Comparison of 1980s Latin American and 1990s East Asian Financial Crises

Anne Dullum,
Graduate Student, JKSIS, 2201 South Gaylord Avenue,
University of Denver, Denver, CO 8029.

Kishore G. Kulkarni, Ph.D.,
Professor of Economics, and Editor, Indian Journal of Economics and Business,
CB 77, P. O. Box 173362, Metropolitan State College of Denver,
Denver, CO 80217-3362

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Introduction

It is generally argued that developing economies are powerless before global market forces. Perhaps recommendations prescribed by international financial institutions to liberalize economies have made some developing economies vulnerable to the effects of the open market. Perhaps, the combination of financial liberalization in the developing world, irresponsible domestic monetary policies and anti-inflationary policies of the developed world, particularly the West, have allowed financial crises to occur. Crises have spread from Latin America to East Asia to other regions of the developing world, induced by financial instability (Hirst and Thompson 2004). An international financial crisis is a situation where the international elements considerably exacerbate a crisis in ways that would not occur in a closed economy (Summers 2000).

Typically, a financial crisis occurs as an economy enters a recession that follows a period of productive economic activity fueled by credit and capital inflows. The cycle of over lending, which occurred in both the Latin American financial crisis and the East Asian financial crisis, is intensified by implicit or explicit contracts between lenders and borrowers, poor supervision of financial flows, and issues among the banking sector (Kaminsky and Reinhert 1999). Financial crises are accompanied by a depreciation of the economy's currency, weakening exports, loss of financial credibility and negative economic growth.

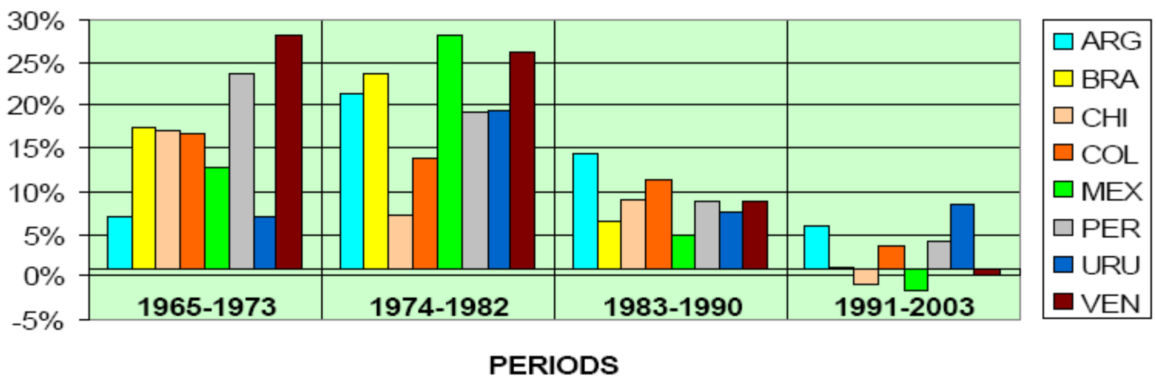
The financial crises in Latin America and East Asia occurred in different decades and were caused by different external and internal influences. "Throughout the most successful of developing regions, living standards are falling as unemployment rises and the effects of huge devaluations work through into higher import prices. Many millions of people are at risk, and many millions of people who were confident of middle-class status feel robbed of their lifetime savings and security (Wade and Veneroso, 1998)."

Therefore the main question to be answered is "Do international financial crises occur and are worsened by the exposure of nations to an open world economy?" or "Has Globalization proven to be the primary cause of financial crises in recent decades, yet crises are substantially influenced by nations' socio-economic condition?" The causes of the financial crises in Latin America and East Asia vary according to the nation's degree of income equality, maintenance of government budget, extent of foreign borrowing, amount of domestic savings and implementation of effective macroeconomic policies. This paper intends to answer these questions with the following organization. Section 1 explains the causes and circumstances of Latin American crisis, while Section 2 deals with the Southeast Asian Crisis. Section 3 makes contrasts and comparisons of these two crises and Section 4 forms the summary and conclusion.

