

The Causes of the 1997 Asian Financial Crisis: A Comparative Analysis between China, Japan and South Korea

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Abstract. The 1997 Asian Financial Crisis (AFC) was a crisis that affected much of East and Southeast Asia during the final years of the 20th century. It began with a series of events in Thailand before affecting other countries through a chain reaction. Even though later recovery was relatively quick, this crisis could be considered a prime example of financial contagion. This paper employs a comparative case study of South Korea, Japan, and China to adjudicate between these competing theories: one that stresses the importance of a unique Asian developmental model in causing the crisis and another that looks at the AFC through the lens of globalization. This paper uses a comparative analysis method to examine key countries affected by the crisis, through which an overarching cause can be extracted. The conclusion of this paper is that even though both theories have merit in explaining the causes of the AFC, they do not necessarily need to be rival explanations and the cause of the AFC could be better explained as an outcome of individual nations' response mechanisms.

Keywords: Asian Financial Crisis 1997, Economic Globalization, IMF, Culture and Economic Outcomes, Currency Stability

1. Introduction

Following decades of economic growth, Asian countries were not ready to face the onslaught of the 1997 financial crisis. The Asian Financial Crisis (AFC) affected multiple countries in East and Southeast Asia amidst a backdrop of increasing economic globalization and financial restructuring within Asian countries. Current research is split into two theories seeking to explain the causes of the crisis [1]. On one side, neoliberals and classical economists believe that the crisis happened due to a lack of market discipline within Asian countries, which suffered from "crony capitalism" and a discouraging environment for market growth due to the close relationship between states and firms [1]. On the other side, there are those who believe that economic globalization and the free market mode of growth are fundamentally incompatible with the statist style of economy utilized by a majority of Asian countries, stating that the crisis is essentially a result of globalization [1]. This paper aims to explore both theories by examining key countries affected by the crisis to see the extent to which the two theories can explain the crisis as well as to potentially find a new angle to analyze the cause of the AFC. This paper will comparatively compare the policies and domestic

situation of Japan, Korea, and China before, during, and after the crisis to find the causes to the crisis. These three countries were selected due to a common cultural influence (Confucianism) in their society, making it easier to conduct a survey on the "Asian developmental model". By analyzing the causes of the AFC, Asian states can learn valuable lessons regarding their relationship with the global market as well as domestic economic organizational doctrines, through which future economic crises may garner a more ready response. This paper contributes to the debate by systematically comparing the domestic situation and response mechanisms of Korea, Japan, and China in order to provide a potentially new lens regarding the cause of the AFC.

2. Theories of the Asian Financial Crisis

2.1. The Asian developmental model view

One theory regarding the cause of the AFC states that while the Asian developmental model has led to a fast rate of economic growth in Asian countries, the close relationship between the state and the market did not provide ample opportunities for the development of a healthy and competitive free market. An example of this would be the concept of "moral hazard": Asian firms are willing to borrow more recklessly because they know that the state will guarantee the banks [2]. This theory also believes that Asian values, such as Confucianism, played an integral role in the formation of this model.

2.2. The globalization and financial liberalization view

The second theory regarding the cause of the AFC states, other than internal structural issues of Asian political economies, economic globalization, was the prime cause behind the crisis. Asian countries could not respond efficiently to the sweeping changes brought about financial globalization and as such, what ensued was an economic crisis. Premature financial liberalization in response to globalization combined with the large amount of short-term capital inflows sowed the seeds that would explode into the AFC [3]. Foreign investors also exacerbated the situation by causing financial panic and withdrawing capital.

2.3. Research debate and gaps in existing studies

It seems that the primary research debate is centered around the aforementioned theories in 2.1 and 2.2, which will be a better fit to explain the cause of the AFC. The 2.1 view is initially promoted by the International Monetary Fund (IMF) [4]. However, there have been some scholars who believe that blaming the crisis on internal structural issues of the Asian countries will cause a post hoc fallacy of believing that any issues that existed before the crisis would automatically be a cause of it [3].

