CAUSES OF THE 1997-1999 ASIAN ECONOMIC FINANCIAL CRISIS AND LESSONS FOR VIETNAM

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I. SOME DATA ABOUT THE ASIAN CRISIS IN 1996-97

The Asian economic – financial crisis broke out first in Thailand. It started on July 2, 1997 when the Thai central bank decided to float the baht putting an end to a long period of the fixed exchange rate. The rate of the baht to the dollar varied between 25.09 and 25.61 in the years 1991-1996.

After being floated, the baht fell by 20%. The rate in January 1998 was 53 baht to the dollar. In July and August 1997, the Philippines, Malaysia and Indonesia decided to have their currencies floated. In December 1997, the South Korean won was floated. And its exchange fell to a record level of 2,000 won to the dollar.

We may say that the depreciation of these Asian currencies is the most noticeable sign of the crisis.

The second sign of the crisis is the loss and bankruptcy at unusual level of the systems of banking institutions in Asian countries.

The third sign is the unusual level of loss and bankruptcy among companies.

The serial bankruptcies led to increasing unemployment rates and decreasing growth rate

The South Korean GDP fell from US$528 billion in 1996 to 317 billion in 1998 while the personal income fell from US$11.380 to US$6,823.

Generally, the crisis in those four countries includes the following four facts: (1) high and uncontrollable falls in the exchange rate; (2) serial bankruptcies among banking institutions and companies; (3) increasing unemployment rate; and (4) drastic falls in the growth rate.

There are also additional facts, such as inflation rate, net capital inflow, foreign debt, lending rate, import and export values, etc. which fluctu-

Table 1: Exchange rates to the dollar of some Asian currencies in 1996 and 1997

Year	Thai baht	Filipino peso	Malaysian ringgit	Indonesian rupiah	South Korean won
1996	25.61	26.29	2.52	2,308	844.2
1997	47.25	39.50	3.88	5,400	1,695.8

Table 2: Loss and bankruptcy among banking institutions

Country	Number of banks (up to March 31, 1997)	Fiscal year from April 1, 1997 to March 31, 1998				
		Banks closed	Banks nationalized or supervised	Banks merged	Banks sold to foreigners	Banks in troul le
Thai land	108	56	4	0	4	64 (59%)
Malaysia	60	0	0	41	0	41 (68%)
Indonesia	228	16	56	11	0	83 (36%)
South Korea	56	16	2	0	0	18 (32%)

Table 3: Loss and bankruptcy among companies

Country	Time	Companies going bankrupt
Thailand	January – May 1998	3,961 stopping operation (582 of them went bankrupt)
Malaysia	1996	489 bankruptcies
	1997	6,583 bankruptcies
Indonesia	1998	Some 80% of companies out of business
South Korea	1997	14,000 bankruptcies
.	1998	53,000 bankruptcies

Table 4: Growth and unemployment rates

Country	Growth rate			Unemployment rate		
	1996	1997	1998	1996	1997	July 1998
Thailand	6.7	–0.4	–8.3	3.3	3.7	
Malaysia	8.2	7.0	2.0	2.6	2.7	5.0
Indonesia	7.8	4.6	–13.7	2.2	3.0	
Philippines	5.8	5.2	–0.5	9.5	10.4	13.3
South Korea	7.1	5.5	–5.8	2.3	2.5	8.0

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ated differently over countries.

II. OBSOLESCENCE OF MACROECONOMIC THEORY

The Asian crisis not only caused damage for many Asian countries but also challenged economic theories. Before the crisis, the economic and political circles considered the growth rate of 7% to 9% in Thailand, South Korea, Malaysia and Indonesia in decades as miracles. Up to early 1997, there was no prediction of what would take place six months later. Failure to predict such a far-reaching crisis reflects the obsolescence of the macroeconomic theories. Everybody started to wonder why the crisis took place so drastically in Asian countries and not in others.

Some called it a monetary crisis, others thought it was a financial or economic one and wanted to know what its causes were. After studying changes in those economies before and after the crisis, we chose another approach to the problem. We consider the crisis as a consequence of the accumulation of preconditions for the crisis, or a process in which quantitative changes led to qualitative changes. In other words, the crisis originated from small and annual changes with no dangerous appearance, and after a period, these changes developed into causes of the crisis.

