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Term Paper
A Case Study of the 1997 Asian Financial Crisis & Foreign Exchange Reserves
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Introduction

The well-being of markets has an enormous impact on the daily life of the average person, without mentioning public and private institutions that make up the framework for a socially and economically prosperous society. Nevertheless, financial crises are when the assets of these institutions are devalued to the point of greatly damaging this framework. One such example is the Asian financial crisis of 1997-98, wherein the Asian economy, and, by extension, the world economy became greatly destabilized. Granted, there are intergovernmental agencies who act as a mechanism to re-stabilize markets such as the IMF and the World Bank, but they are not end-all-be-all solutions to the problem. This paper will be divided into two complementary sections to vulgarize how financial globalization has been accompanied by recurrent financial crises on the international stage. Mexico in 1995, East Asia in 1997, Russia in 1998, Turkey in 1998 and 2001, Brazil in 1999 and Argentina in 2002 are all examples of the fact that developing countries cannot rely on the International Monetary Fund or reforms to survive and thrive (Rodrik, 2007). As American economist Martin Feldstein stated, “international financial architecture is not a hero for all”. This paper will dive precisely into the Asian financial crisis, showing its causes and its consequences on the most affected countries and elaborate on the cost of foreign exchange rates and all that comes with it, from the opportunity cost of self-insurance to the optimality of current reserve policies with each respective countries’ GDP.

Hypothesis

Generally, financial crises occur when institutions and/or assets become overvalued and, in turn, the overvaluation is addressed through shifts in the market, be it the customers of a bank or the bank completely failing; the latter was what happened during the Global Financial Crisis of 2007-08, where banks had to be bailed out by governments or, more recently, during the Russian invasion of Ukraine, where Russian banks were cut off by the Society for Worldwide Interbank Financial Telecommunication (SWIFT). In situations where banks fail, their customers are inclined to withdraw their savings in a panic, therefore causing an outflux of capital and subsequently devaluing the currency of the bank's respective country. So, according to these reasons, it is safe to assume that the 1997 Asian financial crisis was caused by a large loss of capital from the banks of the countries in the region, which surely affected the value of surrounding currencies in a negative way.

Description of the Asian Financial Crisis

Causes

The Asian financial crisis originally began in Thailand in July 1997, when, due to it exhausting its foreign exchange reserves, the Bank of Thailand reluctantly unpegged the Thai baht from the United States dollar to let it float (Ba, 2021). There was an excessive flow of short-term capital to the region during this time in the form of speculative short-term loans, which, when quickly withdrawn after (Fujita, 2000), effectively kick-started a series of currency devaluations and a massive outflow of capital. Export-led industrialization – what essentially made many Asian countries economically prosper during the latter-half of the 20^{th} century – makes it mandatory to have as large a world market for exported goods as possible. Thus, Asian countries avoid exclusive regionalism especially due to the risk of protectionist policies in the form of a hypothetical retaliation (Katada, 2002). These countries were heavily interdependent on one another. So, when the Thai stock market dropped 70% and the baht lost half of its value, a chain of speculative attacks on the baht and Thailand's neighbors' currencies occurred (Bazbauers, 2014). In Asia, the strong performance of many economies in the early 1990s had combined with a currency pegged to the U.S. dollar to attract inflows of 'hot money', mainly in the form of very short-term debt (Burke, 2001). This large short-term debt, coupled with inadequate regulation and poor investor protection led investors panic-selling and losing tons of money, which further fueled the burst of the bubble (Vithiatharan & Gomez, 2014). Likewise, from their early warning system model, Zhuang & Dowling (2002) argued that there were strong warning signals of heightened financial vulnerability in each of the five most affected countries prior to the crisis, which consisted of: appreciations of domestic currencies, deteriorations in current account positions, excessive external borrowings by banks, currency mismatches in balance sheets, excessive growth of domestic credit, economic slowdown and the burst of asset price bubbles.

