Published every March and September
ISSN 2302-5808
Jurnal Kajian Sejarah & Pendidikan Sejarah
SUSURGALUR

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A Study on the Asian Financial Crisis of 1997: What Triggered the Crisis?

ABSTRACT: *Since the 1960s up to 1997, several East and Southeast Asian countries had experienced rapid economic growth. Despite the region's economic miracle, it eventually faced the financial crisis at the beginning of 1997. Some observers had different opinions as to why the crisis occurred. This paper, using the qualitative approaches and theoretical review, attempts to explore the potential reasons that triggered the Asian financial crisis in 1997. The findings show that there are a number of explanations for the 1997 financial crisis, but none is adequate to completely understand it. According to some observers, the weaknesses of the financial sector are somewhat contributing to the severity of the financial crisis. This paper has also shown various factors in combination, there is no single explanation that is adequate for understanding the crisis. But, it can be argued that the potential triggers to the crisis were the weaknesses of some of the Asian financial sectors – lack of adequate systems of prudential regulation, poor banking supervision, excessive lending before 1997, the practice of crony capitalism (in the allocation of loans), and so forth. So, this paper intends to look at to what extent does the statement is reliable in explaining the occurrence of a crisis.*
KEY WORD*: Economic Growth; Asian Way; Financial Crisis; Mismanagement.*

IKHTISAR*: "Kajian mengenai Krisis Kewangan Asia 1997: Apa yang Mencetuskan Krisis?". Sejak tahun 1960-an hingga 1997, beberapa negara Asia Timur dan Asia Tenggara telah mengalami pertumbuhan ekonomi yang pesat. Meskipun keajaiban ekonomi di rantau ini, ia akhirnya menghadapi krisis kewangan pada awal tahun 1997. Beberapa pemerhati mempunyai pendapat yang berbeza tentang mengapa krisis berlaku. Kertas kerja ini, menggunakan pendekatan kualitatif dan sorotan teori, cuba mencari kemungkinan sebab yang mencetuskan krisis kewangan Asia pada tahun 1997. Dapatan menunjukan bahawa terdapat beberapa penjelasan untuk krisis kewangan 1997, tetapi tidak ada yang cukup untuk memahami sepenuhnya. Menurut ramai pemerhati, kelemahan sektor kewangan agak menyumbang kepada keterukan krisis kewangan. Kertas ini juga telah menunjukan pelbagai faktor dalam gabungan, tidak ada penjelasan tunggal yang mencukupi untuk memahami krisis. Tetapi, boleh dikatakan bahawa potensi mencetuskan krisis adalah kelemahan beberapa sektor kewangan Asia – kekurangan sistem peraturan berhemat, pengawasan perbankan yang lemah, pinjaman berlebihan sebelum tahun 1997, amalan kapitalisme kroni (dalam peruntukan pinjaman), dan sebagainya. Oleh itu, kertas kerja ini bertujuan untuk melihat sejauh mana pernyataan itu dapat dipercayai dalam menjelaskan berlakunya krisis.*
KATA KUNCI*: Pertumbuhan Ekonomi; Cara Asia; Krisis Kewangan; Salah Urus.*

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Suggested Citation: Suif, Nur Syazwani binti Haji Md. (2018). "A Study on the Asian Financial Crisis of 1997: What Triggered the Crisis?" in *SUSURGALUR: Jurnal Kajian Sejarah & Pendidikan Sejarah*, Volume 6(2), September, pp.109-116. Bandung, Indonesia: Minda Masagi Press and UBD Bandar Seri Begawan, Brunei Darussalam, ISSN 2302-5808.

Article Timeline: Accepted (July 3, 2018); Revised (August 31, 2018); and Published (September 30, 2018).

INTRODUCTION

According to J. Rigg (2002), since the 1960s up to 1997, several East and Southeast Asian countries had experienced rapid economic growth. This was, to some extent, a result of the rise of ambitious Asian capitalists throughout the years which eventually led the region towards its "miracle" (Rigg, 2002).

J. Rigg (2002), then, also mentions three possible explanations for the "Asian Miracle" – from Neo-Liberalist standpoint (Washington Consensus), Revisionist, and Culturalist. Neo-Liberalists believe that the reason for rapid economic growth in Asia, prior to 1997, was because they "got the basics right" – practising free market, limited government intervention, deregulation, and the privatization of the economy. The Revisionists, however, disagree with Neo-Liberalist's point of view. They believed that the economic growth was due to the State's involvement – the presence of Developmental State. They maintain that the market should be mediated, regulated, and guided by the State – "governing the market" – for economic growth. And lastly, the Culturalists believe the economic growth was the result of their cultural values in the "Asian Way" – maintaining the idea of hardworking, loyalty/respect for authority, scholarship and learning, the importance of family connection, and so forth (Rigg, 2002:142).

