The Global Financial Crisis and Asian Economies

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1. Introduction

Since the global financial crisis originated from the Wall Street on the September, 2008, Asian economies also had a very hard time. Their financial market began to turmoil and macroeconomies to be unstable. Stock prices in major Asian countries fell rapidly and foreign exchange rates fluctuated very much. It is no wonder that economic growth rates began to fell and trade volumes among countries to decrease.

In this paper, we try to examine the economic effects of global financial crisis on Asian economies. We do not try to show how much economic growth rate of Asian countries will falls or what time the stock prices will rebound. Rather, we try to do it by more qualitative methods. First, we first examine the traditional financial crisis theory and try to explain the current one by it. Second, we compare current financial crisis with previous ones such as 1997-98 Asian financial crisis or Latin American debt crisis during 1980s. Then, we try to figure out the important characteristics of current financial crisis and finally, we try to explain the effect of this financial crisis on Asian economies based upon it.

1. Financial Crisis in Theory.
2. Twin Crisis

 Generally, financial crisis is composed of two different crises such as a banking crisis and a currency crisis.[[1]](#footnote-2) The banking crisis means that the financial activity suddenly drops because of closure or bankruptcy of banks or other financial institutions. We also may mention it a banking crisis that government takes very strong actions to restructure the financial industry to prevent the future bankruptcy of financial institutions. If a banking crisis occurs, the credit crunch will happen because bank’s creating activities will shrink. As a result, economic activities will seriously decline and finally, production will fells and unemployment rate will increases. Major cause of a banking crisis is an increase of the non-performing loans caused by the improper management of banks credit risk. Macroeconomic unstability may be the indirect reason for it because the recession or speculative bubbles may cause economic recession.. If a banking crisis happens, government initiates banking restructuring actions to overcome it.

A currency crisis is different from the banking crisis because it is a phenomenon in the currency market. The currency crisis generally indicates the cases when the fixed exchange rate system collapses, when the exchange rate under the flexible exchange rate system rapidly changes, or when a central bank spends so much foreign exchange reserves to prevent the rapid exchange rate change. Major causes of the currency crisis are a large amount of current account disequilibrium or an attack on a specific currency by a speculator in foreign exchange market caused by a rapid change in expectations of foreign exchange rate. So the government tries to change exchange system to overcome it and to accumulate enough foreign exchange reserve to prevent it. When a currency crisis happens, a government tries to raise the interest rate and reduces the capital outflow to stabilize the exchange market. In some cases, it asks liquidity assistance to the foreign government or international organization such as IMF. Restrictive marcoeconomic policy or accumulation of foreign exchange reserves on a central bank is crucial to prevent the currency crisis.

In conclusion, we may say that these two crises are different in sense that a banking crisis is more related into microeconomic factors in the financial market, while a currency crisis is into macroeconomic phenomenon.

It is known that banking crisis and currency crisis occurred independently before 1980 in many cases.[[2]](#footnote-3) According to Kaminsky and Reinhart(1999), there is no apparent link between currency crises and banking crises during the 1970’s. But after 1980s, following the liberalization of financial markets across many parts of the world, banking and currency crises become closely entwined. The problem of banking sectors makes such a large amount of capital movement that the currency market becomes unstable.

1. Contagion of Crisis

It is very popular that a financial crisis makes a contagion effect to neighboring countries. If it happens in one country, soon neighboring countries may have a risk to have it. We have seen some examples of financial crisis contagion such as 1997-98 Asian financial crisis, 1982 Mexican financial crisis, and 1992-92 ERM crisis etc.

According to Mason(1999) and Moser(2003), there are three different channels that the financial crisis looks to move from a crisis originating country to neighboring countries. First, there is an expansion effect. A rapid depreciation of a currency of crisis originating country makes a current account of neighboring countries deteriorate. In addition, a recession caused by a crisis originating country reduces the demand for the import from the neighboring countries. As a result, a new depreciation pressure happens at a neighboring country and it has a risk to have a currency crisis.

 Second, there can be a monsoon effect. A monsoon effect means the case when two or more countries receive a similar shock from the outside. At first, a relatively weak country falls into a crisis, but later the healthy one also falls into a crisis if the negative shock continues. Even if the cause of the crisis is the same, it seems that one country fall into a crisis at first and the next one does because of contagion. Suppose that there are three countries exporting similar commodities to the outside of the world. If the price of export product falls significantly, a most week country will fall into a crisis at first. But the other countries may have a risk to fall into a crisis later.

Third, there is a ‘pure contagion effect’. It focuses more on the properties of the financial market to explain the contagion of currency crisis. A currency crisis may happen because of self-full filling expectation.[[3]](#footnote-4) According to it, a simple change of expectation of investors in the foreign exchange market or stock market may cause a currency crisis or a banking crisis. Suppose that one country has a currency crisis, then the uncertainty and risk of stock market or currency market of that country will increase very much. Since the financial market of the neighboring countries are closely related that of crisis originating country, the market uncertainty or risk of the neighboring country will also increase. Finally, it has a more chance to have a currency crisis, too.

