What Happened During the Turmoil? Overview of Some Major Economies During the 1997 Asian Financial Crisis

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Abstract. The Asian financial crisis brought turmoil to several Southeast Asian countries. This paper selected some major affected countries and regions, including Hong Kong, Thailand, Indonesia, Philippines, and Singapore, to analyze their economic performance throughout the crisis.

Introduction

The Asian Financial Crisis (AFC) officially originated in Thailand. The beginning of the traumatic and devastating event was marked by Thailand allowing the baht to float and its subsequent depreciation on 2 July, 1997. Within days of floating the baht, the turbulence quickly spread to neighbouring Southeast Asian economies. Authorities in Philippines, Malaysia, and Indonesia had to widen the bands for exchange rate fluctuations, which was soon replaced by direct floating. Following that, Singapore also allowed its dollar to depreciate. This paper present a review of some major economies’ performance throughout the crisis.

Hong Kong during the Crisis

On 14 August 1998, 4 billion HKD was spent on Hong Kong stocks and index by the Hong Kong government. This unprecedented purchase was a decision undertaken at a peculiar time for the region. What happened to this small open economy? And what made the Hong Kong authority take such drastic action? What were they protecting or defending?

According to data from the Census and Statistics Department of Hong Kong, strong GDP growth up to the third quarter of 1997 was brought to a sudden halt when speculators attacked the linked exchange rate, resulting in an unusually sharp rise in the interest rate, as the monetary authority is attributed with halting the currency haemorrhage (So, 2011) (see Table 1). In the third quarter of 1998, Hong Kong’s real estate prices fell by 40%, accompanied by high unemployment. An immediate contributor to the drop in the CPI was the property bubble bursting and prices of other durable goods falling. Hong Kong suffered deflationary recession and a rising unemployment rate, and indicators of recovery emerged in 1999 (Martin, 2007).
Table 1. Hong Kong’s recession from 1997 to 2003.

<table>
<thead>
<tr>
<th>Year</th>
<th>Real GDP growth (%)</th>
<th>CPI (%)</th>
<th>Unemployment rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>5.1</td>
<td>5.8</td>
<td>2.2</td>
</tr>
<tr>
<td>1998</td>
<td>-5.5</td>
<td>2.8</td>
<td>4.7</td>
</tr>
<tr>
<td>1999</td>
<td>4.0</td>
<td>-4.0</td>
<td>6.2</td>
</tr>
<tr>
<td>2000</td>
<td>10.0</td>
<td>-3.8</td>
<td>4.9</td>
</tr>
<tr>
<td>2001</td>
<td>0.6</td>
<td>-1.6</td>
<td>5.1</td>
</tr>
<tr>
<td>2002</td>
<td>1.8</td>
<td>-3.0</td>
<td>7.3</td>
</tr>
<tr>
<td>2003</td>
<td>3.2</td>
<td>-2.6</td>
<td>7.9</td>
</tr>
</tbody>
</table>

Source: Census and Statistics Department, HKSAR

Hong Kong authority followed a “positive non-interventionist” principle since the end of World War II. This policy confines government’s intervention in the economy to a minimum. Government spending is only on essential support services. However, 1998 saw an increase in official involvement which was the biggest change since financial deregulation in the 1980s. Buying shares of 100.8 billion HKD in August, the government became the largest shareholder on the stock market. Hong Kong’s success in defending its currency can be attributed to a huge outlay of foreign exchange, large sums of reserves (Table 2), no foreign default, and no trade deficit (Wang, 1998).

In September, new measures to promote liquidity were implemented and the overnight interest rate rose from 8% to 19% to prevent speculators (Martin, 2007). On 5 September, Joseph Yam, the then Chief Executive of the HKMA, declared seven technical measures to strengthen the HKMA system, and to prevent speculators from controlling Hong Kong currency. The seven measures were divided into two categories: issues regarding convertibility of the HKD to the USD, and issues regarding LAF. The target of these measures, stated by Joseph Yam, was to increase the transparency of the whole system, maintain the stability of the CB, and reduce extreme volatility of interest rate.

Table 2. Foreign currency reserve assets, 1993-2002 (in USD million).