This explanation, however, was debated by some scholars, such as C. Tremewan (1994); I. Buruma (1995); and others, who argued that such cultural value like "Asian way" could not be utilized to explain Asian economic growth as the region itself was culturally diverse. Therefore, it is not legitimate to say a single set of cultural values like "Asian way" was, in fact, the factor behind the Asian miracle up to 1997 (*cf* Tremewan, 1994; Buruma, 1995; Thompson, 1999; Rigg, 2002; and Bell, 2006).

Despite the region's economic miracle, it eventually faced the financial crisis at the beginning of 1997. Some observers had different opinions as to why the crisis occurred. Some observers had agreed to the fact that the crisis was started when Thailand was hit with currency crisis, which later affected the region's economy. It also caused the sudden out-flow of capital from the region partly, due to their inadequate systems of regulation, inadequate supervision of the banking system, and so forth (Corsetti, 1998; Noble & Ravenhill, 2000; Joosten, 2004; Dowling & Valenzuela, 2010; and Head, 2010).

In this context, J. Rigg (2002), however, maintains that the three above-mentioned explanations for the Asian miracle provided primary factors behind the development of 1997 financial crisis – liberalization policy/privatization and de-regularization policy, government interference, and "Asian Way" (Rigg, 2002). Thus, creating the flaws of the financial sector in which somewhat contributing to the severity of the financial crisis.

This article, using the qualitative approaches and theoretical review (Caprio, Atiyas & Hanson eds., 1994; Stein & Lim, 2004; Acharya & Richardson, 2009; and Allen & Carletti, 2010), tries to analysis the outline of the possible triggers of the 1997 financial crisis in Asia. It will be analysed as follows: (1) *Currency Crisis in Thailand*; (2) *Policy Errors – De-Regulation and Liberalization Policy*; (3) *Crony Capitalism*; (4) *the Role of IMF or International Monetary Fund: A Savior?*; and (5) *Lack of Prior Research on Economic Situation: Over-Confidence on "Asian Way"?*

FINDINGS AND DISCUSSION

Currency Crisis in Thailand. Generally, some observers believed that the currency crisis in Thailand in 1997, and its devaluation of currency, was as

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a starting point for the Asian financial crisis (Corsetti & Roubini, 1999; Julian, 2000; Lai, 2008; and Dowling & Valenzuela, 2010). One argues that the crisis began when the Thai government changed its exchange rate system – from fix to floating exchange rate. The new shift, to some extent, that had caused the devaluation of Thai Baht, due to lack of foreign reserve (Berben *et al*., 2002; Lai, 2008; and Frankel & Rose, 2010).

The collapse of the new "floating Baht" had resulted in Thailand's lost about a fifth of its value. The financial crisis in Thailand, then, spread and affected the other Southeast Asian (Indonesia, the Philippines, and Malaysia) and East Asian (Japan and Korea) regions. For example, the Philippine Peso and the Malaysian Ringgit were under pressure as soon as the Thailand move was announced (Corsetti & Roubini, 1998; Julian, 2000; and Ranta, 2017).

Financial panic spread across the region and currency collapsed. Investors and companies involved were also dragged to the crisis – some companies had gone technically bankrupt (*cf* Corsetti & Roubini, 1998; Julian, 2000; Akyuz, 2002:16; and Ranta, 2017).

According to M. Beeson (2002), this event had led to a withdrawal of large amounts of capital from the Asian countries. As a consequence, there was "a major loss of (investor's) confidence in most of its economies, and collapse in foreign exchange and equity markets". Seemingly, this shows how "Thai currency crisis was transformed into a wider, regional, banking, financial, and economic crisis in the Asian region" (Beeson, 2002:140).

The IMF (International Monetary Fund) was called to resolve the problem – to restore stability. However, instead of improving situation, a number of influential observers argued that IMF's actions only made things worse. Its intervention in the region has brought up the feeling of resentment as the region was made vulnerable to international system (Fischer, 1998; Beeson, 2002:554; and Gilbert & Vines eds., 2003).

IMF emergency fund was provided to the affected countries, but required tight budget and monetary policy. The result was an increase in non-performing loans and damage in domestic industries (Beeson, 2002; Woods, 2006; and Li, Sy & McMurray, 2015).

Policy Errors – De-Regulation and Liberalization Policy. Similarly, G.W. Noble & J. Ravenhill (2000) argue that the Asian crisis was basically brought up by the sudden outflow of capital from Asian countries. They, further, add that the countries' lack of adequate systems of prudential regulation and whose foreign exchange rate proved disastrous weak were the factors that made the 1997's crisis possible (Noble & Ravenhill, 2000).