Following this approach, we develop a "Preconditions and Mechanism for Economic- Financial Crisis Model" that presents four preconditions for the crisis and its four levels of impact. The model is based on analyses of macro- and micro-economic relations with some mathematical methods applied when necessary. We hope that the model will offer a simpler and clearer explanation of the crisis. This model also shows that Thailand, Indonesia and South Korea faced all four preconditions for crisis while Malaysia faced only one.

III. PRECONDITIONS AND MECHANISM FOR ECONOMIC- FINANCIAL CRISIS MODEL

The model indicates that the crisis only breaks out when the following four dangers are found in the economy:

- Poor performance of companies;

- Poor performance of banks and finance companies,

- Appreciation of the domestic currency, and

- Default in the repayment of loans.

In cases of Asian countries, their economies also faced an external factor: withdrawal of capital by foreign investors.

When domestic currencies rose against foreign ones because of fixed exchange rate system, poor export and high interest rate on loans in domestic currencies, those countries faced dangers of default and an increasing difficulty in keeping the fixed exchange rate with the result that the floating of the exchange rate was only a matter of time.

When foreign investors thought the government of recipient country was running short of foreign exchange reserve needed for maintaining the fixed exchange rate, they started to turn their investments into hard currencies. Governments are forced to float the exchange rate when running short of foreign exchange reserve while investors are trying to turn their investments into hard currencies. This makes the exchange rate fall drastically. This is the first level of crisis that