<table>
<thead>
<tr>
<th>Date</th>
<th>Exchange Fund</th>
<th>Land Fund</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/1993</td>
<td>43,013</td>
<td>-</td>
<td>43,013</td>
</tr>
<tr>
<td>12/1995</td>
<td>55,424</td>
<td>-</td>
<td>55,424</td>
</tr>
<tr>
<td>12/1996</td>
<td>63,840</td>
<td>-</td>
<td>63,840</td>
</tr>
<tr>
<td>12/1997</td>
<td>75,341</td>
<td>17,482</td>
<td>92,823</td>
</tr>
<tr>
<td>12/1998</td>
<td>89,625</td>
<td>-</td>
<td>89,625</td>
</tr>
<tr>
<td>12/1999</td>
<td>96,256</td>
<td>-</td>
<td>96,256</td>
</tr>
<tr>
<td>12/2000</td>
<td>107,583</td>
<td>-</td>
<td>107,583</td>
</tr>
<tr>
<td>12/2001</td>
<td>111,159</td>
<td>-</td>
<td>111,159</td>
</tr>
<tr>
<td>12/2002</td>
<td>111,919</td>
<td>-</td>
<td>111,919</td>
</tr>
</tbody>
</table>

Source: HKMA

The first self-defence financial battle began on October 23, 1997 (Ye & He, 1999). First, the HKD were absorbed by selling the USD on the foreign exchange market. Banks were forbidden to lend HKD above the quota, otherwise they were punished by fines up to 1000% (Ye & He, 1999). This measure forced banks that had lent to speculators to borrow HKD from the inter-bank borrowing market, drawing the inter-bank rate to 300% level. Second, the government bought blue chips with 17.1 billion USD land fund, then the stock market price decline was narrowed down (Ye & He, 1999). Third, three NIBs (the Hong Kong and Shanghai Banking Corporation Limited (HSBC), Standard Chartered Bank, and Bank of China) announced an increase in the best lending rate from 8.75% to 9.50%. Major banks refused clients’ claims to withdraw outstanding deposits.
Failing in 1997, international speculators attacked the HKD for another three times in January, June and August of 1998. The first two were similar to 1997, and the third one was intense. Prior to August, the stock market and the price of real estate fell sharply. Industries of tourism, retail and catering were in deep decline (Li, 1998). The unemployment rate was 4.8%, the highest level in the past 15 years. Many international speculators, represented by George Soros, intended to attack the Hong Kong stock market thus seeking excessive profits in the futures market (Li, 1998). On 14 August, the SAR government bought a large quantity of stocks and index with the exchange fund. On the index closing date, the government purchased blue chips at the cost of 60 billion HKD, and the Hong Kong government finally beat the speculators (Ye & He, 1999).

Thailand during the Crisis

The AFC originated in Thailand. Before 1997, Thailand, Malaysia, and Indonesia were praised as “Three Tigers in Asia” for their rapid economic growth rate. Between 1990 and 1996, the average economic growth rate in Thailand was up to 8%. In 1995, Thailand’s national income per capita exceeded 2,500 USD, and it was classified as a middle-income country by the World Bank. However, the outbreak of the AFC, like a violent typhoon, swept through the once prosperous country. In distinct contrast, Thailand’s GDP growth rates were -1.4% and -10.5% in 1997 and 1998 respectively.

Buildings never collapse in one day. In retrospective analysis, Thailand’s introduction of foreign capital, its rapid boosts of financial liberalisation reforms, and super-imposed export promotion and protection were all factors contributing to the subsequent misery in 1997.

In 1989, Hong Kong experienced loss of investors’ confidence and decline in foreign capital investment. Since then, Thailand had set the ambitious plan to attract foreign investment to promote economic development and build its capital Bangkok as an international financial center comparable to Hong Kong. In order to achieve the target, Thailand enacted a package of measures to advance reforms of financial liberalisation, and speed up the opening pace. It adopted a floating exchange rate in 1989, and allowed free convertibility of foreign exchange in 1990. Plenty of liberalisation measures followed. The liberalisation was implemented in several aspects. First, domestic foreign exchange settlement was permitted. Citizens could make transactions and settlements following domestic regulations. Second, residents were allowed to remit securities below 10 million USD with no charges. Third, they also authorised unlimited loans and foreign debt from residents to non-residents. Fourth, commercial banks’ were granted access to the offshore currency market to issue bonds. Fifth, vigorous financial derivatives were created and developed, such as currency futures and options, bond futures, interest rate options, swaps, and other instruments (Wong et al., 2001). Simultaneously, Thailand actively opened up its financial sector by allowing foreign banks to enter the domestic currency market. In 1995 and 1996, Thailand updated foreign banks to comprehensive banks, allowing establishment of additional agencies, thus the number of foreign banks rapidly approached local banks.