3. Comparative case analysis

3.1. South Korea: rapid liberalization & vulnerability

The economic growth of Korea before the AFC was dominated by a strong government-led program [5]. It consisted of a top-down approach where the central government intervened in the economy and guided private sectors in profitable ventures. There was a close tie between industries and the government [5]. Large conglomerates known as the "chaebol" formed and dominated the Korean

economy. Being called by many a statist approach to development, this form of economic growth continued in Korea until economic globalization incentivized the Korean government to join the OECD. As a result, the government began to deregulate the previously state-monitored financial market to align with OECD expectations, leading to an increase in loans (from 14.32% of GDP in 1994 to 23.8% of GDP in 1995) [5]. Loans were also increased due to the strategy of short-term borrowings utilized by the Korean government as a means of economic growth [5]. This was partially due to an increase in international funds, which resulted in a larger available amount of short-term investment capital [1]. In 1997, when the AFC occurred, Korea was still in the process of market liberalization and lacked sufficient market expertise and free-market institutions [5].

Even though there were aspects of the Korean statist development that could be considered as negative, for example, nepotism as well as political authoritarianism, which made reform attempts difficult [5], the crisis itself was not caused by these issues. In fact, the chaebols had a positive impact on the Korean economy since they were able to utilize internal capital markets to transfer capital to member firms that had high growth potential. This action mitigated the negative effects of the crisis and firms that received support had better performance in the aftermath of the crisis [6]. A chain of reaction involving the growth of transnational corporations (TNCs), which led to increased productivity resulting in lowered prices of Asian products, contributed to capital outflow [7]. Combined with investors withdrawing their capital across Asia following a collapse of market confidence due to events in Thailand, this created a severe shortage of foreign currency.

As a result, in 1997, Korea requested International Monetary Fund (IMF) support [5]. At the time of its foundation, the IMF was an organization in charge of balancing exchange rates to prevent and to mitigate the negative outcomes of economic crises [8]. By the time of the AFC, it had transformed into an organization that intervened in other countries' macroeconomic policies to conduct structural reforms more in line with a free market economy. In Korea, the IMF accepted their request for help but demanded the government implement trade and capital market liberalization (which were policies desired by the US government, resulting in some criticizing that the IMF was acting like an American puppet) [8]. However, this made the issues worse. The IMF did not realize that it was exactly the unregulated nature of the private sector that led to the crisis in the first place and that there was an urgent need for government intervention to support those affected by the collapse rather than to implement free market reforms during the middle of a crisis [9].

3.2. Japan: unhealthy bank loans and the "liquidity trap"

Japan was, for a long time, a nation that earned the envy of other Asian countries for its rapid economic growth following WWII. It absorbed approximately one third of Asian exports [10] and its developmental model was emulated by many Asian countries for decades. The Japanese economy was characterized by a meritocratic elite, a desire to catch up with the American economy, and government guidance in economic policy similar to Korea's. The Japanese government focused on advancing the interest of the producers and industrialists rather than defending consumer rights, a policy known as stakeholder capitalism [11]. Despite enjoying a period of growth, the Japanese economy had been in stagnation well before the 1997 crisis due to issues with the housing market. Declining land prices left many Japanese banks with bad loans and increased economic uncertainties as a result [10].

Japan's experience in the AFC was different from Korea's in that it was connected to Japan's own structural problems. Japan had a severe issue with debts (around 8% of GDP before the AFC), and it did not adequately deal with the debt for an extended period of time [12]. The Japanese debt

problem was primarily due to the Bank of Japan dictated the amount of loans that banks must meet (bank quotas), resulting in many banks creating loans funded towards the real estate industry, creating the later real estate industry bubble [13]. Despite a pledge from the Japanese government, major securities and banks declared failures consecutively. Consumer confidence in Japan plummeted, and as a result, demand within the Japanese market decreased drastically [10]. Due to the interdependent nature of Asian trade as well as the export-focused policies of most Asian countries, other countries were not able to export to Japan due to the weak economic situation in Japan. This created a chain effect where Asian economies were weakened collectively and these weak economies influenced each other [10]. Domestically, the Japanese government attempted to increase the money supply and ease the interest rate to around 0% to promote spending [12]. However, spending did not increase, and Japan was faced with a liquidity trap. Despite this, the Japanese government did not engage in fiscal expansion because there was a lack of public confidence in government spending, with many believing the infrastructure projects to be a wasteful source of spending [10].