Consequences

In the first six months of the crisis, the Thai baht had fallen down by over 50% in value, the Indonesian rupiah down by 80%, the South Korean won down by around 50%, and the Malaysian ringgit down by 45% and after the first year, the most affected economies in East Asia had lost over $100 billion in capital inflows (Ba, 2021). In late 1997, Thailand, Indonesia and South Korea all quickly accepted rescue packages from the International Monetary Fund (IMF), totalling $68 billion (Scott, 1998). The following year, Indonesia's annual GDP growth had gone down by 13.2%, South Korea's by 6.7%, Malaysia's by 7.5%, and Thailand's by 10.2% (Burke, 2001). Malaysia, from the early 1980's to the mid-1990's, saw unprecedented sustained rapid economic growth alongside poverty reduction, while also mentioning one of the world's highest trade to GDP ratios of the time; this earned Malaysia a membership in the World Bank's High Performing Asian Economies (Cheok Cheong et al., 2015). However, Malaysia was not without its faults, either. The regulatory system involving governance of its corporate sector was subjected to major legislative and institutional reforms mostly because of how the crisis revealed serious cases of corruption and cronyism within the system by the well-connected businesspeople, with one such example being the Port Klang Free Zone scandal that drew attention to many conflict-of-interest issues involving numerous key politicians (Vithiatharan & Gomez, 2014). Thailand also saw a change in its fiscal attitude towards adequacy of the amount of reserves – in the 15 years after the beginning of the financial crisis, Thailand amassed around $178 billion in reserves, ranking it 14th in the world in January 2012 (Prommawin, 2013). Furthermore, Singapore's Prime Minister at the time, Goh Chok Tong, emphasized the globality of the problem and rejected it being a simple regional problem; he called on the United States to play a central coordinating role in the international response to the crisis by leading global meeting with the Asia-Pacific Economic Cooperation (APEC) and officials from the European Union to prevent a worse meltdown (Scott, 1998). As a response to the crisis, South Korea's budget was altered quite significantly. The South Korean government increased its public spending to provide a social safety-net program to its citizens, provide government assistance to those in need. In turn, from 1995 to 1997, South Korea's expenditures on social development grew from 8.1% to 11.1% (Jung & Clark, 2010). Therefore, even though it needed to accept that IMF loan, South Korea did not follow the IMF's model of fiscal austerity and government downsizing and chose instead to prioritize the welfare of South Koreans. Though, with large public spending comes budget deficits, which may be a problem in the long-term. Unlike South Korea, however, Thailand, Indonesia and Malaysia (among others) experienced current account surplus in the mid-2010's. Hoque et al. (2015), with their panel error correction model, assert that these countries' current account balances reflect the optimal decisions of borrowers and lenders, which in turn means that policy intervention in Thailand, Indonesia and Malaysia would simply be unfavorable.

Foreign Exchange Reserves, the IMF & the World Bank

Foreign Exchange Reserves

Foreign exchange reserves (FER) are holdings from countries that manage and exchange supply and demand that arise from trade transactions (Rodrik, 2007). Amassing FER is important since liquidity provides self protection from financial crises and exports get oriented towards a growth strategy, where exports do not lose their international competitiveness (Aizenman & Lee, 2007). The Asian financial crisis showed that countries with higher levels of foreign assets are better prepared to withstand panics in a financial crisis than countries who do not (Rodrik, 2007). The gold standard or even Bretton Woods showed how each currency always strives to be stable, and if one is not stable, strives to be supported by a stable one. With stability, countries can even shelter themselves from said crise. It is then a question of protection and liquidity, but with the foreign exchange reserves held by emerging countries being at an all time high, the cost of accumulating said reserves can be costly, socially and economically (Olivier & Rancière, 2006). We can link globalization and trade liberalization to the policy makers' choices in holding FER in the form of low-yielding short term securities, and how it can amount to 1% of the GDP of those nations taken as a whole (Rodrik, 2007).

Rapid Rises

1990 is the transitive year that led to the era of financial globalization, which also led to rapid rises in emerging economies' foreign exchange reserves (Rodrik, 2007). From 6 to 8% in the 1970s to almost 30% of the GDP by 2004, we can conclude that the solution to criseises is the increase of reserves while reducing the short-term liabilities (Jeanne & Rancière, 2006). Weirdly, some emerging countries have not reduced their exposure to short-term debt, while actively working on their reserves. The reasoning behind this decision could be explained by the need of borrowing for infrastructure and economic growth. In the past years, the WTO and the IMF have been accused of regulating national and local governments to prevent them from regulating international trade, turning Third world nations into loan addicts while serving the U.S corporate interest (Cavanagh & Mander, 2003). With latter information in mind, it is non-rational to take on debt while working on reserves, since that makes it that the cost of reserves have a price tag. It was concluded that policy makers are then reluctant to short-term borrowing and that the recent growth is due to the policy maker's concentration in the appreciation of their currency and the maintenance of their competitiveness on the international import and export market. (Aizenman & Lee, 2007), provided evidence that suggested that self-insurance was the main reason in the accumulation of reserve wealth, where it contrasted with mercantilism. The reasoning was that the increase of reserves prevented the appreciation of their currencies, which then controlled inflation and kept the production cycle at its strongest. Before 1990, the rule of thumb was that each developing country should hold a quantity of FER equivalent to 3 months of exports; the increase in reserves may then be explainable by the world trade augmentation in recent years (Feldstein, 2004). More exports means bigger reserves = rule of thumb applied. Nations went from reserves of 3 to 4 months of exports to reserves equivalent to 8 months. All of this shows that the increase in developing countries is not the consequence of quantity production, but quantity of production is a derivative of the new financial magnitude that came with trade liberalization (Feldstein, 2004). Countries started accumulating reserves as a consequence of reserves barely being able to keep up with the banks as a result of globalization, which means that they were on the path even before the IMF put a name on it.