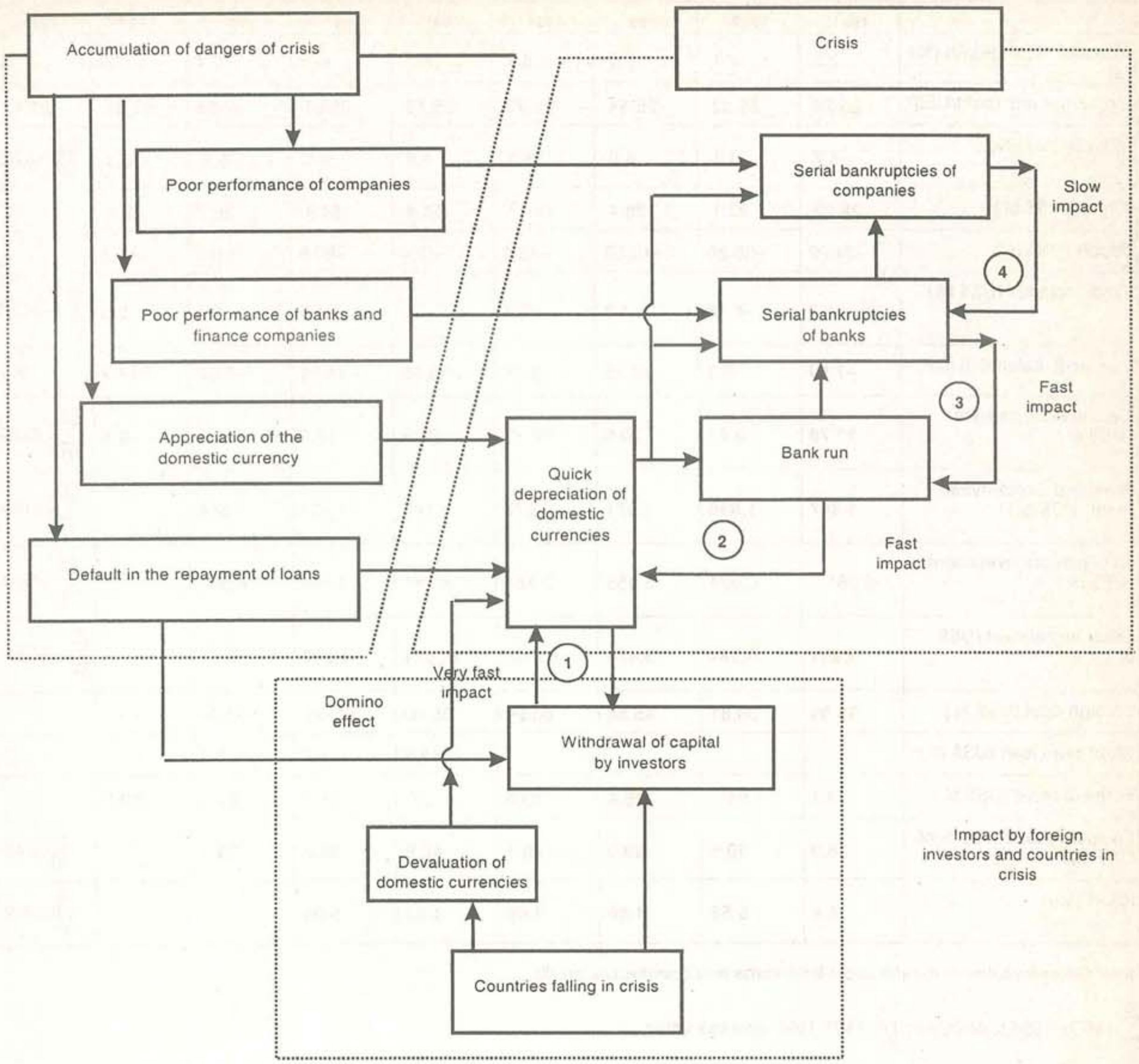


Figure 1: Preconditions and Mechanism for Economic- Financial Crisis Model

leads to the bank run and sale of all kinds of stocks and shares for hard currencies and the economy reaches the second level of crisis.

Facing the bank run and foreign debts, banks with poor performance quickly become insolvent and go bankrupt. The first closure of banks makes the public panic and a second bank run comes. At this time, even banks with good performance and track record become insolvent. This is the third level of crisis.

When the exchange rate falls, foreign debt in companies becomes heavier when it is expressed in the domestic currency while they can't get any loans from banks or finance companies. Companies, regardless of their performance, are all on the brink of bankruptcy and their insolvency accelerates the fall of banks and finance companies. This is the fourth level of crisis.

The fall in the exchange rate makes exports from the country more competitive, which force others to devaluate their currencies accordingly. This is the domino effect of the crisis.

In the 1997 Asian crisis, damage varies over countries based on their accumulation of dangers and policies adopted after the crisis broke out. We call it an economic- financial crisis because it has close relations with the foundation of the economy, that is companies and banks (economic aspect); with the exchange rate system, national solvency and foreign financial investment (financial aspect): and interaction between these factors during the crisis.

IV. THE CRISIS IN THAILAND

1. Thailand before the crisis

Table 5: Thai economic data (area: 514,000 sq.km. population: 61 million)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Indicator GDP growth (%) (a)	7.0	7.1	8.2	8.6	8.7	6.7	–0.4	–8.3	1
Exchange rate (baht/US$)	25.28	25.32	25.54	25.09	25.19	25.61	47.25	41.37	37.11
Inflation rate (%)	5.7	4.1	4.6	5.1	5.8	4.8	5.6	8.1	$\overset{96}{\underset{91}{TB}}$=5.02
Export (US$ bi.)	28.23	32.1	36.4	44.47	55.4	54.4	56.7	52.9	
Import (US$ bi.)	–34.22	–36.26	–40.09	–48.2	–63.4	–63.9	–55.1	–40.6	
Trade balance (US$ bi.)	–5.9	–4.16	–4.3	–3.7	–7.7	–9.5	1.5	12.3	$\sum_{91}^{96}$= –36.26
Cur. acct. balance (US$ bi.)	–7.59	–6.3	–6.36	–8.08	–13.55	–14.69	–3.02	14.3	7.2
Capital acct. balance (US$ bi.)	11.76	9.47	10.5	12.17	21.9	19.5	–15.8	–9.5	$\sum_{91}^{96}$= 85.29
Standard direct investment (US$ bi.)	1,847	1,966	1,571	0,873	1,182	1,405	3,344		$\sum_{91}^{96}$= 8.844
Net financial investment (US$ bi.)	–0.081	0.924	5,455	2,481	4,181	3,544	4,361		$\sum_{91}^{96}$ =16.4
Other investment (US$ bi.)	9,994	6.584	3,474	8,812	16,644	14,537	–23.51		$\sum_{91}^{96}$ =60.04
Foreign debt (US$ bi.)	35.99	39.61	45.84	60.99	65.00	89.00	97.00		
Short-term loan (US$ bi.)					43.6	45.7	45.6		
Forex reserve (US$ bi.)	18.4	21.2	25.4	30.3	37	38.7	27.0	29.5	
Fixed investment as % of GDP (b)	38.0	39.5	39.9	40.1	42.8	39.8	39.1		$\overset{96}{\underset{91}{TB}}$= 40
ICOR (b/a)	5.4	5.56	4.86	4.66	4.92	5.94			$\overset{96}{\underset{91}{TB}}$= 5.2