Section 1: Case of Latin American Financial Crisis

In the early 1980s Latin America, as a rapidly developing region, abruptly experienced a debt and development crisis. Latin American financial crises began in the 1970s though were more prominent during the early 1980s. During the period, the countries of Latin America were experiencing soaring economies. The advancing economies of Latin America were the result of rising governmental deficits caused by excessive foreign borrowing. In the 1960s and 1970s many Latin American countries, notably Brazil, Argentina, and Mexico, borrowed huge sums of money from international creditors with the intention to develop industries and improve infrastructure. Figure 1 shows the annual growth in public external debt. In the 1970s, Mexico, Venezuela, Brazil and Argentina acquired the most public debt. At the time of borrowing, Latin American

FIG.3: AVERAGE ANNUAL GROWTH IN PUBLIC EXTERNAL DEBT (in current US dollars)



economies were exhibiting great performance and development. Nations' large budget deficits were accelerating inflation and the incrementing entry of capital was increasing the economies' vulnerability to violent external shocks. Nations increased resources towards repaying debts which resulted in the reduction of domestic output and consumption (Hirst and Thompson 2004). The economies were no longer capable of increasing their economic growth. Foreign debt of Latin American nations surpassed the amount the economies were able to earn. The large amounts that the government borrowed were careless and corrupt (Wade and Veneroso 1998). Between 1975 and 1982, Latin American debt to commercial banks increased at a cumulative annual rate of more than twenty percent. This heightened borrowing led Latin America to quadruple its external debt from $75 billion in 1975 to more than $315 billion in 1983. Interest payments and the repayment of the principal amount increased rapidly, amounting to $66 billion in 1982 compared to only $12 billion in 1975 (Theberge 1999). The Latin American crisis was a result of bad macroeconomic policies and foreign borrowing by governments.

The Latin American financial crisis followed the world economy's recession in the 1970s and 1980s. The world was experiencing a recession in which oil prices were increasing and the interest rate was growing in the United States and among European nations. The United States and Europe became more attractive for foreign direct investment resulting from the growing interest rate. During the global recession, oil prices rose dramatically. Figure 2 shows

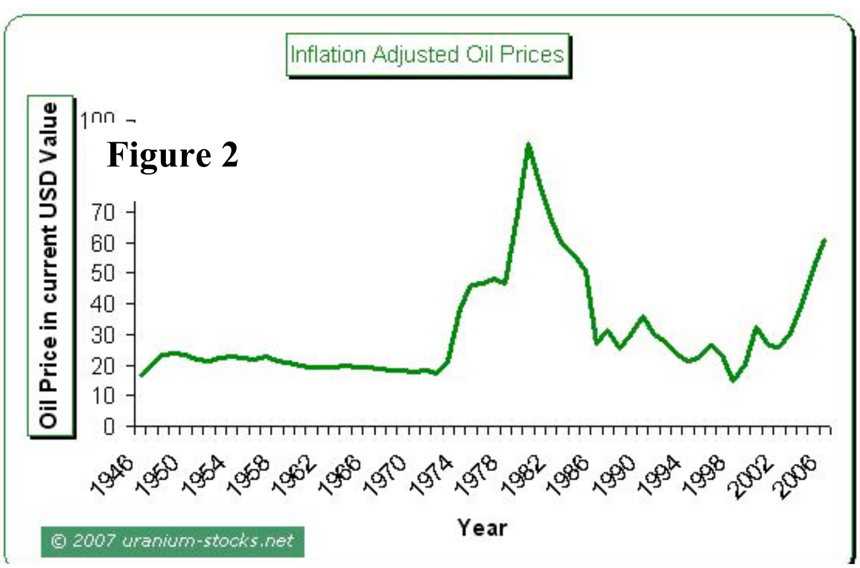


Figure 2

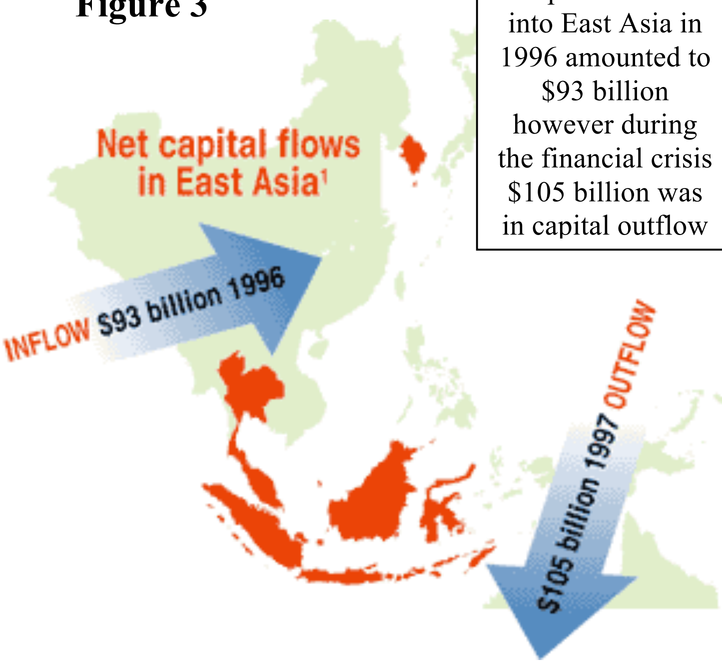
that during the 1970s, oil prices were increasing with a peak in the early 1980s. Petroleum exporting countries accumulated large amounts of cash due to the increase in the international price of oil. These nations were able to invest more money in international banks. The money invested in international banks provided banks the ability to lend more money. Latin American governments were able to continue borrowing money for domestic purposes. As the interest rates continued to increase in the United States and Europe in 1979, Latin American nations found it increasingly more difficult to repay loans. While the risky accumulation of foreign debt by Latin American governments occurred over a number of years, the debt crisis began when the international capital markets became aware that Latin America would not be able to repay its loans. Consequently, Latin America's inability to repay the loans was initially revealed by Mexico to the international community.

