ABSTRACT

Much has been written on the Asian Financial Crisis. The salient features of the turmoil are indicative of strong myopia among banks, firms and foreign lenders. For instance, banks used short-term foreign capital to overexpose themselves to risky local projects. There was also an abrupt reversal of massive capital flows in late 1997. Finally, the deterioration in GDP and exchange rate forecasts was very sharp. The initial impression one gets is that the inability to engage in complex, farsighted optimization had made agents focus only on the immediate past and exhibit herd behaviour. This would imply exuberance with a subsequent meltdown, as was actually observed.

In Chapter 1, we summarize the existing literature on the crisis, in order to locate the key determinants. These can be placed under two broad categories – fundamental weaknesses and panic. Fundamental weaknesses refer to misuse of bailout guarantees, nepotism, real exchange rate appreciation and consequent resource misallocation. On the other hand, theories of panic focus on co-ordination failure and sudden capital outflows. Both these strands of arguments identify capital account liberalization as an important reason behind the boom-bust episodes. Therefore, if agents are seen to be myopic, the literature seeks to identify policies and institutions which motivate such behaviour.

This thesis adopts such a policy-oriented approach to the crisis but argues that domestic financial liberalization, rather than government subsidies or capital account liberalization, would be a stronger stimulant for myopia. The most important policy change since the late 1980s, in East Asia, was in terms of greater financial deregulation and banking competition. The existing literature on financial crises has enough evidence

to implicate such policies as significant contributors to economic distress. The empirical work on the Asian crisis also confirms our conjecture – domestic financial liberalization did make countries vulnerable.

It is necessary for us to specify how financial liberalization can cause systemic myopia. In this thesis, we break up the discussion into three issues. These are as follows:

a) Reckless financial allocation: A necessary condition for excessive risk in financial allocation – lending booms or overexposure to the property and household sectors - is a short-term focus. If banks care about their long-run survival, they will not follow such strategies. Therefore, the first question to ask is:

*Why did banks assume so much risk***?**

We try to demonstrate that the answer lies in the domain of domestic banking competition. The intuition is that the erosion in market share can make future crises irrelevant for competing banks. They might be tempted to reduce client supervision and attract high-risk borrowers from their rivals. In Chapter 2, we elaborate on this theme to show why banking competition, rather than bailout guarantees or capital account liberalization, could be problematic.

b) Role of the government: It is instructive that the high rates of growth in East Asia during the 1980s were financed by long-term foreign and domestic debt. Given the reputation of the East Asian developmental states, it is natural to relate such outcomes to public policy. So, the next question is:

*In what circumstances can the government ensure allocative efficiency without making an economy susceptible to crises***?**

In our opinion, the government has to use self-selecting subsidies, as incentives for the use of long-term relationship loans. In turn, foreign public debt, for these projects, must be long-term to rule out premature liquidation. In Chapter 3, we try to develop this argument and demonstrate how the state can co-ordinate efficient and riskless lending.

c) Short-term debt and efficiency: In contrast to the 1980s, the 1990s saw a sharp reduction in the maturity structure of domestic and foreign debt in East Asia. In view of the crisis, a logical question might be whether short-term debt is also compatible with allocative efficiency. An answer in the affirmative should indicate why such a maturity reduction was required to achieve efficiency. Hence, the last question is:

Can efficient banking involve short-term domestic and foreign debt?

We suggest that debt maturity reduction is an artifact of financial deregulation and banking competition, in a world with severe problems of contract enforcement and asymmetric information amongst agents. Such a regime forces agents to use different signals. Good firms signal with short-term domestic debt while good banks signal with short-term foreign loans. In Chapter 4, we develop this argument to show how, in a liberalized environment, a fragile debt structure may ensure efficiency, but also expose the economy to panics.

To sum up, our basic motivation was to study the strong systemic myopia in East Asia on the eve of the crisis. This dissertation tries to show that government intervention, during the 1980s sought to contain such myopia. In contrast, domestic financial liberalization stimulated it in the 1990s. In this sense, we suggest that government subsidies or capital account liberalization are peripheral while financial liberalization takes the lead in making the corporate and financial sectors vulnerable to panics.