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Asian Financial Crisis: Causes, Response, Lessons Learned

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What Was the Asian Financial Crisis?

The Asian financial crisis, also called the “Asian [Contagion](#),” was a sequence of [currency devaluations](#) and other events that began in July 1997 and spread across Asia. The crisis started in Thailand when the government ended the local currency’s de facto [peg](#) to the U.S. dollar after depleting much of the country’s [foreign exchange reserves](#) trying to defend it against months of speculative pressure. ^[1]

Just weeks after Thailand stopped defending [its currency](#), Malaysia, the Philippines, and Indonesia were also compelled to let their currencies fall as speculative market pressure built. By October, the crisis spread to South Korea, where a [balance-of-payments](#) crisis brought the government to the brink of [default](#). ^[1]

Other [economies](#) also came under pressure, but those with solid economic fundamentals and hefty foreign exchange reserves fared much better. Hong Kong fended off several major but unsuccessful speculative attacks on [its currency](#), which is pegged to the [U.S. dollar](#) via a currency board system and backed by massive U.S. dollar reserves. ^{[1][2]}

KEY TAKEAWAYS

- The Asian financial crisis started in July 1997, when Thailand stopped defending the baht after months of downward market pressure, causing the currency to fall quickly.
- The [contagion spread quickly](#), with currencies across the region falling —some quite catastrophically.

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- The International Monetary Fund (IMF) bailed out many countries but imposed strict spending restrictions in exchange for the help.
- Affected countries have since put in place mechanisms to avoid creating the same scenario in the future.

Impact of the Asian Financial Crisis

As the Thai baht fell, other Asian currencies fell—some precipitously. Across Asia, inflows of [capital](#) slowed or reversed.

The Thai baht had been trading at about 26 to the U.S. dollar before the crisis but lost half its value by the end of 1997, falling to 53 to the dollar by January 1998. The [South Korean won](#) fell from about 900 to the dollar to 1,695 by the end of 1997. The [Indonesian rupiah](#), which had been trading at around 2,400 to the dollar in June 1997, plummeted to 14,900 by June 1998, less than one-sixth its precrisis level.

Some of the more heavily affected countries fell into severe [recession](#). Indonesia's [gross domestic product \(GDP\)](#) growth fell from 4.7% in 1997 to -13.1% in 1998. ^[3] In the Philippines, it slid from 5.2% to -0.5% over the same period. ^[4] Malaysia's GDP growth similarly slid from 7.3% in 1997 to -7.4% in 1998, while South Korea's contracted from 6.2% to -5.1%. ^[5] ^[6]

In Indonesia, the ensuing economic crisis led to the collapse of the three-decade-old dictatorship of President Suharto. ^[7]

Thailand, Indonesia, and South Korea to bail out their economies. ^[1]

 Asian Financial Crisis Hammers GDP

As a result of the the crisis, affected countries restructured their economies, generally because the IMF required reform as a condition of help. The specific policy changes were different in each country but generally involved strengthening weak financial systems, lowering debt levels, raising [interest rates](#) to stabilize currencies, and cutting government spending. ^[1]

The crisis also serves as a valuable case study for [economists](#) to understand how interwoven markets affect one another, especially as it relates to currency trading and national accounts management.

Causes of the Asian Financial Crisis

The crisis was rooted in several threads of industrial, financial, and monetary government policies and the investment trends that they created. Once the crisis began, markets reacted strongly, and one currency after another came under pressure. Some of the [macroeconomic](#) problems included [current account deficits](#), high levels of [foreign debt](#), climbing [budget deficits](#), excessive [bank](#) lending, poor [debt-service](#) ratios, and imbalanced [capital inflows](#) and [outflows](#).

closely with manufacturers to support exports, including providing [subsidies](#) to favored businesses, more favorable financing, and a currency peg to the U.S. dollar to ensure an [exchange rate](#) favorable to exporters.

While this did support exports, it also created [risk](#). Explicit and implicit government guarantees to [bail out](#) domestic industries and banks meant investors often did not assess the profitability of an investment but instead looked to its political support. Investment policies also created cozy relationships among local conglomerates, financial institutions, and the regulators who oversaw their industries. Large volumes of foreign money flowed in, often with little attention to potential risks. These factors all contributed to a massive [moral hazard](#) in Asian economies, encouraging major investment in marginal and potentially unsound projects.