In August of 1982, Mexico declared that it would no longer be able to service its debt by stating default on its loans. Following this realization, the majority of commercial banks reduced or stopped lending to Latin American nations. Latin America's loans were primarily short-term and the financial crisis ensued when lenders refused to refinance the loans. Billions of dollars of loans that previously would have been refinanced were now due immediately. In response to the crisis most nations abandoned their import substitution and industrialization (ISI) models of economy and adopted an export-oriented industrialization strategy with the exceptions of Chile and Costa Rica which adopted reformist strategies. Consequently, massive amounts of capital outflow occurred, particularly to the United States. Currencies depreciated and the real interest rate continued to increase. During the crisis of the early 1980s, gross domestic product (GDP) growth rate for the region was only slightly more than two percent. In per capita terms, Latin America experienced negative growth of almost nine percent (Palat 2003). The debt crisis is one of the factors which contributed to the collapse of some authoritarian dictatorships in the region, such as Brazil's military regime and the Argentine bureaucratic-authoritarian regime.

Section 2: East Asian Financial Crisis

The East Asian Financial Crisis began in July of 1997. Prior to the crisis, the Asian economies were experiencing a period of progress and prosperity due

Figure 3



Capital inflows into East Asia in 1996 amounted to $93 billion however during the financial crisis $105 billion was in capital outflow to immense amounts of capital inflow. The Asian economies performed rapid industrialization, had high values of gross domestic product and export growth in the 1980s and 1990s. They were envisioned as model economies for the rest of the developing world able to offer valuable lessons to other countries seeking to overcome the challenges of late development (Grabel 1999). The process of liberalization in the 1990s failed to implement national financial supervision to control excessive borrowing.

The Asian economies had high interest rates which attracted investors, consequently, large amounts of investment accrued. Hence, individuals and firms acquired large amounts of short-term, private debt (Wade and Veneroso 1998). The Asian economies needed continuous investments in order to sustain productivity and growth (Hirst and Thompson 2004). There has been general agreement on the existence of a crisis and its consequences however the causes of the crisis are less understood. It is debatable what really led to the devaluations of currencies but whether it was a fast outflow of capital from Japanese banks due to their own domestic issues particularly concerning real estate, the United States' interest rate's increase to challenge inflation leading to a more attractive investment region than Asia and/or a final peak of investments into the region led to its decline. Contagion effect resulted by an abrupt withdrawal of short-term funds by Western investors leading to the consequence of many firms' bankruptcies (Hirst and Thompson 2004).

All the causes may not be clearly understood, but the consequences were depreciations of the currencies among the region, inflation, weakening exports, bankruptcies of firms, banks and companies, as well as, declining economic productivity.

The financial crisis was a surprise to leaders, institutions and investors. At the end of 1996, four of the economies which were disrupted by the financial crisis were the world's third, forth, fifth and sixth top recipients of private foreign capital inflows. In 1996, Indonesia received approximately eighteen billion dollars of private capital inflows. Malaysia received sixteen billion dollars, Brazil acquired approximately fifteen billion dollars and Thailand received more than thirteen billion dollars of foreign capital invested in private ventures prior to the crisis (Grabel 1999). The Asian economies experience with corruption, flawed assumptions on real estate values, over spending by governments and ineffective government policies were causes of the problem however the financial crisis that spread throughout East Asia came as a surprise to the international community.