The damage could only be prevented by introducing effective regulation and control of destabilizing capital flows. They also believe that the rapid increase of international capital inflow in Asia, in the 1990s, was also an important key to understand the development of the 1997 crisis (Noble & Ravenhill, 2000; Kawai & Lamberte eds., 2010; and Milne, 2014).

They looked also at the Asian policy error, which relates to their financial deregulation and capital account liberalization. For instance, Asian economies had followed the Japanese path of financial liberalization, granting financial institutions more freedom in borrowing and lending decisions, and introducing market-based monetary policy by loosening regulatory controls (Lee, 2000; Noble & Ravenhill, 2000; and Milne, 2014).

G.W. Noble & J. Ravenhill (2000) argue again that such policies were part of the errors that have certainly played a role in the outbreak of the crisis. In addition to the government adoption of fixed exchange rate policies also posed a problem (Noble & Ravenhill, 2000).

Y. Akyuz (2002) supports their statement by pointing out that this policy did initially give more freedom to financial institutions to diversify their assets for higher returns (Akyuz, 2002). In Southeast Asia, for instance, the result of such policy was the increasing foreign (Western and Japanese) interest – rapid capital inflow. They assumed that the growth exchange rate would continue and remain stable. They ignored their prudential limits on lending to companies with high debt ratios, because each wanted to win business. Consequently, Asian economies who undertook this financial deregulation faced the problem. This was due to having an inadequate regulation to cope with the capital inflow (*cf* Lee, 2000; Akyuz, 2002; Noble & Ravenhill, 2000; and Milne, 2014).

The uncontrollable inflow, then, invited over-money-supply and inflation. According to N.B. Walters (n.y.), over-investment resulting from that activity sparked a financial complication. The quality of investment deteriorated during this period as investors chose risky opportunities/ventures believing that they would be supported (by banks). The banks must accept responsibility. The bank, at this stage, was not supervised and, thus, could provide funds for investor's risky ventures (Walters, n.y.:196-197).

Besides, most banks (state-owned) believed that would be bailed out if something goes wrong. This created a moral hazard to domestic borrowers (excessive lending) with no risk of exchange rate leading the banks to borrow excessively from abroad and at home country. This, then, created an imbalance domestic and foreign debt accumulation and management. Later caused a negative downward spiral of declining confidence undermining local currencies, creating problems for domestic banks – failing banks (Claessens & Kose, 2013).

All in all, as G.W. Noble & J. Ravenhill (2000) argue, the Asian financial crisis was evidently the result of inadequate regulation to cope with the excessive capital inflow in Asia – lack of experience and expertise and the predominance of short-term debt, which made their economies vulnerable and, lastly, the role of banks with risky lending practices. All these weaknesses of financial sectors created economic instabilities in Asia in early 1997 (Noble & Ravenhill, 2000).

Crony Capitalism. Asian financial crisis, to some extent, could link to the nature of Asian capitalism. Crony capitalism in the region was no doubt played a role before the 1997 crisis as a major player in Asian miracle (MacIntyre, 1999; Prakash, 2001; and Winters, 2011).

According to Y. Akyuz (2002), the bonding between government and business institutions was also seen as a key element in economic development – the guiding role of the government to manage economic rents and prevent market failures, due to possible information and coordination problems (Akyuz, 2002).

However, the extensive government interference in financial systems later years had altered the Asian economies. R. Wade & F. Veneroso (1998) equate "crony capitalism" in the region with corruption and favouritism that led to the distortion of the market (Wade & Veneroso, 1998).

The government-support-businesses can be viewed as a puppet by which their activities or decisions were controlled or influenced by the government. The government had control over external borrowing and it guided the private investment (Wade & Veneroso, 1998; Prakash, 2001; and Winters, 2011).

For example in Korea, they had tapped external finance in its

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industrialization through borrowing from international banks, but this was subject to government approval and guarantee. Moreover, according to Y. Akyuz (2002), policy in financial sectors is also always important in coordinating private investment decisions – to avoid capacity and competition (Akyuz, 2002).

However, when the government had control over financial systems/policies, misallocation of resources and over-investment tend to take place. This explains why the country vulnerable to external debt and have a problem with its currency. For this reason, crony capitalism is a form of capitalism in the region that attributed to the 1997 financial crisis (Wade & Veneroso, 1998; Prakash, 2001; and Dowling & Valenzuela, 2010).

The supporters of this perspective give Singapore as a good example that survived the crisis without experiencing severe impacts like Malaysia, Indonesia, and Thailand. Singapore was believed to be one of the "cleanest" country in terms of corruption. The good quality of government and economic management made it less vulnerable to the impact of the financial crisis (MacIntyre, 1999; Rigg, 2002:147; and Ranta, 2017).