1. Characteristics of Current Global Financial Crisis
2. Crisis Origin and Contagion

The current financial crisis originates from the United States. Several elements are chosen as cause such as (1) speculative bubbles in the real estate market, (2) expansion of bank credit and financial derivatives and (3) poor management of investment banks. In addition, lack of proper supervision and surveillance of monetary authority or supervisory agency on the financial market are also said to add to them.

United States is one of the most advanced countries, which is known to have the most efficient financial system and market. As a result, it is very surprising that the financial crisis happens in the US because the financial crisis usually happens in the developing countries. We may show so many cases of financial crises happened in developing countries. The good examples are the Latin American crisis during early 1980s and the Asian financial crisis during 1997 and 1998. It is because the poor management of financial institution, unskilled supervision on it and retarded foreign exchange market generally belongs to developing countries.

We may say that the current financial crisis belongs to a banking crisis because it begins with the insolvency of the major financial institutions in US such as Lehman Brothers or AIG. Improper management of credit risk is considered the main causes of it.

The important characteristics of these financial institutions are that troubled financial institutions are very large financial institutions and that their business activity covers not only the US but also the world financial market. They take the financial resources from savers of all around the world and invest them through the world as well.

We are sure that US and other advanced countries will eventually overcome a current crisis. But during that time, they should experience very hard time because they have to take a very dramatic restructuring procedure in the financial market. Considering that the importance of financial market in this country is higher than those of developing country, its impact may be bigger than we expected.

1. Currency Market

At this time, we can say that both the currency crisis and banking crisis happen at the same time. While the main problem is caused by the rapid increase of non-performing loans caused by the real estate bubble, the currency market also shows a sign of turmoil. Or if not, we may say that the currency of crisis originating country at least takes the weak position in the currency market.

This fact looks true when we see the exchange movement of US dollars against major currencies such as Euro or Yen. The US dollar depreciates against Euro in September and October of 2008 more than % percent just after the crisis happens.

However, this theory does not fit well when we look at the movement of the foreign exchange rate of US dollar against to currencies of Asian developing countries. US dollar appreciates against the currencies of developing countries such as Korean won, Thailand Baht, etc.

1. Global Financial Crisis and Asian Economies
2. Asian Economies Before crisis

The macroeconomic conditions of Asian countries were relatively stable before crisis. Their economic growth rates were reasonably high and unemployment rate were low. More importantly, government budgets were in balance and current accounts balance recorded surpluses in most countries. While some countries had problems of inflations, it was consider as manageable. Moreover, it was not due to the expansionary monetary or fiscal policy but due to the historically high oil price of 2007 and early 2008.

The financial markets in Asian economies were not in the bad shape, either. The effect of restructuring process on the financial industry of late 1990s and early 2000s still worked. Financial institutions kept sound balance sheets and the amounts of their non-performing loans are under control. While the stock price or land price of some countries has increased during 2006 and 2007, it did not reach the level of national speculation.

The foreign exchange market and system are also managed properly. After the financial crisis of 1998, most Asian countries change their exchange rate system from fixed one to flexible one. In addition, most central banks kept so much foreign reserves to take care of speculative attacks. Furthermore, by the currency swap agreements among central banks of this region, so-called Chiang Mai Initiative, central banks can use foreign exchange reserves of other countries up to 80 billion dollars.

1. Contagion of the Crisis

After the current crisis begins in US, Asian countries receive very serious and diverse impacts from it. The first and immediate impact of the crisis is a pure contagion effect. US financial institutions have invested so many amounts of capitals to Asian market for the past 20 years after the financial market in Asia begin to open in early 1990s. Consequently, financial markets of Asia are closely linked with that of US. When the crisis begins in the US, the uncertainty of financial market in the US has increased very much. Investors in the US fall into panic and begin to get the similar expectations to the Asian market. They tend to manage their portfolio very conservatively.

In addition, the fact that the US dollar is the safest international financial asset also accelerates the demand for US dollar to increase in this region. In Asian region, still most of trade and financial transactions are done in terms of US dollar.

Another effect is the liquidity shortage of US financial institutions. As the crisis begins in September, 2008, US financial institutions realize the liquidity shortage problem. To solve it, they try to withdraw their investments in Asia, which result in acceleration of the capital outflows in the Asian market. For this reason, the stock price fells and currencies of Asian countries take the weak positions in Asia. We may call it as a short-run effect of a current crisis.

