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# Research on the Asian Financial Crisis in the late 1990s

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**Abstract.** The 1997 Asian financial crisis was a financial storm that began in Thailand and quickly spread to East and Southeast Asia, characterized by currency depreciation, stock market decline, banking system collapse, and economic recession. Thailand, Indonesia, South Korea and other countries have been severely affected. This article conducts research on the above-mentioned crisis and finds that the direct cause of the crisis is Thailand's abandonment of the fixed exchange rate system, leading to the depreciation of the Thai baht. Before the crisis, the economy of Southeast Asian countries grew at a high speed and attracted a large amount of foreign capital. However, after the opening of the capital account, a large amount of short-term capital flowed in, forming a foam economy. The banking system lacks risk management and has accumulated a large number of non-performing loans. The fixed exchange rate system appears fragile under capital outflows. External factors include fluctuations in global capital flows, changes in the monetary policies of developed countries, and instability in international financial markets. The international community, especially the IMF, provided assistance, but the accompanying conditions exacerbated social unrest and economic recession. The lessons learned from the crisis include strengthening financial regulation, avoiding excessive borrowing, establishing sound risk management mechanisms, and enhancing the flexibility of the exchange rate system and the importance of international cooperation.

**Keywords:** Asian Financial Crisis; Fixed Exchange Rate System; Capital Account Liberalization.

## 1. Introduction

The 1997 Asian Financial Crisis was a sudden financial storm that began in Thailand and quickly spread to many countries in East and Southeast Asia. The crisis was characterized by currency devaluations, sharp falls in stock markets, the collapse of banking systems and a sharp economic recession. Thailand, Indonesia, South Korea, the Philippines and Malaysia are among the countries most affected by the crisis. Their currencies have depreciated sharply, economic growth has fallen sharply, and instability in the banking system. It has exacerbated panic in financial markets, causing international investors to pull their money out.

The trigger for the crisis was Thailand's abandonment of its fixed exchange rate in July 1997, which led to a sharp devaluation of the baht. Subsequently, the crisis quickly spread to other countries like a domino effect. The Philippines, Indonesia, South Korea and other countries were hit one after another. Although the financial crisis was initially limited to Southeast Asia, due to the close connection of the global capital market, the impact of the crisis spread to the global financial system [1].

In the late 1980s and early 1990s, before the crisis broke out, East and Southeast Asian countries experienced high economic growth and attracted large amounts of foreign direct investment. These countries, had low labor costs, open policies and relatively stable political environments, and had become hot spots for global investment. The influx of foreign capital has fueled the construction of infrastructure. The rise of manufacturing and the development of an export-oriented economy. Behind this economic boom, however, lurks big risks.

With the gradual opening of the capital account, Southeast Asian countries relaxed the control of capital flow, and a large number of short-term capital poured in. This capital is often concentrated in the real estate and stock markets. Also drove up asset prices and formed a bubble economy. At the same time, the banking system expanded rapidly, but the risk management ability was seriously

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inadequate, and the banking sector accumulated a large number of non-performing loans. In addition, many countries maintain a fixed exchange rate system, pegging their currencies to the US dollar, and lack sufficient foreign exchange reserves to stabilize the exchange rate when faced with capital flight and US dollar appreciation pressure [2].

## 2. Factor Analysis

### 2.1. Internal Factors

The main internal causes of the Asian financial crisis are structural problems in the economic development model of Southeast Asian countries. The first is excessive borrowing and leverage. In the years leading up to the crisis, companies and financial institutions in Southeast Asian countries borrowed a lot, especially for short-term capital, and most of this borrowing was used to support risky investments in real estate and stock markets, causing the prices of these assets to inflate rapidly, so that it created a huge bubble for the countries. However, as investors' expectations of high returns have increased, the fragility of the economic foundation has gradually been ignored. When economic growth slows down or foreign capital is suddenly withdrawn, asset prices fall rapidly, resulting in the failure of enterprises and banks to repay foreign debts in time, and the debt crisis breaks out.

The second is poor regulation of the financial system. In the context of rapid economic growth, the banking and financial systems of Southeast Asian countries expanded rapidly. Yet, the corresponding risk control and regulatory measures have failed to keep up in time. Banks lent heavily to real estate and other risky sectors, which became a major source of bad loans when the crisis hit. In addition, banks in many Southeast Asian countries rely on short-term external debt financing, and the funding chain of the banking system will be severely affected once the international capital markets fluctuate. Such systemic fragility led to the failure of banks to effectively withstand the shock when the crisis came, resulting in the collapse of the financial system.

At last, the fixed exchange rate system was also an important internal cause that worsened the crisis. Most Southeast Asian countries have adopted fixed exchange rate systems that peg their currencies to the US dollar. Although this system has played an important role in attracting foreign investment and ensuring economic stability, it has also left these countries with insufficient monetary policy flexibility in the face of changes in the international capital market. When there is a large-scale international capital flight, Southeast Asian countries need to rely on foreign exchange reserves to maintain the exchange rate, and when the reserves are exhausted, a large depreciation of the currency is inevitable. After Thailand abandoned the exchange rate peg between the Thai baht and the US dollar in July 1997, its currency depreciated sharply, which became the trigger for the full outbreak of the crisis.

