Asia's financial crisis: Origins and impacts

John Kimball Dietrich

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The reasons for the Asian financial crisis become easier to understand when viewed against the backdrop of the 1980’s S&L crisis in the United States, Kim Dietrich said in a presentation to the Global Executive Forum. The similarities include what Dietrich calls a “hide and grow” strategy, lack of regulatory oversight, and greed, fraud and incompetence on the parts of those who ran the institutions.

In the early ’80s, the U.S. government addressed the problems in the S&L industry by expanding its powers through deregulation and hoping the industry would grow out of its malaise (see sidebar below). This “hide and grow” strategy allowed the managers of the S&Ls, the regulators and politicians to delay taking the bitter pills that were necessary to right the situation.

The S&Ls responded to deregulation by abusing their new powers and taking high risk, high return gambles. The problems got bigger. Ultimately, the government was forced to deal with the problems in the now infamous multi-billion dollar bailout of the S&L industry

Relationships, not stability

Hide and grow has also been the strategy of choice in many Asian countries, where loans are often made on the basis of relationships rather than the financial stability of the borrower.

In Korea, the chaebols were in a prime position to receive financing, no questions asked, and no pressure to repay the loan. If the bank were left with too many unpaid loans from chaebols, the bank would seek a bailout from the government. "That stopped about a year and a half ago," said Don Stevens, managing director of the Institute for International Business. "But that is not unlike what's happened in all of these southeast Asian countries."

"It's the Asian way," said Dietrich, "and it's something akin to what happened with the S&Ls in the United States. The S&Ls had a cozy relationship with the regulators and the legislators. They were part of this government's policy where the government was picking the winners."

The banks dominate the allocation of capital in southeast Asia, and it's these allocations that drive investments. If the banks are politically manipulated or influenced, then viable investment opportunities do not take place. "In a competitive market, you would see more efficient allocation of funds," said Dietrich.

Japan, the pivotal player

Japan has been named by some economists as the culprit in the financial mess of Asia. The early ’90s saw the appreciation of the yen and a simultaneous slowdown in the Japanese economy. There was a huge outflow of capital due to the lack of investment opportunities at home.

Japanese investors and lending institutions put their money into ventures in South Korea, Thailand, China, Indonesia, and Malaysia, among other countries. Today, the amount of Japanese loans outstanding in Asia is huge. "This has frozen the Japanese financial system, prolonging the economic stagnation."
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Japan is the pivotal player in the crisis. The threat the Asian countries pose to the U.S. economy "is not simply the weakness of these economies, but the effect these economies will have on Japan, and, consequently, on the United States."

Japan's economy has been underperforming; and the country is experiencing something close to deflation.

- Money market rates are close to zero.
- The real rate of return on investment is incredibly low compared to the U.S.
- Banks are in trouble and the troubles are growing.
- The stock market is "minus 10."

Given the current economic conditions, Japan cannot attract the investments it needs to grow out of its problems. Government bonds are paying 2 percent; corporate bonds 3 percent.

"Five years ago, we were all afraid the Japanese banks were going to take over everything in the U.S. Now there are five Japanese banks in L.A. that you can have for a dime, and the American banks are going gang busters," said Dietrich.

IMF criticized

The International Monetary Fund is being heavily criticized in some quarters because it did not see the problems brewing in Asia.

Some of the criticism is slightly unfair, said a Board member. "The role of the IMF is to step in when a country has a problem with trade or the current account. Therefore, the reserves go out and get built up again. The private sector is buoying up these countries. And it's all short term foreign currency debt."

Nevertheless, the debate continues: Is the IMF helping or, in the long run, hurting the countries it is bailing out? By acting as an implicit guarantor on the liabilities of these countries the IMF may be subsidizing risk and, therefore, limiting the incentives to restructure the financial systems.

An alternative solution is to let a free market system mandate losses. "Some people have to go bankrupt, some have to lose their jobs, and investors have to realize they might get hurt."

But while the IMF bailouts may be controversial, they are in the best interests of the United States, suggested a Board member. "If the people in these countries don't have the money, they can't buy from America. So, we may be bailing out a bunch of rich people in Indonesia, and private banks in Japan, but you have to do that to maintain their buying power."

Dietrich compared this argument to the thinking that was prevalent in the United States in the '80s. "It's called 'too big to fail.' The fear was that the system would collapse if you allow these institutions to go under. So you carry them along, and the losses get bigger."

Best prospects

Dietrich believes that Korea, of all the Asian countries, has the best prospects to reestablish its economy on a sound footing. "Korea has a new president, they have tremendous impatience with the system as it is because of the inefficiencies, and they have the possibility for rapid growth in the small- and medium-size firm sector."
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But the growth will not be painless. Korean companies are not efficient. There will be unemployment in the wake of restructuring, and people will have to be retrained. The Korean government will have to allow foreigners to come in and invest, even though it dislikes and mistrusts them.