Note: Other investment means short-term loans and commercial credit.

$\sum_{91}^{96}$: 1991-1996 total value ; $\overset{96}{\underset{91}{TB}}$: 1991-1996 average value

a. Steady economic and export growth:

Thailand started its industrialization in the 1960s. Its growth rate in varies between 7% and 8% in three successive decades. From 1991 to 1996, the average growth rate was 7.7% and the per capita GDP rose from US$440 in 1955 to 3,012 in 1996.

Thailand has adopted an export-oriented strategy since the 1980s. In 1986-90, the export growth rate was 28% a year. It fell to 13% in 1992 and 1993; 20% in 1994-95 and 3.4% in 1996. The per capita export value rose from US$630 in 1991 to US$1,177 in 1996.

Thus, the growth rate was stable during three decades from 1961 to 1996. This indicator, however, only reflects the output of the economy, not the input, that is, the investment.

In the years 1991-96, Thai gross investment equaled 40% of the GDP. Sustain development requires low cost and high growth rate, that is, the high growth rate must be based on the high economic efficiency. In the years 1991-1996, the ICOR index of Thailand was 5.22 on average, that is, an investment of 5.22 baht makes the GDP increase by 1 baht.

b. Poor performance of companies: High GDP growth rate, high interest rate on savings account (some 16% a year as compared with 7.6% in the U.S.) and stabilized exchange rate provide an ideal business climate for foreign investors, especially those who specialize in financial investment and commercial credit. Thus, Thai companies enjoy lower interest rate when borrowing from foreign banks and companies, especially American ones. If they don't know how to use foreign loans effectively, their performance is poorer and poorer however high their output is.

In 1991-96, foreign direct investment in Thailand was small in comparison with financial investment and short-term foreign loans. The gross investment in this period was US$11.701 billion as compared with Thai overseas investment of 2.875 billion, which means that