#### 2.1.1. Excessive Loan.

In the run-up to the crisis, there was widespread over-borrowing and over-investment in Southeast Asian countries. Banks and companies borrowed heavily, especially short-term, to support the rapid expansion of the domestic economy. These loans were offered to high-risk investment projects. When the bubble burst and asset prices fell sharply, the non-performing loans of banks increased sharply and the entire financial system fell into crisis.

The boom in the housing and stock markets masked deeper problems in the economy. A lot of money is flowing into these high-return but high-risk areas, and the foundation for real economic growth is not sufficiently consolidated. When market sentiment changed and funds began to withdraw, the bubble burst quickly, and banks and companies could not repay their foreign debts, leading to a chain reaction of financial crises [3].

### 2.1.2. Vulnerability of the Monetary and Financial Systems.

Another internal cause of the crisis was the fragility of these countries' monetary and financial systems. Many Southeast Asian countries have fixed exchange rates, in order to peg their currencies to the USD, which stabilized the economic environment and attracted foreign investment for some time. However, this system also means that when international capital flows reverse. These countries' central banks need large amounts of foreign exchange reserves to maintain exchange rate stability. When foreign exchange reserves are depleted, currency depreciation becomes inevitable.

Moreover, the banking systems of these countries have grown rapidly, but their risk management capabilities have not kept pace with the expansion. Non-performing loans are rising. Yet, regulators have not taken effective measures to deal with these risks in a timely manner. When market confidence collapses and the banking system becomes the core of the crisis, a wave of bankruptcies and failures is inevitable [4].

## 2.2. External Factors

External factors also contributed to the outbreak of the Asian financial crisis in 1997. First, the volatility of global capital flows greatly exacerbated the crisis's development. In the 1990s, the opening and liberalization of the global capital market caused a large amount of short-term capital to pour into the emerging markets of Southeast Asia. Most of this capital is aimed at high returns and invested in high-risk assets such as real estate and stocks. However, with the emergence of uncertainty in the international market, especially after the Federal Reserve raised interest rates, international capital began to withdraw from the Southeast Asian market and return to the United States and other developed countries with higher interest rates and lower risks. This sudden outflow of capital brought tremendous pressure to the financial system of Southeast Asian countries, and the rapid depletion of foreign exchange reserves eventually led to the collapse of various currencies.

Second, changes in monetary policy in the developed world had a profound impact on the crisis. The tightening of monetary policy in the United States in the mid-1990s pushed up global interest rates, which caused a large amount of capital to be repatriated from emerging market countries to developed countries such as the United States. For Southeast Asian countries that rely on foreign capital, this means that financial markets have suddenly lost a lot of capital support, causing liquidity to dry up. The strong recovery of the US economy and the appreciation of the US dollar have reduced the export competitiveness of Southeast Asian countries, further worsening the balance of payments of these countries.

Finally, the instability of international financial markets also contributed to the development of the crisis. As international investor confidence in emerging markets wanes, rating agencies have downgraded the credit ratings of Southeast Asian countries, adding to the jitters. Capital markets have rapidly tightened credit and investment to Southeast Asian countries, financing channels have been almost closed, and countries are facing serious external debt pressure. In this context, the financial system of Southeast Asian countries fell into a liquidity crisis, and it was difficult to maintain normal economic operations.

### 2.2.1. Global Capital Flows and Financial Market Volatility.

External factors are also important causes of the crisis. With the opening of the global capital market, the liquidity of capital has increased, and Southeast Asian countries have become the main inflow of international capital. However, international capital is highly sensitive and short-term profit-driven. In the event of turbulence in the global financial market or a change in the monetary policy of developed countries, this capital will quickly withdraw, resulting in sharp fluctuations in the financial market.

In 1997, volatility in global financial markets increased, particularly due to rising interest rates in the United States, and capital flowed back from emerging markets to developed countries. Southeast

Asian countries face the double pressure of capital flight and currency depreciation, making the crisis inevitable [5].

#### 2.2.2. The Impact of Monetary Policy in Developed Countries.

Monetary policy changes in the US and other developed countries have important implications for financial stability in Asian countries. The Fed's tightening of monetary policy in the mid-to-late 1990s caused global interest rates to rise. Capital began to withdraw from risky emerging markets and return to developed countries. In this process, the capital flight phenomenon of Southeast Asian countries intensified, the currency depreciated sharply, and the financial market was further plunged into chaos [6].

### 2.3. Fuse

The collapse of the Thai baht: In July 1997, the Thai government abandoned the fixed exchange rate system, so it caused the Thai baht to depreciate rapidly in the foreign exchange market. Thailand's foreign exchange reserves were already insufficient to maintain a fixed exchange rate. Massive external debt and capital flight exacerbated the crisis. The collapse of the Thai baht not only triggered economic turmoil in Thailand but also quickly spread to other Southeast Asian countries and became the fuse of the entire Asian financial crisis [7].