The crisis began in Thailand in May of 1997 with the financial collapse of the Thai baht resulting from the Thai government's decision to float its currency and eliminate its peg to the American dollar, a decision based on its domestic real estate crisis. At the time, Thailand had acquired a burden of foreign debt that forced the country into bankruptcy prior to the collapse of its currency. Following the forced devaluation, Thailand's earnings from imports decreased making recovery impossible. The crisis spread to other nations in the region. Most of the currencies in East Asia and Japan depreciated, the value of stocks fell and private debt increased. Indonesia, South Korea and Thailand were the countries most affected by the crisis. Hong Kong, Malaysia, Laos and the Philippines were also considerably affected by the crisis. The People's Republic of China, India, Taiwan, Singapore and Vietnam were relatively unaffected. Japan was not considerably affected by the crisis however was experiencing its own economic difficulties. In October of 1997, the crisis reached Brazil and Russia. By early December the crisis had reached South Korea. In early 1998, a new cycle of instability disrupted the financial markets of South Korea and Indonesia (Grabel 1999). The crisis, in terms of scope and depth, was very disruptive to the East Asian economies.

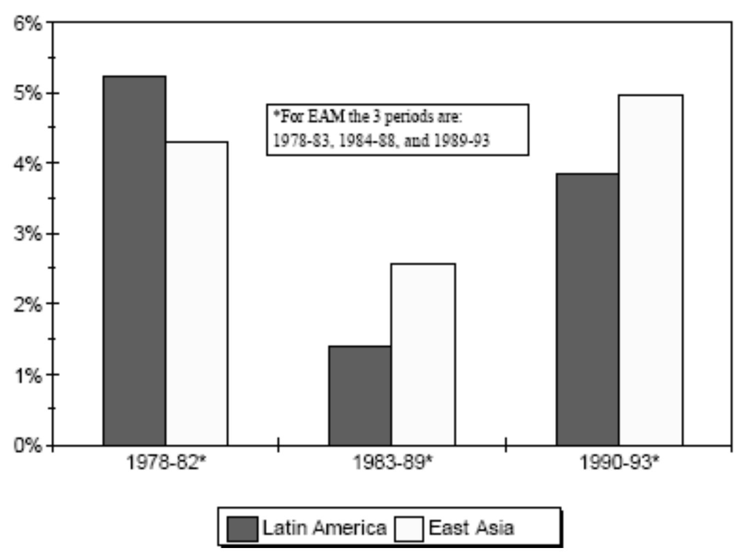
All of the East Asian nations saw their currencies depreciate significantly relative to the American dollar. The currency crisis caused Indonesia's gross domestic product (GDP) to decline to fifteen percent in one year. Thailand and Malaysia suffered losses amounting to approximately ten percent of their gross domestic products (Leblang 2005). Although most of the governments of Asia had no national debt and reliable fiscal policies, the International Monetary Fund (IMF) was forced to initiate a forty billion dollar program to stabilize the currencies of South Korea, Thailand, and Indonesia, whose economies were hit particularly hard by the crisis (Jayasuriya & Rosser, 2001). Japan was experiencing its own recession due to a highly inefficient banking system resulting from unmanageable and large quantities of debt. The United States intervened to stop the continual decline of the value of the yen by purchasing approximately two billion dollars worth of the Japanese currency (King 2000). The regional and global economic crisis resulted in political instability in Indonesia and drastic inflation caused by depreciation of the Indonesian rupiah. The effects of the crisis lasted through 1998 as the growth in the Philippines dropped to almost zero in 1998 (Leblang 2005). In 1999, however, the economies of Asia were beginning to recover.

The two factors that contributed to the principal outcome of the financial crisis in East Asia was that the private sector had excessive reliance on foreign loans and the economies failed to control portfolio investment flows (Grabel 1999). The Asian economies involved in the crisis of the 1990s were vulnerable to the risks of the withdrawal of currency and investors' actions. Once the risks became apparent, it was too late for the governments to be able to reverse the crisis. During the financial crisis of East Asia the governments were coerced to implement neoliberal policies economically and socially in order to create a financial environment in which private capital would return and entice the International Monetary Fund (IMF) to offer financial assistance.