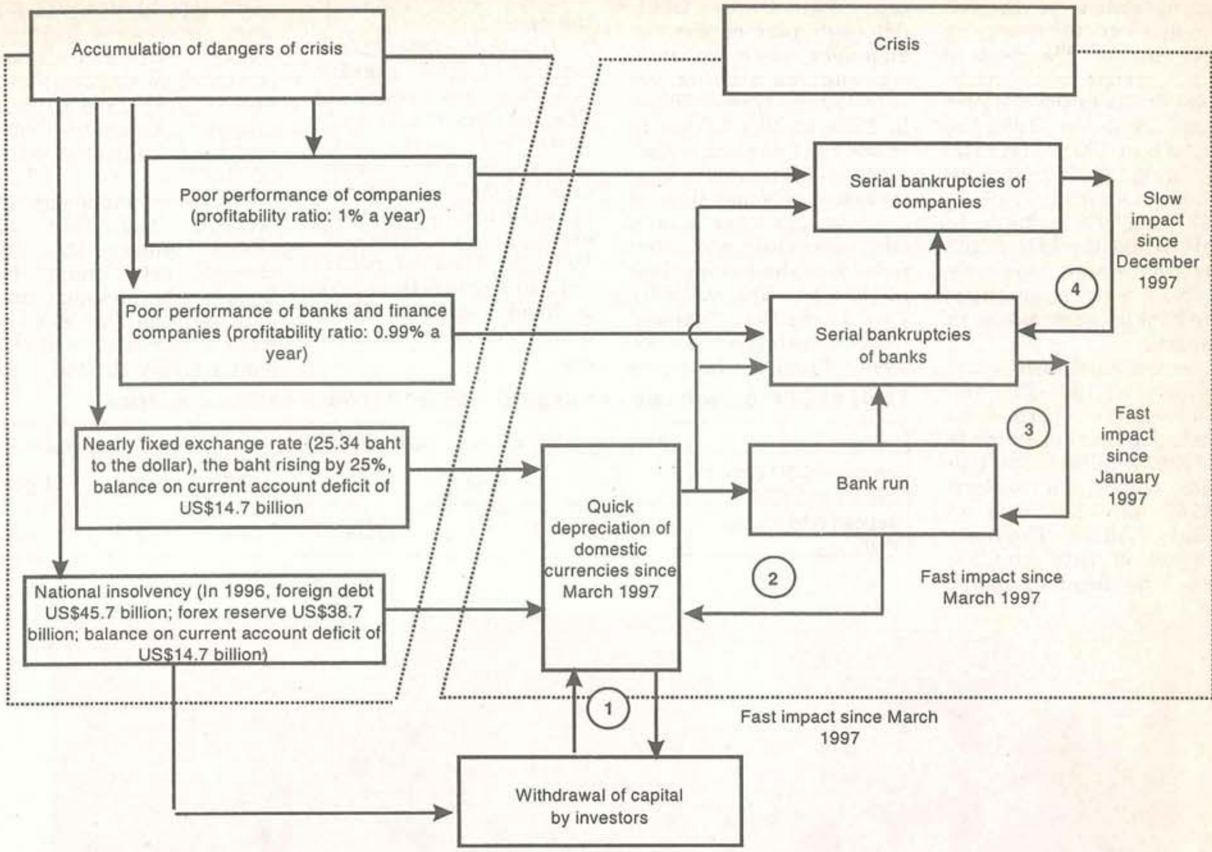


Figure 2: Preconditions and mechanism for the Thai crisis 1997-1999

the net direct investment was US$8.844 billion, while the net financial investment was US$16.4 billion and net short-term loan was US$60.04 billion. Thus of the capital inflow in 1991-96 that amounted to US$85.293 billion, the foreign direct investment accounted for 10.36% (8.844 billion); indirect investment 19.23% (16.404 billion) and commercial loans 70.4% (60.045 billion).

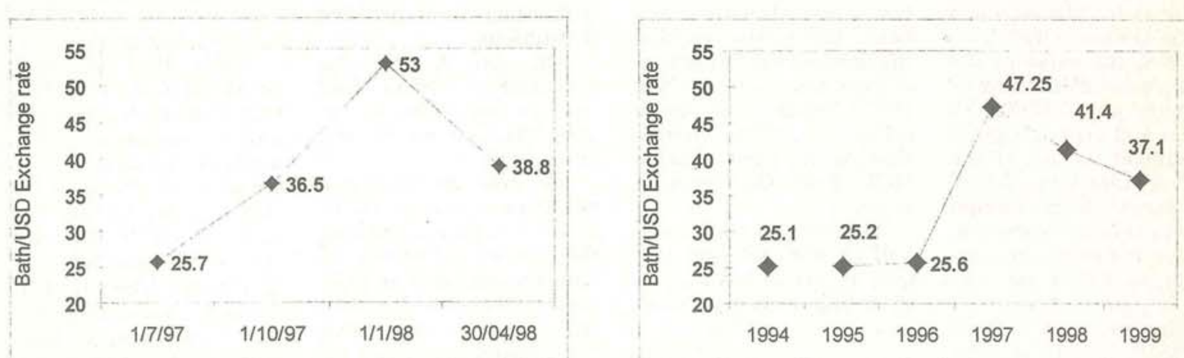
With some 90% of foreign capital put in financial investments and short-term credits, Thai companies were under great pressure because they had to pay interest in foreign exchange. And as a result, their business performance would be poor because of bad management.

In 1991, the net financial investment and short-term loan amounted to US$9.913 billion equaling 536% of the net direct investment (1.847 billion) and rose to US$18.079 billion in 1996; 12 times higher than the direct investment (1.405 billion).