## 3. The Process and Impact of the Crisis

### 3.1. Timeline

The crisis quickly spread from Thailand to the Philippines, Indonesia, South Korea and then Malaysia. The currencies of these countries have experienced sharp depreciations, and the panic in the foreign exchange market has spread to the stock market, causing the stock market to plunge. In Indonesia, for example, the rupee lost more than 70% of its value in just a few months, the stock market plunged nearly 60%, and the entire financial system was paralyzed [8].

### 3.2. Economic Impact

The crisis led to a severe economic downturn in Southeast Asian countries: GDP is falling sharply, unemployment is soaring and inflation is rising. For example, GDP in Indonesia contracted by 13.1% in 1998, and unemployment rose from 4.7% before the crisis to nearly 20%. At the same time, inflation soared to 58%. Other countries such as Thailand, South Korea and the Philippines also experienced varying degrees of economic decline [9].

### 3.3. Banking Impact

The instability of the banking system is one of the main problems of the crisis. A large number of banks failed in the crisis. However, the remaining banks faced severe capital shortages and were unable to carry out normal business. This further exacerbated the credit crunch, affecting business survival and economic recovery. Indonesia's banking system suffered heavy losses during the crisis, with more than half of the banks forced to close or restructure [10].

### 3.4. International Response

The international community, especially the International Monetary Fund (IMF), quickly stepped in with rescue packages for the affected countries. However, the IMF bailout package comes with strict conditions. These strict conditions, while stabilizing financial markets to some extent, have also led to social unrest and a deeper economic recession. In Indonesia and South Korea in particular, government austerity policies have led to social discontent and protests [11].

## 4. Comparative Analysis

### 4.1. Comparison

There are many similarities between the Asian financial crisis and the 2008 global financial crisis. They were both triggered by excessive borrowing and the bursting of asset bubbles, and the fragility of the financial system was laid bare in the crisis. The Asian financial crisis mainly occurred in emerging markets, but the 2008 financial crisis originated in developed countries such as the United States. The international impact of the two is also different. The Asian financial crisis mainly affected East and Southeast Asia, while the 2008 financial crisis affected the global financial system.

### 4.2. Evidence

With case studies of countries such as Thailand, South Korea and Indonesia, we can tell while the IMF bailout helped stabilize financial markets in the short term, it also had a profound negative impact on the economies of these countries. The IMF's austerity policies led to rising unemployment and slow economic recovery, with many countries still not recovering to pre-crisis economic levels for several years after the crisis.

### 4.3. Inspiration

The Asian financial crisis of 1997 brought many profound lessons. Firstly, the stability of the financial system is important to the health of the economy. The crisis showed that excessive reliance on external debt and short-term capital inflows greatly increases the vulnerability of the financial system. Once foreign capital is withdrawn, companies and banks will face difficulties in repaying their debts, triggering an economic crisis. Therefore, countries should strengthen financial regulation to avoid excessive borrowing and speculative investment, especially in high-risk sectors such as real estate and stock markets. At the same time, the banking industry must establish a sound risk management mechanism to prevent the accumulation of non-performing loans.

Second, the crisis has highlighted the limits of fixed exchange rates. Compared with fixed exchange rates, floating exchange rates can provide countries with greater policy flexibility and help them better cope with challenges in the face of fluctuations in international capital markets. After the crisis, many countries gradually abandoned the fixed exchange rate system and adopted a more flexible exchange rate mechanism to enhance the resilience of the economy. In addition, international cooperation played a key role in the response to the financial crisis. The International Monetary Fund's intervention in the crisis, while controversial, provided funding and policy advice that helped some countries weather the toughest times. Therefore, in the future, countries should pay more attention to regional and international cooperation and establish an effective financial firewall to reduce the impact of similar crises on the global economy.

## 5. Conclusion

The outbreak of the Asian financial crisis in 1997 was the result of internal economic imbalance and external capital market fluctuation. The crisis revealed inadequate risk management in the financial system and the impact of international capital flows on the economic stability of emerging markets. In the future, Southeast Asian countries must strengthen financial supervision. Especially in the aspects of capital flow and banking risk control, to prevent the recurrence of similar crises. Southeast Asian countries should also improve corporate governance, restructure corporate groups, and reform bankruptcy and competition laws to enhance transparency and efficiency. In terms of regional cooperation, ASEAN has strengthened monetary and financial cooperation with regional partners such as China, Japan, and South Korea, and established a regional financial safety net, such as the Chiang Mai Initiative for Multilateralization (CMIM) and the ASEAN China Japan Korea Macroeconomic Research Office (AMRO), to provide emergency funding support and enhance regional economic monitoring. These measures contribute to building a stronger and more resilient

financial system, reducing vulnerability to external shocks, and promoting regional economic stability and growth. Through these reforms and cooperation, Southeast Asian countries can better cope with future financial challenges and maintain long-term healthy economic development.

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