 1997, Korea's loans were the highest, then Thailand, Indonesia and Malaysia respectively. (See Table 1.5). Japan, the United States and Germany had provided the bulk of these loans, with Japan in particular providing the largest loans to the four countries, US\$112.1 billion to Thailand, US\$69.5 billion to Korea, US\$66.2 billion to Indonesia and US\$26.0 billion to Malaysia. Clearly then, Japan's banks were most affected by the financial crisis, simply because they had made the greatest contribution to East Asian loans.

Accordingly, excessive investment is considered to be the basic cause of the financial crisis in East Asia, with speculator activities being nothing but a fuse. The most important factor is that if the internal excess investment had not been financed with external excess savings, it would not have been possible for these countries to make so much unnecessary investment in real estate and stock markets and to create such a serious financial crisis. On the other hand, if their financial sectors had been sound, the financial crisis would have been diluted to some extent, even if the financial crisis could not have been completely avoided.

As for the contagion of the financial crisis, when it broke out in Thailand, it immediately and quickly swept across Northeastern Asia and all the ASEAN countries. Theoretically, capital and trade flows should have been the channels of contagion; but actually, psychological factors played the most important part in this respect, since the pessimistic psychology caused by the financial crisis occurring in Thailand was reflected in foreign exchange and stock markets creating rapid currency depreciations and dramatic falls in stock prices.

To sum up, it may be reasonable to argue that the outbreak of the financial crisis in many East Asian countries can be considered a marriage of internal excess investment and external excess savings.

8. THE ROLE OF THE GOVERNMENT

When a financial crisis occurs in the exchange market and stock market, what kind of reaction and attitude should be expected from the government? This issue has caused many debates. One school argues that the government should leave the market alone, and allow the “invisible hand” to automatically adjust the markets accordingly, in other words, government intervention is unnecessary. The alternative argument is that the government should intervene in the markets because they were only destroyed as a result of international speculation and they had subsequently failed to adjust themselves.

An infamous case took place in August 1998, when international speculators made use of enormous amounts of capital to penetrate the Hong Kong stock market. First of all, the speculators bought successively large