These series of reforms did introduce foreign investment and accelerate economic development. However, they also brought a significant amount of negative influences, which later played a role in the outbreak of the financial crisis. First, foreign capital inflows fostered non-government institutions’ borrowing of foreign loans as a common practice. According to the data released by the World Bank, Thailand’s external debts climbed 63.4% of Gross National Income by the end of 1996, of which more than half was short-term debt. The second influence was a great deal of capital inflow to the real estate industry. A quarter of loans were invested in real estate, resulting in high housing vacancy rates. Property developers were faced with the currency mismatch that developing projects in foreign exchange and receiving income in baht (Doner & Ramsay, 1998). Third, financial liberalisation and foreign capital inflow induced an overheated stock market, property market, and the whole economy. The boosted overall price in rent, property, labour, and consumer goods severely weakened the competitiveness of export products, causing dramatic devaluation pressure of Thai
Thai baht. Fourth, Thai baht was till pegged against USD, leading to it being overvalued. Fifth, the Thai authority did not give priority to reforms of financial institutions (Jackson, 1998). The quality improvement of local banks and financial institutions could not keep pace with marketisation and liberalisation. Lack of financial talent and regulatory rules could not meet the rapid development of the derivatives market. Last, financial liberalisation made it convenient for the large-scale withdrawal of foreign capital.

Thailand’s loss in foreign investment and the impact of the financial crisis were extremely heavy. From July 1997 to January 1998, the baht depreciated by 56.7%, and property prices fell by more than 35%. Finally, 63 out of 91 financial companies had to be shut down or were taken over. Only 4 out of 15 local banks were not taken over by the government.

**Indonesia during the Crisis**

The Indonesian rupiah (RP) began to be attacked shortly after the depreciation of the Thai baht on 2 July 1997, leading Indonesia to bog down in the maelstrom of the financial crisis. Compared to other affected economies, Indonesia performed worst. Although several countries at that time suffered significant currency depreciation, Indonesian RP depreciated much more than all the others. RP’s value dropped sharply from 2342 RP per USD in 1996 to 10014 RP per USD in 1998; i.e. by 327.58%. Its inflation rate during the crisis was also far higher than other regional economies, soaring to 58.4% in 1998. The strong negative impact of the crisis was also reflected in a decline in GDP growth by -13%, almost as bad as Thailand.

Prior to the crisis, Indonesia assumed a fixed exchange rate policy. It was not fixed at a particular level, but was fixed effectively at a rate of depreciation. When the crisis hit, there was a huge amount of capital outflow, so their reserves threatened to fall quickly. As a result, Indonesia decided to float the RP. Professor P3 advocates the policy to float exchange rate at any time, but says some kind of nominal anchor for monetary policy is also needed. When the RP was then floated, the nominal anchor was lost. Nobody realised a replacement for the anchor was needed, however. Indonesia’s problem was that they no longer had a nominal anchor for their monetary policy. The turbulence of the RP exposed bank customers to a non-balanced foreign exchange position with liquidity problems. The central bank responded to these difficulties by lending more money to banks, and effectively increased base money, and money supply expanded quickly (Fig. 1). This meant there was no longer any nominal anchor, which could have been money supply, in the semi-fixed exchange rate.

All the private sector banks were members of big business conglomerates, and they loaned to their own companies. They used these loans to buy foreign exchange from the central bank and participated in speculative activities. The central bank at that time was essentially financing speculation against itself (McLeod, 2004). Because banks were lending to their own companies who had no intention to repay, the government decided to recapitalise them. This meant the losses incurred by banks were transferred to the general public, which led to Indonesia’s meltdown in the AFC.

**Figure 1. Indonesia money supply (M2) in 1997-98 (in RP billion).**

![Source: Bank Indonesia](image)
The Philippines during the Crisis

The depreciation of Thai baht was followed by the slump of Philippine peso and the stock market. The Philippines became an area of contagion for two reasons. The first was structural problems in economic development, such as the peg to USD, excessive bank loans to real estate, and the current account deficit caused by massive growth of imports and sharp decline in exports. The other reason was the shock from international speculative capital and depreciation in neighbouring countries.

Before the crisis, the exchange rate fluctuated moderately around 26.4 peso per USD. On 22 October 1998, it depreciated to 42 peso per dollar, a 60% decline compared to 1 July 1997. In the market slump, a large number of companies announced their inability to repay bank debt. In addition, the government revenue and expenditure experienced deficit of 170 billion pesos. By February 1999, the Philippine’s annual inflation rate reached 11.6%. Currency devaluation corrected overvalued currency and strengthened export. However, it also struck the banking industry and hindered the entry of foreign capital. Foreign direct investment decreased by 247%. The depreciation of the peso forced interest rates to remain high. The interest burden prevented business and industry from paying due debt. High interest rates might bring banks profits in the short term, but in the long run, banks were faced with more bad debts.