As the crisis spread, it became clear that the impressive economic growth rates in these countries were concealing serious vulnerabilities. In particular, domestic [credit](#) had expanded rapidly for years, often poorly supervised, creating significant [leverage](#) along with loans extended to dubious projects. Rapidly rising [real estate](#) values (often fueled by easy access to credit) contributed to the problem, along with rising current account deficits and a buildup in external [debt](#). Heavy foreign borrowing, often at short [maturities](#), also exposed corporations and banks to significant exchange rate and funding risks—risks that had been masked by long-standing currency pegs. When the pegs fell apart, companies that owed money in foreign currencies suddenly owed a lot more in local currency terms, forcing many into [insolvency](#).^[1]

Many Asian economies had also slid into [current account](#) deficits. If a country has a current account surplus, that means it is essentially a net [lender](#) to the rest of the world. If the current account balance is negative, then the country is a [net borrower](#) from the rest of the world. Current account deficits had grown on the back of heavy government spending (much of it directed to supporting continued export growth).

Response to the Asian Financial Crisis

P The IMF intervened to stem the crisis with [loans](#) to stabilize the affected economies. The IMF and others lent roughly \$118 billion in short-term loans to

subsidies. By 1999, many of the affected countries began to show signs of recovery.

Other financial institutions also intervened. For example, in December 1997, the U.S. Federal Reserve Bank brokered a deal under which U.S. banks owed money by South Korean companies on short-term loans voluntarily agreed to roll them over into medium-term loans. ^[1]

Lessons from the Asian Financial Crisis

Many of the lessons of the Asian financial crisis remain relevant today. First, beware of asset bubbles, as they have a habit of bursting. Another is that governments need to control spending and pursue prudent economic development policies.

How do government spending and monetary policy affect a currency's value?

When governments spend, implement policies that keep taxes low, subsidize the price of staple goods, or use other methods that effectively put more money in people's pockets, consumers have more money to spend. As most economies rely at least partly on imports for many goods and services, this increased spending creates demand for foreign currency (usually U.S. dollars), as importers have to sell local currency and buy foreign currency to pay for imports.

Demand for foreign currency (and selling of local currency to buy it) increases exponentially when those policies also promote heavy investment in infrastructure, new businesses, and other economic projects. As more local currency is offered for sale on foreign exchange markets, its value goes down, unless there is a corresponding demand to buy it (say, by exporters selling foreign currency that they earn from exports).

Why do governments keep exchange rates high?

Governments, especially in developing economies, seek to manage exchange rates to balance their ability to pay debts denominated in foreign currencies. Because investors generally prefer instruments denominated in more stable

However, if the value of the domestic currency falls vs. the currency in which its debt is denominated, that effectively increases the debt, as more local currency is needed to pay it. So, when the Thai baht lost half of its value in 1997, that meant local borrowers needed twice as many baht to pay debts denominated in U.S. dollars. As many developing countries also rely on imports, a higher-valued local currency also makes those imports cheaper in local currency terms.

Why do governments keep exchange rates low?

Conversely, governments may seek to keep their exchange rates low to increase the competitiveness of exports.

In the 1980s, following years of complaints from U.S. companies about competition from cheap Japanese imports, the U.S. government convinced Japan to allow its currency to [appreciate](#) as part of the [Plaza Accord](#).^[8] The currency's value climbed from 250 yen to one U.S. dollar in early 1985 to less than 130 yen by 1990. The U.S. [trade deficit](#) with Japan fell from \$55 billion in 1986 to \$41 billion in 1990.^[9]

The Bottom Line

In 1997, decades of economic policy planning that featured close relationships among government policy planners, regulators, the industries they regulated, and financial institutions came to a head when markets began putting downward pressure on Asian currencies. The most vulnerable were those countries with high levels of debt and insufficient financing to pay it.

The IMF stepped in to bail out the most affected economies, but it imposed strict conditions in exchange for the help. Some measures included requiring governments to cut spending, raise taxes, eliminate subsidies, and restructure their financial systems.

The crisis also serves as a case study in asset bubbles and how quickly [panic selling](#) can trigger contagion that [central bankers](#) cannot control.

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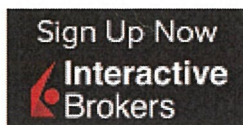
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