

“THE FREE MARKET” AND THE ASIAN CRISIS

ABSTRACT: *The Asian financial crisis, which devastated many of the newly industrializing countries, is said to have demonstrated the inherent fragility of economies built upon laissez-faire principles. However, it appears that the major sources of disruption have come from policies that deviate from laissez faire, such as government-guaranteed bailouts and international monetary policy. That capitalist economies were afflicted by the crisis does not constitute an indictment of free markets.*

Was the Asian financial crisis a failure of “the global free market”? Some have argued that it was; this faction includes George Soros and Prime Minister Mahathir of Malaysia, who declared in the midst of the crisis that the world’s governments needed “to bring order to the market” (Saludo 1998). The anti-“laissez faire” chorus also includes several economists, such as Paul Krugman (1998a). All of these opponents of what Soros calls “market fundamentalism” contend that the hypermobility of financial capital had a destabilizing effect on developing countries by allowing stampeding investors to bring about severe economic dislocation.

Others have maintained that such claims are misplaced, and that the problem in Asia wasn’t that the financial markets were too free; rather, markets were distorted by too much government interference. In this view, investors felt safe pouring money into developing Asian

economies because they had learned, especially after the 1995 Mexican peso crisis, that government agencies, including the International Monetary Fund (IMF), would come to the rescue if investments turned sour. This expectation, referred to as “moral hazard,” encouraged foreign investors to put their money into international investments after only minimal research: this was prudent, since government and quasi-government agencies were thought to be implicitly guaranteeing a fairly safe rate of return. And with so much capital flowing in, Asian businesses invested in projects that they would have rejected had funds been dearer. By 1997, however, investors came to realize that they were unlikely to earn the lofty returns they had expected, and so they pulled their money out, bringing financial ruin.

Are either of these analyses on target? Fortunately, economists and other international specialists have spent an enormous amount of energy trying to understand the causes of the Asian financial crisis, and have come to some tentative conclusions. However, the overarching historical issue of whether free-market policies per se caused the crisis has been somewhat obscured by economists’ preoccupation with policy analysis and advocacy.

In order to shed some light on the historical issue, I will begin with a brief narrative of the crisis, review some of the leading research on its causes, and then explain why it does not appear to be attributable to *laissez faire*.

### *The Asian Financial Crisis*

The crisis started with an attack on the Thai baht, leading to its devaluation on July 2, 1997. Until then, the baht had been pegged to the U.S. dollar. Thailand’s devaluation occurred even though the country held more than enough foreign reserves to convert its entire monetary base (bank reserves plus baht in circulation) into hard currency. Indeed, all of the countries where the crisis hit hardest—Thailand, Malaysia, Indonesia, and South Korea—held foreign reserves in excess of 90 percent of their monetary base plus all checking deposits.

After the baht devalued, investors speculated that other countries with economic situations similar to Thailand’s, and countries that competed with Thailand in export markets, might also be quick to devalue. (The same search for similarities apparently occurred after the Mexican peso crisis of 1995; see Sachs, Tornell, and Velasco 1996.) At the time

(and even today) economists weren't sure which perceived similarities with Thailand drove the bulk of the devaluation speculation in other countries, although the countries that devalued their currencies the most tended to have either a low ratio of foreign currency reserves to domestic, dollar-denominated short-term debt (emphasized by Radelet and Sachs 1999), or a high percentage of nonperforming loans—a possible indicator of future government-financed bank bailouts (emphasized by Burnside et al. 1998). Either of these problems could require a currency devaluation, although for completely different reasons.

Why would speculators think devaluations likely in countries that competed with Thailand in export markets? Investors are well aware that prices are slow to adjust to currency fluctuations, so that once Thailand devalued its currency, it would be temporarily easier for Thai firms to sell their now-cheaper goods to their customers both inside and outside of Asia. This would make competition tougher for, say, Malaysian firms competing in the same markets. If prices were perfectly flexible, mere exchange-rate changes would have no competitive impact; but since prices adjust sluggishly, Malaysia's exports became relatively less appealing compared to Thailand's on the day of the baht's devaluation. This was one of many forces encouraging the Malaysian government to devalue *its* currency, the ringgit; and speculators, knowing this, found it appealing to sell their ringgit to Malay banks for dollars immediately, in hopes of getting more ringgit after the predicted devaluation (Goldstein 1998).