Section 3: Contrasting Causes of the Financial Crises in Latin America and East Asia

Latin American and East Asian financial crises were both a cause of excessive foreign borrowing. The principal lenders to Asia were commercial banks who were also primarily responsible for excessive lending in Latin America during the 1970s (Hirst and Thompson 2004). Prior to the financial crisis, Latin American public debt from commercial banks increased. Latin American economies were driven primarily by high rates of government borrowing. According to figure 4, in the period of 1978 to 1982, Latin America had greater capital flows than East Asia. However following 1983, the period in which Latin America was experiencing a currency crisis, East Asia had more capital flows than Latin America (Gavin 1997). When the world economy went into recession in the 1970s and 1980s and interest rates increased in the United States and in Europe, debt payments also increased making it harder for borrowing countries to pay back their debts (Sachs, 1989). The international markets realized the fate of Latin America and the

Capital flows to Latin America and East Asia
Percent of GDP **Figure 4**



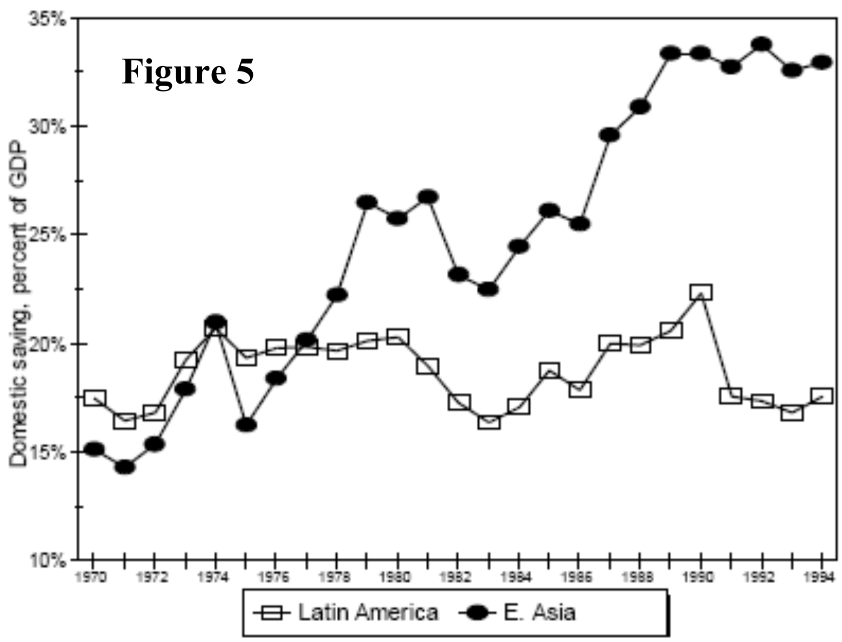
government's inability to repay their loans. The governments in Latin America had borrowed billions of dollars collectively and were forced to repay the loans immediately. The borrowing in Latin America was "wasteful and corrupt" (Wade & Veneroso, 1998) because it was done by governments rather than by private firms operating in competitive markets.

In contrast, most debt in East Asia is private debt, accumulated by private firms and individuals. Corporate debt is much higher in Asian countries, particularly South Korea, than in Western economies (Wade and Veneroso 1998). Until the inception of the crisis, Asia attracted almost half of the total capital inflow to developing countries because the economies of East Asia maintained high interest rates attractive to foreign investors looking for a high rate of return (Radalet & Sachs 1998). The resulting large quantities of credit that became available influenced the economic climate and increased asset prices to an unsustainable level. These asset prices eventually began to collapse, causing individuals and companies to default on debt obligations (Hirst and Thompson 2004). In addition, Japanese banks were the largest lenders in Asia and the key creditor in Thailand. Japanese banks began the contagion effect of withdrawing investments and other foreign commercial banks followed by withdrawing their loans (King 2001). A primary contrast between the financial crises in Latin America and East Asia was the differences in debt accumulated. Latin American foreign debt was accumulated by the government while East Asian debt was a source of revenue for businesses and households.

Governments in Latin America and East Asia managed their balance of payments accounts differently prior to the financial crises. Large budget deficits were common among Latin American nations whereas the East Asian economies held large amounts of domestic savings. In the debt crisis of the 1980s, Latin American countries displayed strong similarities by all possessing large balance of payments deficits that produced high inflations and internal instability (Sachs 1989). Latin American nations' large deficits are outcomes of populist policies in which governments implemented procedures that rapidly and significantly increased government spending in order to correct inequities in the income distribution and to raise the living standards of the poor in their nations. East Asian nations did not have large budget deficits thus had balance of payments in surplus or in balance.