Having described Japan's various economic ills before the crisis, it becomes evident that the AFC in Japan was exacerbated by Japan's own internal weaknesses. However, despite these issues, the crisis could not be described as being completely caused by an "Asian developmental model". Bank failures during this time period were not unique to Japan. According to an IMF study, 133 countries out of 181 IMF member states experienced some form of financial issues from 1980 to 1995, and out of these countries, 36 were related to banks [12]. Furthermore, if anything, Japan's domestic macroeconomic situation was stronger than most countries experiencing similar issues [14]. Japanese scholars believe that even though reforms should be carried out to prevent the debt problems held by Japanese banks during the crisis, Japanese society should remain skeptical of a full-scale adoption of American-style free-market capitalism [12]. After all, changes in economic organization and financial liberalization were contributing factors to the debt problem of Japanese banks in the first place [12]. Furthermore, it is also important to note that countries like Korea and Japan suffered from a loss of exports due to the growth of TNCs.

3.3. China: cautious market liberalization

China's economic situation during the latter half of the 20th century was marked by its experimentation with market economies following decades of disastrous planned economic policies. During the AFC, China received recognition from the international community for maintaining the stability of its currency, while other Asian countries have depreciated [15]. China has been chosen for this analysis because by studying its case, one can isolate two determining factors in causing the crisis: currency stability and method of exposure to foreign markets.

Having a high foreign exchange reserve was a characteristic shared by all countries that survived the crisis the best, and China had a high foreign exchange reserve. Unlike other Asian countries, China kept its currency inconvertible on its capital account, even though it was made convertible on all other accounts as of December 1996 [16]. The government was dominated by a cautious and conservative opinion regarding market liberalization. They believed that the liberalization of capital accounts should only be considered as the final phase in economic liberalization since a premature opening of the domestic financial market may cause unwanted over-competition and therefore breed instability [16]. All foreign exchange transactions were strictly maintained and anyone who wants to do so must seek approval from the state [7]. Furthermore, China's central bank was able to act as an effective lender of last resort, which was something that the IMF was criticized for as lacking. The

IMF was unable to be a true lender of last resort because its loans are restrictive and conditional, and as such, leave doubt within markets. These doubts were worsened as the IMF attempted to enforce its policy of accelerated capital market liberalization during the AFC [17].

As mentioned earlier, economic globalization has led to an increased amount of capital available for short-term borrowing. Many Asian countries took advantage of this and used these loans for domestic growth to the point where some researchers described the growth of these countries as being reliant on "unhindered access to the U.S. market". This huge influx of foreign direct investment (FDI) and foreign portfolio investment (FPI), as well as a sudden liberalization of capital markets to gain more foreign investments, leaves corporations and financial institutions with much debt [11]. China, on the other hand, maintained a low level of short-term foreign capital inflows [16].

China, similar to Korea and Japan, had a strong government grip over domestic growth. Yet its different course of actions with regard to foreign capital, domestic currency exchange rates, and financial market liberalization allowed it to better weather the storm than some of its neighbors.

4. Discussion

4.1. Cause 1: globalization & liberalization

As can be seen in the case of Korea, economic globalization was a key factor in causing the AFC. In Korea, ongoing reforms to respond to worldwide globalization resulted in an inadequate preparation of financial institutions to guard against a potential crisis. The IMF response further worsened the situation by imposing free market reforms on a nation that needed government intervention to mitigate the negative effects of the crisis.

4.2. Cause 2: institutional weaknesses

Institutional weaknesses also contributed to the AFC, as we can especially see in the case of Japan. Even though, as mentioned earlier, the crisis in Japan should not be completely attributed to the failures of Japan's internal issues, the Japanese economy was plagued by widespread "bad" loans, low public confidence in government spending, and a weakened import sector. These issues all contributed to Japan's unreadiness at facing the crisis.

4.3. An alternative angle: response and prevention mechanisms of individual countries

There were cases of both globalization and institutional weaknesses contributing to the AFC. However, perhaps the critical determining factor of the crisis was the response and prevention mechanisms taken by individual countries. China's cautious approach towards liberalization and tight control over foreign currency reserves allowed it to be relatively spared from the chain effect of the Asian crisis. Korea's dependence on the IMF, in the short term, exacerbated the effects of the crisis. Japan's centrally directed bank system laid the seeds of the economic bubble that made it vulnerable to the crisis.