What was predicted for Malaysia occurred there and in Singapore, Korea, and Indonesia. Much of the trade in these countries was domestic or was with other countries in Asia, so that even if a firm's level of sales remained unchanged after devaluation, the proceeds from those sales would be in the form of suddenly less-valuable Asian currencies. Businesses in these countries, however, had built up billions of dollars in dollar-denominated debt in the years of enthusiastic foreign investment. After the devaluations, such businesses had to repay their short-term loans in suddenly more-expensive dollars. Hence, the devaluations led to a deterioration in the balance sheets of many companies, with a greater proportion of their cash flow dedicated to debt repayment.

In response, many foreign investors called in or chose not to renew their short-term loans to firms in the affected countries. As these countries depleted their foreign-exchange reserves in attempting to defend their currencies, investors—concerned with both the inherent risk of their investments and the risk that they would soon be unable to turn

them into hard currency—pulled out en masse. Many Asian firms quickly found it difficult to sustain those of their day-to-day operations that had been financed with short-term lines of foreign credit. The withdrawal of foreign credit thus led to a widespread inability to meet payrolls and buy raw materials, devastating the Asian economies. Many firms quickly shrank, and others went bankrupt. Unemployment rates skyrocketed, and some Asian economies—that of Hong Kong, for example—experienced their first recession in decades.

### *The Free-Market Panic Thesis*

The foregoing summary of events has only hinted at possible causes of the crisis. One batch of explanations contends that the various crises were, in effect, circular: they happened because investors thought they would happen, and not (primarily) because of any fundamental weaknesses in the economies. This explanation is compatible with the view that free-market capitalism is inherently prone to instability caused by speculative frenzies.

Jeffrey Sachs (1997) is the best-known proponent of the circular panic model. In *The New York Times* he put it this way:

The Asian crisis is akin to a bank run. Investors are lining up to be the first out of the region. Much of the panic is a self-feeding frenzy: even if the economies were fundamentally healthy at the start of the panic, nobody wants to be the last one out when currencies are weakening and banks are tottering because of the rapid drain of foreign loans.

The power of this crisis-as-bank-run model lies partly in its familiarity: images of people standing in line outside U.S. banks during the Depression spring immediately to mind. We all know that the merest rumor of a bank's insolvency can sometimes bring about a bank run, especially in countries without deposit insurance.

Economists have some broad ideas about how bank runs are caused—everyone wants their money now, but only a small percentage of deposits are kept as currency—and how they can be cured: for example, with massive infusions of cash from the central bank. (The canonical model is Diamond and Dybvig 1983; an extension to the Asian crisis is Chang and Velasco 1998.) For the Asian crisis to be like a bank run, we need merely to relabel two elements of the model: for in-

dividual banks, substitute the central banks of each country; for bank depositors, substitute foreign investors who changed their dollars into, say, baht in order to fund their investments in Thai firms, and who then suddenly wanted their dollars back from the Thai central bank.

There is no international parallel, however, to the lender of last resort—the central bank that saves the day in the bank-run scenario; for at the international level, there is no agency with enough dollars to repay foreign investors. Once the “bank run” begins, in anticipation of devaluation, devaluation itself becomes almost unstoppable. Like a self-fulfilling prophecy, a bank run that starts for no reason makes the bank unsound for no reason other than the run itself; like a bank run, the expectation of devaluation, even if initially groundless, makes a previously sound economy unsound by inducing investors to withdraw their capital, causing a financial crisis; and, like a bank run, a financial panic can be prevented only if investors are confident of a “central-bank” bailout.