But the average return on assets of companies reduced from 8% in 1991 to 1% in 1996. In an economy where the company ROA was 1% and lending interest was 16.3% a year, the danger of crisis was apparent.

c. Falling banking performance: Thai banks and finance companies were eager to secure foreign

Figure 3: Exchange rate of the baht to the dollar before and during the crisis



loans to finance local companies without paying full attention to the company performance. The ratio of total foreign debt lent to Thai banks to the M2 rose from 2.8% in 1991 to 28.69% in 1996. The ratio of foreign debt to banks' assets rose from 171% in 1991 to 694% in 1996. In this period, the ROA of the banking system was only 0.99% a year. Apparently, the banking system was in danger.

d. National insolvency: In the years 1991-96, Thailand suffered permanent trade gap that amounted to US$35.26 billion. The balance on current account deficit in 1996 rose to US$14.7 billion. The main reasons of this situation were the fixed exchange rate that encouraged the import instead of export and the inflation rate was higher than American one (5% as compared with 3%). In 1996, the value of the baht rose by 25%. To cover the trade gap of US$35.26 billion and keep the gross investment at 40% of the GDP, Thailand was forced to borrow from foreign lenders (banks, companies, private investors, governments, etc.) That was why the foreign debt was increasing over years, from US$35.99 billion in 1991 to 89 billion in 1996 equaling 54% of the GDP.. Although part of the foreign debt was used for increasing the national reserve (from US$.4 billion in 1991 to 38.7 billion in 1996), the financial investment and short-term loan represented some 90% of the foreign investment (short-term loan accounted for 67% of the foreign debt in 1995 and 51% in 1996). This means that Thailand has become insolvent since 1995. Foreign investors who predicted that the baht would be floated would certainly try to turn their investments into hard currencies making the demand for foreign exchange soar. Up to June 1997 before the crisis broke out, the foreign short-term loan equaled 150% of the Thai forex reserve.

In short, in the second half of 1996, all four dangers of crisis have made their appearance in Thailand.

Table 6: GDP growth rate and deposit rate in 1991-96 in certain countries

	Thailand	South Korea	Indonesia	Malaysia	U.S.	Singapore
Indicator GDP growth rate (% per year)	7.72	7.42	7.2	8.75	5.32	11.26
Deposit rate (% per year)	10.26	8.9	17.33	6.7	4.77	3.3

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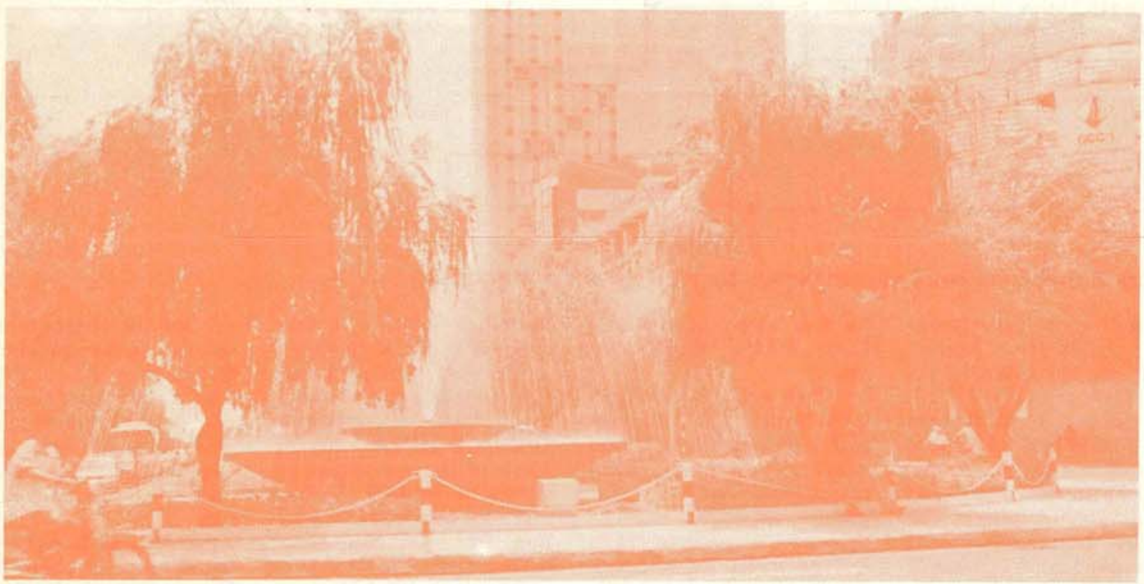

2. What happened during the crisis

In the first three months of 1997, sensible investors and savers in Thailand started to withdraw their capital from banks and finance companies, which forced the government to close the stock exchange on March 3, 1997, ask financial institutions to increase their cash in hand and name 10 finance companies in danger.