As both regions were experiencing economic growth, private and public saving was exhibited in one region while the other region struggled to save. The economies of East Asia promoted domestic savings and have proven successful in expanding their savings substantially during the period of economic growth (Hirst and Thompson 2004). In contrast, Latin American nations do not domestically save. "Given the low domestic savings rate in Latin America, much of the budget deficit was financed by borrowing from abroad (Hayami 2003)." East Asian economies have strong governmental reserves and significant domestic savings whereas Latin America has negative governmental reserves and contains small amounts of domestic savings (Sachs, 1989). Figure 5 depicts the relationship between savings rate in East Asia and Latin America. Following the mid 1970s, East Asia possessed a greater savings rate than Latin America (Gavin 1997). These factors exemplify the contrasting differences in the financial system of the two regions possibly explaining how East Asian economies have been able to recover more quickly than Latin American economies.

Saving rates in Asia and Latin America, 1970-1994



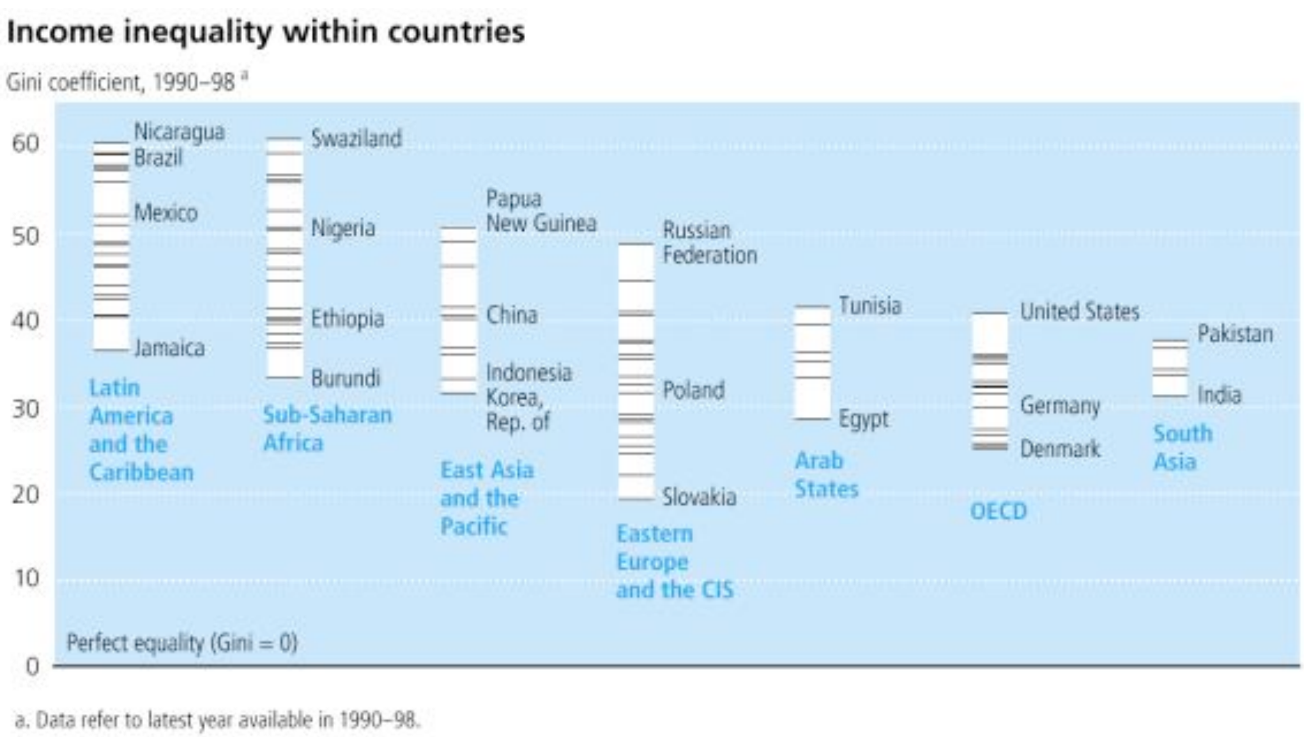
Financial crises occur as a consequence of governments' mismanagement of macroeconomic policies which are influenced internally by domestic policy makers and externally due to Western influence by the International Monetary Fund (IMF) to liberalize economies by deregulating financial institutions. Import substitution industrialization (ISI) is a trade and economic policy on the premise that a state should attempt to substitute products imported with domestically produced substitutes. In Asian nations' ISI policies are focused externally by promoting exports whereas in Latin American nations' ISI policies focus on internal conditions among world markets (Krugman & Obstfeld 2005). Prior to the financial crises, the regions promoted diverse economic and trade policies. In the aftermath of the financial crises, Latin America and East Asia experienced drastically different consequences as bankruptcies occurred.