However, the historically inclined reader should question the notion that bank runs are inevitable in the absence of a central bank willing to print money. (The theoretically inclined economist will also object to this notion, although for different reasons). Private banks in the United States and other countries had tools to deal with bank runs long before central banks existed: when a panic struck, private banks would agree to lend money to their troubled competitors, as long as the troubled banks appeared to be fundamentally sound (see Calomiris 1998). These guarantees made bank runs less likely, and often stopped bank runs once they began. So in Asia, why didn't large financial firms or other countries come to the rescue of the troubled economies, just as Walter Bagehot urged a century ago, lending “freely, at penalty interest rates, on appropriate collateral” (quoted in Feldstein 1999, 94)?

The answer to this question has led to an entire literature in international macroeconomics concerned with (roughly) how high interest rates will go in a country in crisis before it decides to give up on defending its currency and simply devalue (e.g., Obstfeld 1996). Raising interest rates by pulling domestic currency out of circulation is the classic way to defend a currency. By paying a higher interest rate, the country in crisis makes it more appealing for investors to keep their money there and bring new money in. But high interest rates have an enormous cost: by raising domestic firms' interest payments, their investment is curtailed, and so, indirectly, are domestic consumption and employment.

These features can be a source of self-fulfilling currency crises: if in-

vestors know that a country would be unable to defend its exchange-rate peg if it were fiercely attacked, then whether a devaluation occurs depends entirely on whether investors decide to exchange the currency for another one. This is why countries such as Hong Kong and Taiwan, which had foreign-exchange reserves that dwarfed those of Thailand, Indonesia, Malaysia, and South Korea, made poor speculative targets.

While Thailand, Malaysia, Indonesia, and South Korea had fewer foreign-exchange reserves than some of their neighbors, the weaknesses of their banking sectors also appear to have contributed to speculators' suspicions. Problems of moral hazard and weak financial systems have been common in the developing nations of Asia, and may have played a major role in the crisis.

### *Asia's Politicized Economies*

The IMF's bailout of Mexico during the 1995 peso crisis may have encouraged investors to set aside reservations about investing in the developing countries of Asia, but if we want to explain the devaluations themselves, a bigger culprit appears to be the fact that "politically connected individuals or institutions—Thai finance companies, members of the Suharto family, *chaebol*-controlled banks—were widely perceived to be backed by implicit government guarantees" (Krugman 1998b). When the IMF bails out investors, it pays them in hard currencies. The Asian governments, however, could back up *their* implicit guarantees only by running budget deficits to bail out investors—deficits that would likely be paid off via the printing press.

The perverse incentives that the IMF provided surely added to the overall level of indiscriminate investment, but it appears to have been the unwritten guarantees provided by Asian governments that convinced investors that the printing presses would soon be starting up. As investors began to see a lot of bad debts accumulating, they began to fear that Asian governments were going to have to make good on their unwritten guarantees. This caused the relevant currencies to fall in perceived value, putting irresistible downward pressure on the exchange-rate pegs.<sup>1</sup>

Craig Burnside, Martin Eichenbaum, and Sergio Rebelo (1998) have pursued this line of thought. They start by observing that while the four Asian countries they study (Korea, Thailand, the Philippines, and Malaysia) had abundant hard-currency reserves, these countries'

banks held many nonperforming loans, and their financial sectors had declining stock valuations during the years before the crisis; these declines ranged from 34 percent in the Philippines to 92 percent in Thailand. While nonfinancial stocks took a beating in all four countries, bank stocks performed far worse. Burnside et al. infer that investors expected governments to bail out the firms that owed money to the banks—not the banks themselves—by printing money and handing it to indebted firms. (Equivalently, the governments could be expected to make loans to these firms at below-market rates, with easy repayment schedules; either method would boost the money supply, devaluing the currency.) Had investors expected governments to insure the banks themselves, then the stock-market outcomes should have been reversed: financial stocks should have done better than nonfinancial stocks.