On March 4 and 5, 1997, over 21.4 billion baht (US$820 million) was withdrawn from banking institutions.

On April 9, 1997, the exchange rate fell to 26.08 baht to the dollar, a low level that has never seen since 1991.

On June 25, 1997, the government closed 16 finance companies making the number of closed finance companies rise to 58 (among 91). To maintain the exchange rate when the demand for foreign exchange soared, the government sold hard currencies from its reserve making the reserve decrease drastically, from US$38.78 billion in June 1996 to 37.7 billion in December 1996 and 31.4 billion on June 30, 1997.

If the reserve keeps decreasing and falls to US$10 billion, the exchange rate must be floated. Foreseeing this situation, the Thai government declared to float the baht on July 2, 1997 and the exchange rate to the dollar fell from 25 baht in June 1997 to 53 baht in January 1998, a 112% fall within six months.

Thus, the Thai crisis broke out at the third level (Fig. 2) when banks and finance companies went bankrupt because of quick withdrawal of money, and then spread to the first and second levels when the exchange rate fell drastically. The fall in the exchange rate made over 4,000 companies go bankrupt in the first half of

1998 leading to the fourth level of crisis in which a lot of bank went out of business. Of 108 banks and finance companies in Thailand, 68 were in great trouble since April 1997; 56 of them were closed, four were nationalized and four sold to foreign companies.

At the first and second levels of crisis, the exchange rate fell from 25 to 53 baht within six months and then rose to 38 baht on April 30, 1998.

3. Consequences and tactics

a. Consequences:

- The GDP growth rate fell from 6.7% in 1996 to –0.4% in 1997; –8.3% in 1998 and 1% in 1999.
- More than two million people became jobless.
- The business climate worsened: foreign investors expressed doubts about business opportunities in Thailand. They withdrew US$15.8 billion from Thailand in 1997 and 9.5 billion in 1998.

The crisis was a terrible shock to the political system. Four months after the floating of the baht, the Thai PM resigned. Thinking through, all crises originate from human errors, especially bad management of the government.

Many experts agreed that the Thai economic recovery should be based on a political reform, especially in the financial business. After the crisis, a Bankruptcy Law was passed; a National Commission for Financial Restructuring, a Debt Management Company and a Fund for Financial Institution were formed. In December 1997, a new constitution was promulgated to provide a basis for the political reform.

After the baht was floated, the exchange rate didn't stop falling until January 1998 when the government promised to repay all debts for commercial banks.

V. LESSONS FOR VIETNAM

We can draw three lessons from the 1997 Asian crisis:

1. Business performance and economic efficiency are important bases for the sustainable development and must be considered as targets for both the government and company management.

To ensure that full attention is paid to the business performance, industrial authorities and local governments must include various indicators in their annual reports, such as profitability ratio, retained profit, increases in the equity capital and changes in the ICOR index, etc.

2. The interest rate on loan capital must be lower or equal to the profitability ratio of the industry.

To ensure the sustainable development, the banking authorities must let the interest rate decided by the supply-demand relationship instead of by government intervention. If the interest rate is lower than the company profitability and company's products are competitive enough, it will obtain good performance and develop well even if it has to depend on loan capital.

The following table gives us interesting facts about the GDP and deposit rates in some countries.

We see that in all three countries where dangers of the crisis were apparent before 1997 the average GDP growth rate was lower than the average deposit rate, whereas in the U.S. and Singapore where the economic efficiency is high, the GDP growth rate was higher than the deposit rate. Even Malaysia, a country affected greatly by the Asian crisis, also obtained a growth rate that was higher than the deposit rate.

3. There must be a governmental body responsible for keep a close watch on inflation rate, exchange rate, interest rate, balance on current account, national debt and company performance in order to work out necessary policy and regulations needed for maintaining the sustainable development.■

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