IMF and The Guidotti-Greenspan Rule

The policy guideline by the IMF concerning emerging nation reserves was clearly summarized by Stanley Fischer in 2001: "The executive board last year agreed that holding reserves equal to short-term debt was an appropriation starting point for a country, but since it is only a starting point, countries need to hold reserves well in excess of this level, depending on a variety of factors: macroeconomic fundamentals, exchange rate regimes, the quality of private risk management and financial sector supervision, without forgetting the size and currency composition of the external debt." That made it that every nation should hold liquid reserves equal to their foreign liability coming within a year, said the then deputy finance minister of Argentina, Pablo Guidotti (Fischer, 2001). The Guidotti-Greenspan rule was then born. With that mentality, practically all emerging countries build enough reserves to abide by the rule, with the only exception being Argentina in 2004, which had just come out of a vicious financial crash. By 2004, Africa had 8 month worth of import reserves, while the Western Hemisphere had 6 and Asia had 10. The reserve build up phenomena affects everyone, the world poorest countries as well (Jeanne & Rancière, 2006).

If a country lives by the Guidotti-Greenspan rule, this situation occurs: if a private firm takes a short-term loan of 2 million dollars, the central bank has to increase its reserves by the same amount. The central bank will buy foreign currency to invest in their domestic markets to sterilize the effects of the 2 million dollars of the private firm (Rodrik, 2007). This leads to few consequences: firstly, the application of the IMF rule implies that even if the process of borrowing is started abroad, the home economy loses with no ressources from abroad (Feldstein, 2001) . It also means that the home economy pays an insurance premium for every 1$ of reserves assets a nation accumulates (Broner et al., 2004) . There is also the fiscal cost of holding reserves where there's an opportunity cost from the transfer of wealth in the public and private sectors and vice versa (Broner et al., 2004).

The high cost of holding FER does not stop there, as the difference between the interest rate on securities and the low level of interest earned on FER are relative and adjusted to any exchange rate regime (Rodrik, 2007). Economist Schmukler (Broner et al., 2004) argues that money should simply be invested in higher yielding domestic securities or in long term global capital markets. Those ideas cost between 1% (Rodrik) and 1.85% (Schmukler) of the nation's GDP.

To conclude, some economists argue that increasing liquidity levels are rational despite their high cost and that the insurance ends up paying for itself with the economic growth (Rodrik, 2007), while economist all have different paths of solutions: Schmukler believes in the creation of an international facility that manages external assets and that charges small fees and uses the revenues for domestic spending (Broner et al., 2004) while Rodrik believes in having foreign reserves while focusing on reducing short term debt (Rodrik, 2007).

Reforming The World Bank

Origins

The Guidotti-Greenspan rule and the regulation of FER of emerging countries are all administered by international entities, who state the best interest of those countries at heart. It is crucial to understand the mechanism between economic growth and economic domination some countries may be under with organizations such as the World Bank. The world saw and felt the tragedy of the war and the Great Depression that developed and spread through lands and lands, countries to countries. Bitterness became the breeders of fascism. After the end of WW2, 45 allied nations sent their delegates to the Bretton Woods conference, where the IMF, the International bank for Reconstruction and Development, and the General Agreement on Tariffs and Trade saw the day. The World Bank was first called the *Bank for the Reconstruction of the United and Associated Nations* with no regards to poverty whatsoever (Rodrik, 2007). The bank is composed of 5 distinct but related institutions:

- The International bank for Reconstruction and Development (IBRD)
- The International Development association (IDA)

- The International finance Corporation (IFC)
- The Multilateral investment Guarantee affect (MIGA)
- The International Center for settlement of Investment disputes (ICSID)

With David Malpass, an American, as director of the bank, we can see which nationality controls this international organization, and which country has an exhaustive international power.