Part of this model's appeal is that it doesn't require that devaluation occur as soon as bad news about banks hits investors. This fits the observed data, since no big news occurred in the days before the speculative attack on the baht. However, the model also relies on a lot of guesses about unobserved variables regarding such factors as governments' unwillingness to raise taxes rather than print money and the exact timing of the devaluations. But since it captures some key elements of the Asian crisis, and usefully links the devaluations with the weakness of the banking sector, it is a model worth keeping in mind. Perhaps future research will reveal whether key investors believed a bailout was coming. If so, then the weaknesses of these banking systems, combined with the prospect of government bailouts, would seem to explain the devaluations.

What about the recessions that followed devaluation? Many researchers, including Barry Eichengreen (1999), have concluded that the dollar-denominated debts of Asian businesses played a crucial role. With their locally or regionally derived revenue suddenly devalued, more of it had to be paid to foreign debtholders, diminishing Asian firms' future profitability and, therefore, making loans to them less appealing for prospective lenders. With fewer loans, less output can be produced. The question is, why did foreign investors make so many loans to companies in vulnerable countries in the first place?

Recent work by Burnside et al. (1999) demonstrates that a government's implicit guarantees, combined with a fixed exchange rate, can lead foreign investors to overlend quite rationally. Once this moral hazard-inspired overlending reaches a critical point, the currency devalues,

firms' balance sheets are severely damaged, and output and employment decline.

### *Global Capitalism Isn't Global Laissez Faire*

So: was the Asian crisis caused by global capitalism, or by the interventionist tendencies of Asian states and the state-controlled IMF? The short answer is Yes. The depth and severity of the Asian recessions—and possibly even the recessions themselves—were proximately caused by the free international flow of short-term financial capital, which fled when things turned sour. If the Thai, Malaysian, Indonesian, and South Korean governments had restricted global capitalism by limiting short-term financing from abroad (as Chile, for example, had done a decade before), and if they had met their short-term financing needs from domestic sources, then the mere devaluations of their currencies would not have trapped them in a liquidity crisis that soon turned into a solvency crisis. They never would have had to try to get their hands on tens of billions of dollars within a matter of days or weeks, and their dollar-indebted firms would never have been forced into bankruptcy.

On the other hand, extremely important deviations from *laissez faire* had already occurred, and seem to have been critical in causing the crisis. High levels of short-term, private-sector debt were an important precondition for the crisis (e.g., Uchitelle 1999). These high levels of debt appear to have been encouraged by governmental and quasigovernmental agencies that provided implicit bailout assurances. This form of state intervention—combined with mismanagement by government-empowered central banks, pegged exchange rates, and low levels of foreign exchange—appears to have engendered the perceived danger that began the crisis.

High levels of short-term debt alone were not a sufficient condition for a massive financial crisis, as the Singaporean experience shows. Singapore's foreign exchange holdings were massive (detering a currency run), and it already had acquired a reputation for having a "transparent" and relatively *laissez-faire* financial system (minimizing concerns over moral hazard). As a result, it had to weather merely a decline in its growth rate, while its neighbor, Malaysia, suffered a 7-percent drop in output.

There was an element of market-driven, self-fulfilling prophecy at work. But it is simplistic to conclude that this makes the crisis a prod-



uct of free markets. The global “free market” is hardly an arena of unmitigated laissez faire. If anything, it was state failure, not market failure, that produced the Asian crisis.

A free flow of short-term international capital was undoubtedly a necessary precondition of the Asian financial crisis. However, this particular laissez-faire aspect of global capitalism was not sufficient to cause the crisis. Indeed, were it not for *political* failures both global (IMF) and local (pegged exchange rates, low levels of foreign exchange), the flow of capital would simply have continued to alleviate Asia’s poverty, as had been the case before the crisis.

#### NOTE

1. It’s possible to make too much of the moral hazard argument. As many commentators have noted, real (inflation- and exchange-rate adjusted) interest rates were higher in the “Asian tigers” than in the developed world. Ordinarily, economists and financial analysts believe that there is a tradeoff between risk and return: a higher return on investment compensates the investor for taking a higher risk. But in the absence of moral hazard, they would have been even more nervous, and therefore more cautious. High Asian interest rates indicate that investors must have been at least a little nervous about the risks involved.

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