As seen in Figure 1, after September of 2008, when the Lehman-Brothers applies Chapter 11 to the New York court, the major currencies such as Euro or Yen appreciate continuously. However, many currencies of Asian countries depreciate while Chinese RMB maintains at the constant level. The government or central banks of Asian countries do not take any serious action to depreciate their currencies. Rather, it is the market force to make their currencies weak. Actually, central banks try to prevent their currencies from rapidly depreciating.

The second impact is an expansion impact, which is more related to the macroeconomy. As the US and other developed countries fell into recession caused by the current crisis, their imports from Asian countries eventually decrease. Since the main engines of growth of Asian economies are the export sector, and the exports to US and other developed countries take a large portions of their exports, this expansion effect may seriously deteriorate the economic performance of Asian countries. Unless the US or other developed countries fully recovers, the exports to these countries will not recover well. .

1. Overcoming the Crisis

Considering the two facts that the current financial crisis originated from US and that Asian countries soundly manage their marcoeconomy and financial market, overcoming the current crisis will depend upon how to block or to take care of the pure contagion effect and the expansion effect from the US. As seen in above, the current crisis is not caused by the insolvency of financial institutions in Asia. Their credit risks are still manageable and they do not experience the speculative bubble on the national scale.

As for the pure contagion effect, we may say that most Asian countries already overcome it. It is true that for the past several months, the stock market and foreign exchange market show very big turmoil and participants of these markets have a very hard time. But, recently the price of stock market rebounds and foreign exchange rate become less volatile. Furthermore, US financial market begins to show some sign of stabilizations.

We think two important factors help to resolve this pure contagion effects. First, Asian financial institutions are relatively well managed before crisis. We may say that the restructuring process of financial market after the crisis of 1997 and 1998 are quite successful, while it was very painful during the process.

Second, central banks of these countries accumulate enough foreign exchange reserves to protect their currencies from a speculative attack. For the past ten years, many Asian countries record surplus of current account and their central bank increase their foreign exchange reserve. In addition, they make a good framework of policy cooperation. For example, the finance minister of ASEAN + 3 countries meet regularly and make progress their cooperation, which eventually gives a very good signal to the market.

As a result, now we only have to deal with expansion effect of this crisis. As for the macroeconomic policy, we think that governments of Asian countries are on the right track to overcome the expansion effect. According to the economic theory, expansionary aggregate demand management policy is required to overcome the current crisis, including both domestic demand and foreign demand.

Many Asian countries already announce and take many policy measures to promote the domestic demand after the current crisis. They follow the standard macroeconomic policy remedies such as reducing the interest rates and increasing the government expenditure.

Surprisingly, the external balance of Asian countries shows a very positive sign, too. Because of the ‘pure contagion effect’, most currencies of Asian countries depreciated after the crisis of US happens.

This several months of depreciation make a positive impact on their trade balance because it makes improve price competitiveness of Asian export products over other countries. After the January or February of 2009, the trade balances of these countries begin to improve significantly. It is expected that most of Asian countries will have a trade surplus during the year of 2009. In the case of China, the exchange rate did not change but still it records a trade surplus now.

Considering these effects, we think that the Asian countries will have the less impact by the crisis than we expect, while the US and western countries including UK and some European countries will have more hard times.

1. Conclusion.

In this paper, we try to figure out the impact on Asian financial market of the financial crisis originated from US. For this purpose, we show the financial crisis theory and examine the exchange rate movement of major Asian countries.

We find that Asian countries have received two effects from US: a pure contagion effect and an expansion effect. Fortunately, it seems that we have already succeeded in defending a pure contagion effect. A stable macroeconomy, a large accumulation of foreign exchange reserve and a financial cooperation among Asian countries may be the main reasons for it. Especially, the financial cooperation among Asian countries makes a crucial role to prevent this pure contagion effect. Bilateral CMI was not enough but effective in some sense. In addition, frequent meetings among finance ministers of member countries help to give confidence to market participants. Especially, agreement of launching a multilateral CMI contributes to building up the confidence of policy coordination among member countries.

Finally, we think that Asian countries will recover faster than other regions. The pure contagion effect of the current crisis makes the local currencies of Asian countries to depreciate and their competitiveness to improve. We may say that Asia may be an origin for the recovery of world economy. As their economies recover, people of these countries will purchase more foreign goods and they will import more. Finally, it will make a positive contagion effect on the other countries.

<Reference>

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Figure 1. Foreign Exchange Rates of Major Currencies

1. After January 2008
2. After September 2008

Source: Bank of Korea. Ecos.bok.or.kr

1. Currency crisis is often called as a balance of payment crisis or a foreign exchange crisis. [↑](#footnote-ref-2)
2. Kaminsky and Reinhart(1999) [↑](#footnote-ref-3)
3. This theory is called by a second generation theory of currency crisis. [↑](#footnote-ref-4)