Chapter 2

Why Was the 1997 Crisis So Severe?

Introduction

Start of the Crisis

There is broad agreement among economists on what triggered the financial crisis in Thailand on July 2, 1997. As Thai exports sagged, imports surged, and official reserves dwindled, the government of Thailand tried to maintain the exchange rate between the baht and the U.S. dollar at an unrealistic level. This might have been a relatively routine situation, warranting a currency devaluation and modest changes in the Thai economic policy.

However, it soon became clear that there were other circumstances that quickly complicated a response: the Thai financial sector was highly leveraged and poorly regulated; the Thai government had encouraged the creation of thinly capitalized “finance companies” to provide competition to the commercial banks, but many of these firms took excessive risks; local entrepreneurs had counted on a fixed exchange rate and had borrowed large quantities of foreign currency on a short-term basis to fund long-term projects; an extraordinary “bubble” had developed in the Thai real estate market because of overinvestment in residential and commercial properties; and it was gradually revealed that the Central Bank of Thailand had falsified its data on official foreign exchange reserves. Because Thailand had liberalized its currency and capital markets and investors could sell at least part of their Thai assets, they did. The short-selling of the Thai currency and the avalanche of equity sales led to the plunge in the baht and the start of the financial crisis of 1997.1

Three principal theoretical models are widely used in explaining the start of financial crises. These models focus on specific circumstances, but, as we will see, any one country can face multiple difficulties and have a range of causes for its distress.2 The first and most common cause is an unsustainable macroeconomic policy, where overly expansionary monetary or fiscal policy or a misaligned exchange rate leads to a loss of foreign exchange reserves and a serious loss of confidence in the country’s direction.3 A second and more complex situation to analyze is when a country’s economic condition is subject to sufficiently different assessments, where foreign and domestic
investors and even government officials are uncertain what would be a stable exchange rate level. This condition of multiple equilibria creates market instability. A third cause, which has gotten a great deal of attention in the last decade, is moral hazard, where governments or international financial institutions use resources (foreign exchange reserves, loans, or guarantees) to continue an unsustainable policy. In this latter case, it is just a matter of time, until there is a major correction.

As we explore the Thai situation and the circumstances of the other countries most adversely affected in 1997 (Indonesia, South Korea, and Malaysia), we will see that each country had multiple problems and that each of the theoretical models above is useful in our discussion.

Spread of the Crisis

As the Thai currency and stock market collapsed (both losing over 40% of their value in 2 weeks), the initial reaction in East Asia was surprise but confidence that the crisis would not spread. Many observers looked at the basic macroeconomic data for East Asia and concluded that Thailand was the exception. The World Bank’s volume *The East Asian Miracle* had stressed how “orthodox” macroeconomic policy was in the region.

If we look at Table 2.1, we note that Indonesia, Malaysia, the Philippines, and Singapore all ran budget surpluses in 1996 and 1997. In addition, these countries had conservative monetary policies and high savings rates. Thus, if one analyzed the Latin American crises of 1982 and the Mexican crisis of 1994 (where there were large fiscal deficits and irresponsible monetary policies), the Asian situation seemed quite different. In fact, if one focused predominantly on budget deficits, it would appear that Southeast Asia was in good shape and Northeast Asia and South Asia had bigger problems. See Figure 2.1 for a comparison of Northeast Asian and South Asian fiscal data. It is significant that China, Japan, India, and Pakistan all ran major budget deficits in 1996 and 1997, yet did not have financial crises.

Yet, as quickly became obvious, the 1997 financial crisis was not just about deficits and government spending; it was mostly about volatility and vulnerability in the private sector and the interaction between private financial flows and public responses. Although Japan was (and still is) running enormous fiscal deficits, it had massive foreign exchange reserves and extremely high levels of personal savings; thus, its currency and financial system were less vulnerable than those in Southeast Asia. China, India, and Pakistan looked lax in their budget deficits, but each had currency controls and highly regulated capital markets; hence, they too were insulated from the panic selling that started in Thailand and then hit Indonesia, Malaysia, and finally South Korea. Some observers have argued that 1997 crisis was unnecessary and precipitated by currency speculators. Dr. Mahathir Mohammed, the former prime minister of Malaysia, promoted this view in a very strident fashion. In August 1997, at Malaysia’s Independence Day commemoration, Mahathir said, “If we do not strive to protect our independence, directly or indirectly, colonists will return to colonize us.” At the 1997 annual meeting of the IMF in Hong Kong, Mahathir went farther, saying, “Currency trading is unnecessary, unproductive and immoral . . . We know that economies of developing countries can be suddenly manipulated and forced to bow to the great fund managers who decide