Globalization and the Asian Financial Crisis

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The banking and currency crises in Mexico and Asia have brought into question the advisability of globalization for emerging economies. There are many benefits to developing countries for current and capital account liberalization. The portfolio capital inflows that followed liberalization of the capital accounts in Thailand and South Korea helped finance the enormous economic growth that occurred from 1991 to 1996. However, the Asian crisis also illustrated the risks of globalization. Many of these problems could have been avoided if the domestic financial sector had been reformed before the liberalization measures that led to massive capital flows. It began with Thailand's devaluation of the baht in 1997. The factors that led to this devaluation can be traced to the pacing and sequencing of the liberalization of its money and capital markets. In both Thailand and South Korea, liberalization of money and capital markets preceded the reform of domestic financial markets.

The domestic financial markets for Thailand and South Korea were primitive prior to 1991, which was the beginning of the capital inflow period for both countries. For example, certificates of deposit did not exist in Thailand until the late 1980s, and there was a heavy government presence in the domestic financial markets as well as a lack of competition in the financial industry. These factors all combined to produce high domestic interest rates, which made foreign loans with short maturities attractive to domestic banks and corporations. Additionally, prudential regulation and supervision were weak. Weak equity markets made monetary policy impotent in Thailand and forced banks to assess the riskiness of investment projects and the credit worthiness of corporate debtors. Heavy government presence in the financial markets left banks ill-equipped to perform these risk assessment functions.

The poor sequencing of capital account liberalization and domestic financial sector reform left the Asian countries ill-prepared to intermediate the massive capital flows that resulted from liberalization. One result was a great misallocation of loanable funds. The investments for the inflow period were less productive and were often in nontraded goods sectors, such as real estate, which fail to generate the current account surpluses necessary for an emerging economy. In Korea, investment occurred in the semiconductor industry, in which there was a worldwide glut in 1996. The abundance of loanable funds and a belief in the security of the fixed exchange system both resulted in a large quantity of short-term debt and a large current account deficit. This led speculators to question Thailand's ability to avoid currency devaluation. It was soon afterward that attacks on the baht began. Thailand's determination to maintain the peg led officials to exhaust reserves for defense of the currency until devaluation became unavoidable.

In conclusion, globalization is beneficial for an emerging economy and even essential for economic growth to propel the country from the ranks of developing nations. However, if the pacing and sequencing of liberalization measures are not handled properly, a banking or currency crisis can result. (JEL F32) *Atlantic Econ. J., 29(4): p. 472, Dec. 01.*