4.4. "Asian values": a misleading explanation

With the analysis of the domestic situations of Japan, Korea, and China complete, this paper will examine the relationship between "Asian values" and the AFC. Many people saw the AFC as the

final triumph of Western values and Western styles of liberal capitalism over what they called "Asian values" [18]. However, the term "Asian values" is problematic because it is almost impossible to precisely define since "Asian values" are not pan-Asian; in other words, not all Asian countries share the same values. Even Confucianism, which is the hallmark of "East Asian values", is geographically confined to East Asia (specifically China, Korea, Japan, and Vietnam) [19]. This is why this paper chose China, Korea, and Japan as target nations due to their shared Confucian heritage.

Now that it has been established that "Asian values" is a vague term that can not possibly describe the AFC due to its nature, this paper will examine if Confucian values "East Asian values" have been a contributing factor in the AFC. In Japan (and similarly, Korea), Confucian values such as harmony, respect for authority, and loyalty to the firm (treating the firm as your family) were emphasized by corporate leaders, even though it was not explicitly mentioned as Confucianism. Rather than having a negative effect, these values helped these countries maintain longer-lasting business relationships and higher productivity, with the emphasis on cooperation leading to a focus on mutual benefits being a priority during business deals [20]. In the Republic of China (Taiwan), where Confucian values had been preserved more completely than in mainland China, these values also seem to have had a positive effect on economic growth, evolving into a sort of "bourgeois capitalism" that is compatible with modern economic institutions [21]. Confucian values had a net positive effect on the economies of these countries.

The positive effect of Confucian values in the East Asian countries provides a convincing narrative that the denunciation of "Asian values" that "lost" to Western values is not accurate, and that the AFC could be better explained with other factors, such as economic globalization and contagion effects.

5. Countermeasures and implications

The implications of the AFC for countries in Asia in the future include the importance of a regional economic organization that would act as emergency support for Asian economic crises. Korea's case has proven that reliance on the IMF is not reliable and potentially dangerous. Another potential lesson is to be aware of premature liberalizations of capital markets.

6. Conclusion

This paper examines the 1997 Asian Financial Crisis by analyzing its course of development as well as the domestic situations in Korea, Japan, and China. In Korea, the lack of free market institutions due to a government-led economic model, combined with sudden liberalization, created a disastrous effect. IMF actions in the region further exacerbated the issue. Japan's economy, already hobbled by high debt and sluggish growth, exerted ripple effects across the Asia-Pacific region. Yet these challenges cannot be divorced from the unintended consequences of economic liberalization—specifically, its role in exacerbating the banking sector's debt crisis and eroding the competitiveness of Japan's export industry. Even though there have been many researchers who interpreted the crisis as a problem inherent to "Asian values", this paper has shown both the fallacy of using such a term and the lack of noticeable correlation between cultural values and the cause of the AFC. It is true that Asian countries were not immune from domestic issues before the crisis, and indeed, this crisis drove many Asian countries to adopt Western standards of bankruptcy legislation and accounting standards [22].

However, it is important to note that these issues were not indicative of a specific "Asian developmental model", and the political economy of Asian countries before the AFC led to drastic growth. Rather, the AFC could be more accurately described as being caused by a contagion effect in the financial market brought about by increasing globalization: the eye of the storm in Thailand eventually spiraled into a region-wide collapse of consumer and investor confidence, which led to the currency collapse in multiple countries. Nations like South Korea and Japan were caught in the throes of economic liberalization when external shocks struck, rendering them uniquely susceptible to market volatility. This paper has also shown an example of how China managed to be relatively resilient during the crisis through its cautious financial policies. This paper conducted this study through the use of comparative analysis of existing evidence and does not contain any numerical data. Further research that explores numerical data and mathematical comparison could perhaps yield a deeper insight regarding the nature of the AFC and its relationship with economic globalization. To achieve a truly holistic analytical framework, domestic political landscapes and societal attitudes must also be systematically examined.

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