The import substitution industrialization policy in Asian economies focused externally by promoting exports rather than internally. The internal focus of ISI was rejected by many East Asian nations allowing superior economic performance prior to their financial crisis. Many East Asian economies shifted rapidly from ISI policies to an open economic policy. “Asia experienced a crisis because its various countries did not liberalize their financial institutions enough. They failed to turn domestic banks into Western-style institutions (Hirst and Thompson 2004)." They failed to develop appropriate institutions of national financial supervision and to follow cautious policies to control excessive borrowing. “The financial crisis in East Asia was a market failure resulting from liberalizing international capital movements under the fixed exchange rate in the absence of adequate and prudent regulations due to the euphoria created by the extraordinary level of past economic growth (Hayami 2003).” East Asian nations’ experience of economic prosperity was a result of their trade and economic policies however these policies also contributed to their decline at the end of the twentieth century.

In Latin America, institutional substitution industrialization (ISI) policy focused on internal economic conditions influencing the promotion of domestic production rather than imports. ISI failed in Latin America because governments did not invest enough in skills and education to increase domestic production. The policies in many of the Latin American nations provided the region with economic development however the policy failures were a cause of the region's financial crisis. The financial crisis in Latin America was caused by the combination of bad macroeconomic policies like populism and corrupt borrowing by governments and was thus a government failure (Hayami 2003). The East Asian financial crisis was caused by market failure because there should have been greater supervision of capital flows and better protection of the national businesses from external risks. In contrast, the Latin American financial crisis was attributable to governments' failure to implement supportive macroeconomic policies and reduce foreign borrowing.

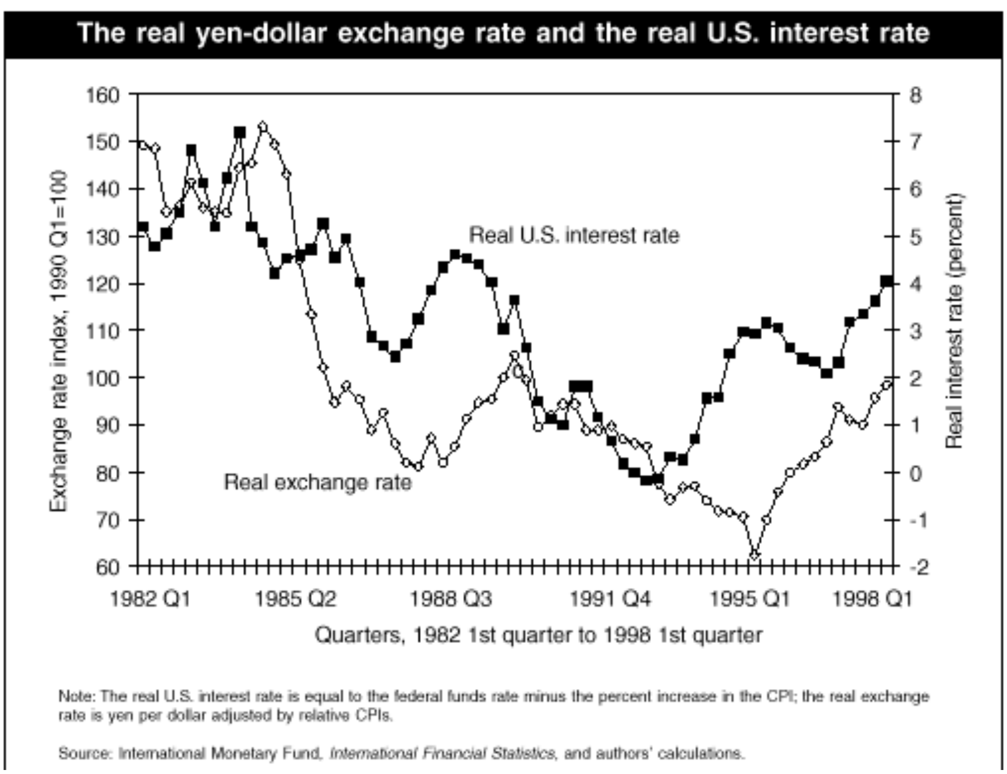
Countries with high income inequality have proven to be especially vulnerable to debt crises. Sachs' research shows that income inequalities in Latin America tend to be much larger then in other regions of the world especially compared to East Asia which has an unusually low degree of income inequality (Sachs 1989). Many of Latin America's economic problems are consequences of income inequality which promotes social unrest and excessive foreign borrowing as a result of social pressures to provide redistributive programs. Figure 6 shows that Latin America has greater income inequality than East Asia. Latin American countries displayed large budget deficits thus creating high inflations and balance of payments crises. Andrew Berg's findings reveal that countries with high income inequality are more likely to reschedule loans (Sachs 1989). Income inequality intensifies political pressure to raise the incomes of the lower classes, which contributes to bad policy choices and poor economic performance. Economic policy in Latin America is challenged by conflicting interests of class, sectors, regions and ethnic groups. Social conflicts lead to weak political institutions and short government tenures (Sachs 1989). The financial crisis in Latin America was partially derived from the internal condition of high income inequalities which led to increased public deficits, rescheduling of loans, poor macroeconomic polices by weak political institutions. Contrastingly, East Asia is characterized by social equality and thusly the social structures of society were not contributing causes to the financial crisis of the 1990s.