Criticisms

Keeping in mind the official slogan of the World Bank – "Our dream is a world free of poverty" – multiple criticisms have emerged in the last few years: the lack of relevance, the lack of effectiveness and the lack of accountability (Cavanagh & Mander, 2003).

In a world with freer capital accounts on a daily basis, the bank is unneeded. There are multiple paths of borrowing now available. In addition to that, the poor bureaucratic management is blamed for the exacerbation of poverty in emerging economies, instead of alleviating poverty (Rodrik, 2007) . There is also an issue of accountability, where the bank receives most of its funding from developed world companies,and the lack of oversight can lead to interest binded decisions. Middle income countries have been borrowing less and less, so there may be a global movement of switching to private firms or hedge funds due to the exaggerated WB demands (Broner et al., 2004). Economist Lerrick suggests that net loan flows shifted from borrowing to repaying, which could be a sign of economic growth in countries: between 1999 and 2001, MIC has borrowed more or less 14 billion dollars. It would be reasonable to think that the borrowing would accrue since MIC are getting bigger and poorer countries are being named MIC's, but from 2003 to 2005, the MIC nations have repaid more or less 15 billion dollars of debt. There is the idea where the WB is not fond of MIC repaying their debt because that legally frees them from the realm of the WB, and the realm of control from it. On another hand, Economist De Ferranti is more suspicious of shifting net loans and he suggests that critics used biased statistics to exaggerate the diminishing relations between the bank and emerging nations (Aizenman & Lee, 2007).

One thing that cannot be disagreed upon is the decreased borrowing of emerging markets explained by the fact that financial volatility and the threats of crisis have made investors way more prudent (Broner et al., 2004). Where the acceptable debt to GDP ratio has been greatly decreased (Feldstein, 1999). Even with the new found prudence, it does not explain why emerging markets are now negative in capital flow, maybe it is because of gradation, where countries gradually switch to private capital markets for their financial safety and ressources (Broner et al., 2004).

In addition, some hassle costs can be associated with bank loans, where environmental and Human rights protection makes it difficult to borrow money: the time between the asking and the receiving of a loan can be long and deceiving, with the fact that drafting, negotiating and implementation a bank funded project is more than a burden (Rodrik, 2007). We could argue that the hassle costs are safeguarding the money and makes sure that the entity asking for said loan really wants the money and is not just looking for quick cash (Jeanne & Rancière, 2006).

With the in-depth of each criticism, there are also ideas of solutions to rebrand the World Bank. Some say that the creation of a new loan production that would limit hassles costs for borrowers with previous good performance can be performative (Jeanne & Rancière, 2006). The creation of a credit ranking system can benefit emerging nations who truly need it (Jeanne & Rancière, 2006). The WB can also introduce different pricing among IRBB borrowers to encourage the graduation of their economies. It is important to not forget that since ⅔ of the population in need live in MIC, the WB is morally obligated to attend to the MIC needs and continue funding them, even with the recent decrease in the ask for help (Cavanagh & Mander, 2003). Since people accuse the WB of not alleviating poverty and being a machine of control by multinational corporations while benefiting the interests of the rich while increasing the wealth gap, the WB has to stick to its slogan and make decisions that may not be encouraged by multinationals, and question is will the WB do what is right for the emerging countries or what is right for the Western capitalist world (Cavanagh & Mander, 2003).

Conclusion

In closing, the hypothesis was somewhat correct, but not entirely accurate. The Asian financial crisis was definitely caused by large currency devaluation and contagion, but that was not all that it entailed. It must not be forgotten that East Asia, due to its economic miracles, was used to short-term investments, inadequate regulation for liberalization measures (Bazbauers, 2014). Therefore, when markets grew and liberalized quickly, the respective countries' credit bubbles had finally burst alongside the asset price bubbles, which drastically devalued currencies and greatly slowed yearly growth (Zhuang & Dowling, 2002). Hogue et al. (2015) argue that, in the future, policymakers would be better off paying attention to supporting long-term capital flows and liberalizing short-term capital movements as opposed to enacting protectionist policies. In addition to that, the liability of owning and maintaining foreign exchange reserves as middle income or emerging countries can be tricky. GDP's, the debt to ratio, borrowing, private markets, the Guidotti-Greenspan rule and the cost of self-insurance are all entities that policy makers have to keep in mind when deciding their capacity holding of foreign reserves.

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