Symposium on the Asian Crisis, 1997
Introduction ...................................................... Kar-yiu Wong

Contagion or Inductance? Crisis 1997 Reconsidered ......................... Henry Wan, Jr and Wing-Keung Wong

Housing Market Bubbles and the Currency Crisis: The Case of Thailand .......... Kar-yiu Wong

Neighbour-Immiscerizing Growth: The Asian Crisis ................. E. Kwan Choi

Real Exchange Rate Overshooting and Capital Controls in a Crisis . ...... Joshua Aizenman

The Choice between Flexible Exchange Rates, Capital Control and the Currency Board in Asian Countries: A Perspective from the “Impossible Trinity” .......................................................... Koichi Hamada and Yosuke Takeda

Financial and Corporate Sector Restructuring in South Korea: Accomplishments and Unfinished Agenda .................... Choong Yong Ahn


The Asian Crisis and Economic Change in China. .................. Yongzheng Yang and Rod Tyers

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1 For a good account of what happened in 1997, see e.g. Wong (1998), or visit the Asian home page at http://faculty.washington.edu/karyiu, which contains a chronology of the events, country reports and a reference list.

2 The reports can be downloaded at the above web site.

3 The above-mentioned web site gives information about these conferences and access to all papers presented at the conferences. A third conference on the crisis was held on the campus of Tokyo University in July 2001.

4 The conference was jointly sponsored by City University of Hong Kong Faculty of Business, University of Washington College of Arts and Sciences, and University of Washington Center for International Business Education and Research. Thanks are due to these units for generous financial support.
readers can gain a comprehensive idea of how certain features of the crisis have been analysed. Roughly speaking, three papers examine the causes of the crisis and suggest theories to explain its occurrence; two discuss some of the features of the crisis, while the remaining three focus more on the effects of the crisis and on post-crisis adjustment.

The papers by Wan and Wong, Wong, and Choi discuss possible causes of the crisis. By taking different approaches to the crisis and analysing it from different angles, they come up with different theories. However, they have one element in common, which sets them apart from many of the other papers. Although the crisis brought troubles to the financial markets of many countries, leading many people to call it the Asian Financial Crisis, these three papers focus instead on the “real” economies, and examine how some real variables might have led to such a disastrous financial crisis.

The paper by Wan and Wong investigates how a country with solid fundamentals may be affected by a crisis in another country. The authors note that crises occurred in many countries within a short period of time: it might have started in the Czech Republic, and then moved to Thailand, Malaysia, Indonesia, Korea, Brazil and finally Russia. They noted further that the financial markets in London, New York and Tokyo were, however, left intact. The crises in these countries could have been coincidental, but many people seek to explain the sequential occurrence of the crisis in terms of the Contagion theory. According to such a theory, those countries that were affected must belong to the same network, and there must be direct or indirect links (through third parties) between them.

Wan and Wong suggest an alternative theory, which they call the Inductance theory. They argue that a crisis in one country can spill over to other countries even if these other countries do not belong to the same network, and even if there are no links between them and the originating country. According to this theory, inductance can occur in a world of uncertainty and imperfect information. When it is known that an investment has gone sour, but is not known which countries or firms going to be affected by the failure, banks and creditors in other countries may become conservative and reduce their lending. As a result, debtors in the latter countries could be hurt by the reduction of credits and a crisis could occur even if the fundamentals of these countries are still sound. According to this theory, transmission of the crisis from one country to another does not require the affected firms to be in the same network.

Wan and Wong’s theory has important policy implications. While the Contagion theory recommends better compartmentalization of risks through the setting up of “firewalls”, the Induction theory puts more emphasis on the need for stricter financial supervision and a higher degree of “transparency”. With more perfect information, creditors would not be over-conservative, and would not be needlessly affected by an investment failure in another country.

Wong puts forward another theory. The crisis begins with a sufficiently large sector such as the housing market in Thailand, the first Asian country to cease defending of its currency against speculative attacks. This market had been experiencing over-optimism, over-investment and over-borrowing before the crisis, causing “bubbles”. The loans to Thai firms were made by local financial institutions, which in turn had borrowed heavily from abroad, usually short-term because of the more favourable rates; and most of the foreign debts were denominated in foreign currencies, because of the confidence in the domestic exchange rate under the pegged exchange rate regime. Soon the “bubbles” in the market burst and the market collapsed, causing widespread bankruptcy and defaults. The problems in the housing market dragged down the whole Thai economy.

To explain what happened, Wong proposes a theory that is based on the following pre-

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liberalization of capital control) might affect exchange rate adjustment and welfare of the economy.

