The 1997 Financial Crisis and the East Asia Development Paradigm

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The South East Asian financial collapse of 1997 which led to regional economic meltdown the following year exposed the link between financial sectors and macroeconomic performances of the troubled economies, and hence the revision of development models pursued by those economies. Nevertheless, before the extent to which the link shows the success or failure of East Asian development is established a distinction needs to be drawn between the financial crisis as the precipitating event or 'the source of Asia's extraordinary vulnerability'[1]. It is fair to regard the South East Asian financial crisis as the culmination of macroeconomic flaws in the financial sector of the troubled economies, Thailand and Indonesia in particular, which followed the 'East Asian Development State' model. More importantly, the so-called mismanagement of government policies arguably led to short-term factor in trigger the financial collapse. The contagion which spread to East Asia was therefore the consequence of the flawed systems of macroeconomic management of which most notably were the misaligned real exchange rates[2] which connected regional trading partners together. On the other hand, such attempt is to over-generalise the 'structural' economic performances of the affected economies since the financial sector and macroeconomic external regimes were rather constituent elements of the broader picture of the economies. In other words, the analysis of the success or failure of East Asian development also requires a deeper investigation into the fundamental, structural functioning of the economies concerned.

First and foremost, the South East Asian crisis exposed the flaws in the financial sector of the troubled economies. Under the East Asian Development paradigm the governments were the principal agents in directing credit to strategic firms and sectors. This has proven detrimental to the economy in the sense that there is always a danger of the government misusing its power to back banks to lend to well-connected firms. In the case of the financial crisis in question the 'crony capitalism' led to misallocation of capital and this idea applied particularly to Thailand which was the initiator of the 'contagion' spreading to regional financial markets. It is true that Thailand enjoyed spectacular growth of real GDP of close to 10% per annum between 1988 and 1996[3] but this boom was explained by the expansion of the capital stock. Yet this was considerably fuelled by growing foreign direct investment rather than physical domestic investment. The former resulted from the country's financial liberalisation and as long as FDI continued it attracted portfolio capital inflows. These short-term mobile funds are not only volatile but also yielded implications on the maintenance of exchange rates via the Bank of Thailand's sterilisation using its international reserves. The over-valued baht only served to further fuel 'irrational exuberance'[4] and the crisis struck when the bubble economy eventually burst and the devaluation of the Thai baht in July 1997 saw, in consequence, other currencies floating.

The question to this, however, concerns the severity of the crisis in terms of the economy's performance and the number of economies infected. It is here that the arguments over the longer-term underlying causes of the crisis following the East Asian Development model, perhaps, gain leverage. The administrative guidance, in fact, was not confined in Thailand only, but in other deeply troubled economies like South Korea and Malaysia the government played an important role in state-directed lending[5] which contributed to the build-up of bad loans. This in turn drove the economy vulnerable to both internal and external shock and therefore explained why Thailand's disease spread to its close trading partners Indonesia, Malaysia and Korea. In this sense, the development model in favour of government intervention simply served to increase the openness and integration into the global economy which the economies were not yet ready to accommodate. The first charge against the paradigm is the market-oriented government intervention in the financial markets to give assurance to depositors and foreign investors pushed up the moral hazard and risk-taking. The initial collapse triggered the butterfly effect since capital flows were made on the short-term basis and hence lenders started to call for immediate repayments. The second charge then came into play. The financial crisis was both the precipitating event and the source of vulnerability. Although it was sensible to reject the import substitution industrialisation and pursued export-oriented industrialisation, the economies' performances were made on a shaky ground. Prior to the crisis export growth had substantially declined in Japan, Thailand, Korea and Malaysia which later became the troubled economies. The current account deficits began to widen and this was most apparent in Hong Kong where its surplus of 7% of GDP in 1993 went into a deficit of approximately 2.5% in 1995-96[6]. Given such picture of the region's performance it was conceivable to regard the financial collapse as a part of the confidence game of speculation in the capital markets. When the loans went bad investors simply moved the funds to safer haven and this triggered a vicious cycle leading to severe economic downturn in the region.

However, an investigation into the financial markets cannot give a complete picture of economic performances under the East Asian development paradigm. In fact, the crisis came as a sudden shock to the international economy but lasted for less than two years prior to a rather spectacular recovery. The question arises as to whether the paradigm accounted for rapid growth during the pre-crisis years and whether government intervention has caused the crisis. Nevertheless, what is more crucial is the quality of government intervention[7]. To claim government failure in the financial sector and the functioning of the capital stock is to under-estimate the market mechanism which was still at work during the time of crisis. Under the paradigm the government was merely an administrative agent in directing the rather free-market economy and by no means the sole principal agent which implemented strong central planning as in a communist economy. In this sense, it views the markets as imperfect but does not view government intervention as a substitute mechanism but instead as a complement in order to enhance the efficiency of the market mechanism.[8]

A framework to understand growth needs to be established and in so doing, alongside macroeconomic stability, the success of an economy can be analysed by assessing three functions of growth which are accumulation, efficient allocation and technological catch-up[9]. Via such functional approach, the East Asian development paradigm in the first instance failed to allocate the capital stock effectively. On the other hand, it was this model which was conducive to the distinctive growth of Asian Tigers plus the promising South East Asian economies particularly Indonesia, Malaysia and Thailand prior to the financial crisis. The neo-classical view regards the government intervention as a reason for the financial collapse and yet had those economies pursued neo-classical principle of free market economy the crisis might probably have been much severe. Rather, the interventionist approach in the economies concerned created a launchpad for growth for the economies which were not yet ready to be fully integrated in the global economy. The governments placed emphasis on capital accumulation via attracting higher levels of investment and one strategy pursued was to maintain the artificial over-valuation of domestic currency which would ensure low domestic prices of capital flows and dampen inflation[10]. The international popularity of the five 'crisis countries' – Thailand, Malaysia, Indonesia, the Philippines and South Korea in fact reflected international confidence in the region. Had financial institutions looked unfavourable there should not have been such massive capital inflows before the crisis. The benefits of high rates of investment and hence savings were straightforward. South Korea during 1950-2000 saw the highest rate of growth of any country. It is difficult to see how its policy of export-orientation per se could have led to such dramatic growth. It is arguable that its government managed to engineer a significant increase in the private return to capital in the early 1960s and how these interventions played a productive role in the overall economy[11].

Further, the financial crisis does not paint a picture of human capital and technological innovation. During 1980s troubled economy like Malaysia spent over 4% of its GNP on basic education[12], which was high compared with other LEDCs. Improvement in human capital is suggestive of that in social capability and thus it is easier for government intervention to succeed. With respect to technological catch-up, government policy in favour of export-orientation contributed to strategic change and continuity in the region's innovation. The GDP per hour worked in the 1990s shows a substantial potential for catching up with the West.

In conclusion, it is tempting to suggest that market-oriented policies as opposed to the East Asia development paradigm have been more successful in that the economies pursuing the former were not relatively affected. Nonetheless, the paradigm was rather market-enhancing and at least accounted for unprecedented growth in the economies concerned. The financial collapse was the consequence of financial liberalisation which the troubled economies' institutions had not yet fully developed to cope with but in other areas of development the paradigm has proven rather successful.

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