The Role of IMF (International Monetary Fund): A Savior? The IMF was called to resolve the problem – to restore stability. According to R. Wade & F. Veneroso (1998), IMF's involvement was designed to provide bridging finance, while a country gets the balance of payments in order. It seeks "to reduce current account deficits, keep inflation in check, and keep domestic demand in control" (Wade & Veneroso, 1998:11).

However, critics argued that IMF's actions only made things worse. N.B. Walters (n.y.) believes that IMF's introduction of tight monetary and fiscal policies to the affected countries was actually based on their misinterpretation of the situation as a balance of payment crisis (Walters, n.y.:198). In reality, they argues that the problem was basically about a crisis of confidence. The IMF policies only added panic and impetus to the existing crisis. The strictness of its policy did not restore confidence nor reassure investors instead deepened the economic contraction (Walters, n.y.; Wade & Veneroso, 1998; and Woods, 2006).

R. Wade & F. Veneroso (1998), further, add that the IMF's approach to the banking system, call for re-structural and institutional reform, was not needed to resolve the crisis – to avoid capital outflows and currency attacks (Wade & Veneroso, 1998). This includes the closing down a series of troubled bank and financial institutions; requiring banks to imitate Western prudential standards' requiring international/Western accounting standards; and international firms to be used for auditing of financial institutions. For this, critics have argued that IMF's intervention in the region could encourage the feeling of resentment as the region was made vulnerable to international system (Wade & Veneroso, 1998; Beeson, 2002:554; and Woods, 2006).

Besides, such a measure would never likely to revive economic confidence. Its policies of closing a series of banks and financial institutions in the middle of economic panic would not improve market confidence. In fact, this approach would give the opposite impact. For that reason, the IMF also played a role in worsening the Asian situation (Fischer, 1998; Gilbert & Vines eds., 2003; Stiglitz, 2006; Woods, 2006; and Li, Sy & McMurray, 2015).

Lack of Prior Research on Economic Situation: Over-Confidence on "Asian Way"? J. Rigg (2002) argues that the 1997 crisis had taken place due to "the failure of the academic and professional communities to predict the possibility that could lead to the downfall of Asian economic" (Rigg, 2002:139).

As mentioned above, some scholars in Culturalist position believed that the "Asian miracle" was literally the result of "the Asian way" – the belief in hardworking, loyalty/respect for authority, scholarship and learning, and so forth – for the development of Asian politics and economics (Tremewan, 1994; Buruma, 1995; Thompson, 1999; Rigg, 2002; and Bell, 2006).

The continuous success of "Asian way", to some extent, had resulted in a form of Asian hubris – believing that as long as the doctrine was maintained, the Asian economic would not have fallen (Thompson, 1999; Prakash, 2001; and Ahmad, 2003).

Due to such feeling of pride and over-confidence, little attention was given to warn or predict the coming crisis through research scheme (Rigg, 2002:139 and 144). Thus, such careless attitude is somewhat part of the potential reasons as to why the Asian financial crisis was able to take place in 1997 (Tremewan, 1994; Buruma, 1995; Thompson, 1999; Prakash, 2001; Rigg, 2002; Ahmad, 2003; and Bell, 2006).

CONCLUSION

Prior to the 1997 financial crisis, East and Southeast Asian region experienced an economic miracle. Some scholars believed that the rapid economic growth was the result of the Asian core cultural values – Asian Way – emphasizing hard work, loyalty and respect for family/authority, scholarship and learning, and so forth for the economic and political development in the region.

Despite their rapid economic growth in 1997, Asia experienced a financial crisis. Many observers agreed that the crisis started when Thailand experienced currency collapse. This affected the entire region of East Asia (Korea and Japan) and Southeast Asia (particularly Malaysia, Indonesia, and the Philippines). This caused a large amount of capital withdrawal from the region, a major loss of economic confidence, and a collapse of the foreign exchange rate.

Nevertheless, as this paper has shown various factors in combination, there is no single explanation that is adequate for understanding the crisis. But, it can be argued that the potential triggers to the crisis were the weaknesses of some of the Asian financial sectors – lack of adequate systems of prudential regulation, poor banking supervision, excessive lending before 1997, the practice of crony capitalism (in the allocation of loans), and so forth.

This paper also argues the fact that the IMF (International Monetary Fund) did play a role in worsening the crisis, especially when it introduced its misguided re-structuring and institutional reform packages in an attempt to resolve the financial crisis. Observers' quote such as, "there are a number of explanations for the 1997 financial crisis, but none is adequate to completely understand it" – that indeed is the case in this quest to finding the conclusive answer.[1]

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[1]***Statement:*** Herewith, I have declared that this paper is my original work; so, it is not product of plagiarism and not yet to be reviewed as well as published by other scholarly journals.

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