Figure 6



Thus financial crises in Latin America and East Asia have similar yet contrasting external factors. “World real interest rates reached unexpected and unprecedented levels in the 1980s, resulting in an enormous drain of resources from Latin American debtor countries to the creditor world. Commodities prices for Latin America’s leading exports collapsed. And in many countries, fragile democratic governments had to try to pick up the pieces in human, political and economic terms—left by earlier military regimes (Sachs 1989).” The effect of world interest rates, including the significant interest of the United States has had major impact on nations competing in the open economy, many times indirectly causing a financial crisis. Figure 7 demonstrates the varying interest rate in the United States where it was at its peak during the financial crises of East Asia and Latin America. In the East Asian economies, the American dollar and interest rate directly affected their ability to compete for foreign direct investment. The

Figure 7



appreciation of the American dollar caused an increase in its interest rate which was politically desirable for the United States yet worsened the situation of financial competition for the Asian economies (Wade and Veneroso 1998). The Asian economies were dependent on continued investment in their firms in order to maintain economic growth. The decline of investment in the region as more investors became attracted to the United States and European economies challenged East Asia's development. In East Asia, as country after country fell into crisis, many local businesses and governments that had taken out loans in American dollars, which became much more expensive relative to the local currency, became unable to pay their creditors. The dynamics of the situation were similar in the Latin American debt crisis yet it was the governments who had borrowed the loans and were now facing the difficulty of repayment. The primary contrasting external cause of the financial crises involves fluctuating dominant currencies and adjustments of interest rates and how the two regions were affected.

The Latin American financial crisis of the 1980s and the East Asian financial crisis of the following decade have a primary contrasting consequence determined by bankruptcies. Many governments in Latin America went bankrupt following the crisis due to their inability to repay loans to foreign lenders. The contagion effect among lenders stemming from the acknowledgement of the credit crisis led to large withdrawals of credit from the Southeast Asian countries, causing bankruptcies of businesses and financial institutions. A common practice in Asian economies is government protection and intervention of major business enterprises when about to fail to avoid bankruptcy (Hayami 2003). However during the crisis major Asian companies went bankrupt. Many businesses collapsed, and as a consequence, millions of people fell below the poverty line in 1997-1998 (Summers 2000). The private bankruptcies in East Asia and the public bankruptcies in Latin America is a contrasting consequence however the people in the two regions were economically devastated and experienced the same fate.

Section 4: Summary and Conclusion

The Southeast Asian crisis differs from the Latin American crisis that originated directly from the behavior of political leaders (Hayami, 2003). Unlike Latin America, the high performing Southeast Asian economies were characterized by reliable economic management, income equality, and substantial domestic savings which protected these economies from the dangers of governments accumulating external debt and eventual bankruptcy (Hayami, 2003). However, the lack of protection and control of external private borrowing resulted in the market failing to protect workers and firms from external forces resulting in the financial crises and bankruptcies of firms. In the case of Latin America, high income inequality, large deficits, considerable public borrowing, lack of domestic savings and dire macroeconomic policies led to the failure of governments to withstand the financial crisis. Many governments went bankrupt in Latin America as a result of the financial crisis of the 1980's. Latin American economies were not able to sustain economic growth after their recovery from the debt crisis. Southeast Asian economies have proven capable of returning to their comfortable path of economic development. Currently, Latin America and Southeast Asia are showing signs of advancement and have returned to the path of economic development. The financial crises of the 1980's and 1990's concerning Latin America and Southeast Asian economies have contrasting and comparable internal and external consequences and causes.

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