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Who Triggered the Asian Financial Crisis?

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Abstract

The Asian financial crisis was triggered by Japanese commercial banks who reduced their exposure to Asia in response to emerging troubles in Thailand and South Korea. Japanese banks had been severely weakened by the collapse of the real estate and stock market bubble in Japan in 1990. As the largest lenders in Asia and the key creditor in Thailand, Japanese banks signaled the change in sentiment to other foreign commercial banks who also withdrew their loans. These capital outflows triggered a devaluation in Thailand in mid-1997, but not in Korea until late 1997, due to the different exchange rate regimes in these countries. Despite the devaluation and outflow of bank loans, bond investors continued to provide capital to Asian borrowers until November 1997, at spreads which did not reflect the risks involved. By 1998, foreign equity investors were returning to these markets in search of bargains. Rather than rushing to the exits in a herd-like fashion, institutional investors made investment decisions which created off-setting private capital flows. The paper's author suggests that more attention should be paid to the incentives facing institutional investors and the design of domestic institutions, rather than to the need for a new financial architecture.

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