A Board member expressed the opinion that the southeast Asian economies were doomed to failure because they were based on low cost manufacturing. "We know that you cannot sustain economies on this basis." More sophisticated types of structures are needed, he said.

The Asian governments have been the targets of severe criticism since the financial crisis unfolded, but some of this criticism may be unfair. A Board member pointed out that from 1970 to 1997, the region experienced the highest growth rates in the history of the world, with more people moving from poverty to middle class than ever before.

"The reason this happened is because these countries' governments got the fundamentals right; they picked the winners, they directed investment." The problems of the last eight months should not undermine the 27 years of success that preceded this downturn, he said.

Prognosis

According to Dietrich:

- China has strong economic leadership but problems exist in its financial systems. The Chinese are definitely trying to hide and grow, and it's not clear that they have the resolve to take the hits that are necessary to bring about reforms.
- Thailand has taken some of the steps that will allow restructuring to occur and foreign investment to come in. The economic fundamentals are great.
- Indonesia has a lot of problems, many of which are political. For example, the proposed currency board was rejected by international organizations because they feared it would bail out the Suharto family by fixing the value of the rupiah at an unsustainably high level.
- Japan's problems are serious. Its economic policy environment seems to have ground to a halt. The question is: Is Japan going to be able to make the necessary structural reforms?

Is there a Big Bang in Japan's financial future? Yes, said Dietrich. But first the country has to undergo two to three years of incredible pain. "When the restructuring is all over, its economy will be like the U.S. in the mid '90s."

There are tremendous opportunities for the U.S. in Asia, providing these countries implement policies that include: transparency in reporting, objectivity in regulation, letting the market work, and allowing foreign investment to take place.

Recent U.S. history parallels Asia's woes and suggests a reason for optimism. Said Dietrich, "We had a stock market crash in '89, a recession in '90. Industry is now staging a comeback. The S&L crisis didn't put us out of business."

Between 1969 and 1982, the U.S. stock market was stuck below 1,000. "But during that period, lots of structural changes occurred, including deregulation of telephone markets, airline markets, and trucking and financial reforms."

"These things have finally produced phenomenal fruit."
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The S&L crisis at a glance

Memories of the S&L crisis in the U.S. rise to the surface as Japan and other Asian countries grapple with their current financial ills. The similarities abound. Then and now, the countries involved failed to heed warning signs of an impending economic disaster until the disaster was full blown.

The idea behind the creation of the S&Ls in the 1930s was to facilitate home ownership for the average citizen. The S&Ls were chartered to offer interest bearing savings accounts, and to use the deposited funds to invest in residential mortgages.

Governed by federal rules and regulations, including interest rate ceilings, the S&L industry could not successfully compete with other financial institutions. In an attempt to level the playing field, Congress in the late 1970s deregulated the banking industry. This allowed the S&Ls to raise interest rate ceilings and expand the types of investments they could make with deposited funds.

Deregulation also opened the door to more buyers of S&Ls, people who previously might not have been able to meet the standards for ownership.

Another important piece of deregulation was to raise the federal deposit insurance from $40,000 to $100,000, which enabled the S&Ls to borrow in substantial quantity. And, given their new ability to buy bonds, the S&Ls invested not in rated bonds, but in junk bonds. By the end of the decade, these bonds were virtually worthless. The Garn-St. Germain Act of 1982 allowed the industry to expand its charter from residential mortgages to include commercial real estate loans.

For a while in the early '80s it appeared that the S&Ls were thriving, thanks in large part to falling interest rates and a subsequent building boom. No one seemed concerned, or aware, that the S&Ls were financing extremely risky development and construction loans.

The real estate boom had a short life, especially in the states of Texas, Louisiana, and Oklahoma, which were hit hard when energy prices collapsed in 1984. About 200 S&Ls failed in these states, but there was no pressure for more Congressional oversight of the S&L industry. And in most cases, it was later learned, the S&Ls' financial statements did not reflect their relatively large loan losses.

Deregulation did not remove all restrictions on S&Ls. There were still strict rules limiting the amount of funds that could be loaned to any single borrower, or in any geographic area. And loans to the owners of S&Ls were prohibited. But these restrictions were either ignored or circumvented by real estate promoters and other investors who saw the S&Ls as a funding source for their own ventures.

Unfortunately, the systems that Congress assumed would expose unsound operators were not up to the task. Neither periodic examinations by regulators, nor auditing procedures of CPAs, were sufficient to uncover the improper and fraudulent transactions that ultimately brought down the industry and caused Congress to enact bailout legislation that saddled the American taxpayer with tremendous debt.