Aizenman notes that Korea relaxed its restrictions on foreign capital inflow after the crisis, and the resulting capital inflow has helped ease the depreciation pressure on the currency, thus diminishing the extent of overshooting of the currency. However, Aizenman is quite sceptical of how this policy may improve domestic welfare, because domestic equities were sold at a discount. He argues that, even if the net gain is significant, using temporary capital controls to prevent capital flight, as Malaysia did, could lead to similar welfare effects for the domestic economy.

Hamada and Takeda examine the following questions: why did different countries choose different policy responses and can these policies be compared and ranked? They pay special attention to three policy regimes: flexible exchange rates, a currency board and capital control. In analysing these regimes, they start with the traditional proposition of the "impossible trinity": a country must give up one of the three objectives of exchange rate stability, monetary independence and capital mobility: it cannot achieve all three. Therefore each of these three policy regimes can attain at most two of the above three objectives.

Hamada and Takeda compare these policies in terms of the criteria of the degree of overshooting, the change in country risk, the degree of strength in the monetary contraction, and the severity and duration of the recovery process. They investigate the experience of Indonesia, South Korea and Thailand, and compare their experience with that of Argentina, Brazil, Chile and Mexico. One conclusion the authors draw is that no single regime dominates the other two. They also note some important features of the adjustment of these economies after the financial shock: for example, the rigidity of the domestic price levels right after the crisis; the smooth adjustments of economies such as South Korea and Thailand; the relatively smooth transition of the Malaysian and Chilean economies after the imposition of capital control; the problems of the currency board in Argentina; and finally the wide range of adjustment costs arising among the countries switching from a fixed to a flexible exchange rate regime.

The other papers in this issue focus more on the adjustment of various economies after the crisis. Ahn examines the adjustment of the Korean economy, which has attracted a good deal of analysis, in part because the crisis arose so suddenly and in part because the economy recovered so well thereafter. Ahn attributes the crisis to the difficulties in Korea's corporate and financial sectors. The paper begins with a careful description and analysis of the economy immediately before and after the crisis. It then turns to the restructuring of the financial and corporate sectors. The work done in these sectors and their subsequent performance are described. However, despite the efforts made by firms in these sectors and the government, and despite the rapid recovery of the economy in 1999, Ahn concludes that Korea has yet to complete the reforms it has committed itself to for the IMF and the global community. Thus, more reform and work are called for. The paper makes several recommendations for the further restructuring of the sectors, which should not be taken lightly by government policy-makers who want to ensure a healthy recovery of the economy and to minimize the chance of confronting similar crises in the future.

The paper by McKibbin, Wang and Coyle investigates how the crisis may affect global economic adjustment and the US agricultural trade using a multi-country, multi-sector dynamic intertemporal general equilibrium model. This study is important not only to

government planners, but also to those who have been following the foreign trade performance of the US economy. Over the previous years, the competitive advantage of the United States in agriculture has been rising, and Asia has been a reliable and growing market for US agricultural products. While agricultural exports currently account for about 20% of the US total agricultural production, about 40% of the US agriculture and food exports go to Asia.

The simulation carried out by the authors suggests that the Asian crisis, taken as exogenously given, has reduced US exports, domestic interest rates and the cost of intermediate inputs of production. The change in domestic interest rates and in the cost of intermediate inputs are favourable to domestic economic activities in interest-sensitive sectors and to the demand for agricultural products. However, the impact on domestic production is ambiguous, depending on whether the stimulus of domestic demand can offset the negative impact of declining exports.

Yang and Tyers, on the other hand, examine the relative contributions of external and internal shocks in China during the Asian crisis. Noting that China experienced a surge in the domestic saving rate before the crisis, the authors investigate how the crisis, which came from outside, and the surge in saving rate, which came from inside, might have contributed to the country's slowdown in 1998. They also try to determine the consequences of China's pegging its currency, and to learn how the surge in the domestic saving rate might have encouraged capital outflow during the crisis.

Yang and Tyers construct a global general equilibrium model to estimate the impacts of the external and internal shocks, and they consider three scenarios: the reference scenario, the "passive China" scenario with no domestic shocks, and the flexible exchange rate scenario. A comparison between the results of these three scenarios reveals the impacts of these shocks. For example, the crisis and the rising saving rate had a dampening effect on the domestic GDP and contributed to capital outflow. Perhaps a more surprising result they find that the rising saving rate had a contractionary effect on the domestic economy.

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REFERENCES


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See Wong (2000) for a theoretical analysis of the crisis in Korea and for more references.