Several factors together caught the Philippines up in the crisis. First was the deficit position in balance of payments, which led to capital outflow and pushed the depreciation tendency of the peso. The second factor was the high interest rate compared to the interest rate in the US. As a developing country, the Philippines had higher interest rates on loans than the US. Therefore, some people asked for loans in the USD. It would have been cost-effective if the peso did not depreciate. Debts borrowed in the USD were contracted to be repaid in USD, including the principal and interest. Because of the continued depreciation of the peso, corporations and individuals with USD debts undersold the peso to buy the USD, which in turn promoted the depreciation of the peso. The high interest rate also hampered economic recovery after depreciation, and massive exporters were complaining about the deterioration in international competitiveness of their products due to the high interest rate. The third negative factor was the bad debt growth in the banking system. According to the survey by Goldmansachs, loans in the Philippines increased annually by 30.7% for five years from 1991. And the loans to private firms at the end of 1997 increased by 50% compared to the end of 1996. However, these loans were not fully collateralised, and bad debts emerged. The fourth factor was the lack of economic vitality. The main reason was the continued recession in the manufacturing industry. The low-tech exports could not cope with fierce competition in the international market. After the breakout of financial crisis, the Philippines government tried to attract foreign investments and obtain technology transfer. This was not effective in the short term, as happened in some other East Asian countries, because the low technological content of export products had been stuck on the past level. The fifth factor was the vulnerability of the financial system, which was the key economic defect in the Philippines. Before the crisis, the current account had a deficit of 3.5 billion USD, accounting for 4.2% of GDP. The deficit of foreign trade account reached 11.3 billion USD. Additionally, external debt was up to 42 billion USD, which was as much as half of the GDP. The international speculators took advantage of the Philippines’ vulnerability against financial turmoil and attacked the peso. The last factor was the negative effect of decontrolled foreign exchange. When the Philippines’ government decontrolled foreign exchange, they did not adopt supporting measures. As a result, the exchange rate of the peso remained high and weakened competitiveness of export, enlarging the foreign trade deficit. And the appreciation of the peso increased foreign investment costs, which offset the effect of decontrolling.

Singapore during the Crisis

Singapore is a small open economy. It was easy for it to be affected by the external environment. The regional crisis adversely affected Singapore in its currency, asset market, banking, and real economy. After the breakout of the crisis, Singapore dollars depreciated against the USD, but appreciated sharply relative to Indonesian rupiah, Thai baht, Malaysian ringgit, and Korean won. Although not
attacked severely by speculation, changes in the market made it necessary to maintain public confidence in currency, ensure price stability, and retain export competitiveness. In the stock market and property market, the decline in assets negatively influenced on the balances of firms and households, and the profitability of real estate developers. Together, the reduction in assets’ price and increase in unemployment rate resulted in more mortgage defaults. The 1997 financial crisis hit financial departments in Singapore. The number of financial institutions reduced from 185 in 1996 to 108 in 1997. Before the crisis, Singapore believed official intervention in that financial market was disadvantageous. Under the principle of financial market liberalisation, Singapore implemented a wide range of sub-industry financial regulatory systems. But the financial regulation was not in place, leading to low efficiency of supervision and growth of lax financial regulation. Potential risks in the financial sector gradually accumulated. For the real economy, the AFC led to a recession in Singapore. In 1998, more than 25,000 companies suspended operations, and the number of bankruptcies was 68% more than 1997, half of which were small and medium sized enterprises.

Fortunately, Singapore managed to recover from the crisis. It outperformed most other Asian countries in the crisis, judging from the rebound of GDP growth, reduction in unemployment rate, stable and low inflation rate, and the resumption of stock market prices during the post crisis period. The experiences of Singapore’s quick recovery can be attributed to several factors. Firstly, in 1978, Singapore removed exchange rate control. The nominal and real exchange rate trended towards consistency. To keep Singapore dollars stable, the monetary authority had a basket of currencies as an exchange rate indicator, and controlled inflation through Singapore dollars’ steady appreciation. Additionally, Singapore adopted a series of effective management practices, such as no internationalisation of Singapore dollars, prohibition of overseas bank branches receiving Singapore dollar deposits, and the provision that banks were required to report foreign exchange transactions involving Singapore dollars. Secondly, Singapore maintained stable economic development by high-tech industries. The government had played a leading role in funding research and development, and promoting development of the manufacturing sector. In 1994, the Singapore government invested 1.175 billion Singapore dollars in research and development, accounting for 1.18% of GDP. Singapore focused on the high value-added manufacturing sector, mainly the electronics industry, which had become Singapore’s leading industry of economic development. When the 1997 crisis swept through Southeast Asia, Singapore survived the direct impact because its electronic industry export to the US was 30%, to the European Union was 20%, and the percentage to Malaysia, Japan, Hong Kong, and mainland China were 12%, 7%, and 6%. When the entire East Asia in general suffered a serious setback, the Singapore economy grew strongly by 8.3%. Thirdly, the Singapore government attached great importance to the rule of law. It was world famous for severe regulations. Regulations and laws were relatively transparent, so market participants were able to obtain sufficient information to reduce uncertainty and risks of investments, and improve the efficiency of the economy as well as public confidence. It was because of its good reputation built on strict regulatory mechanisms and the stronger public confidence factor that prevented Singapore from a serious blow from the financial crisis.

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