ABSTRACT

Much has been written on the Asian Financial Crisis. The salient features of the turmoil are indicative of strong myopia among banks, firms and foreign lenders. For instance, banks used short-term foreign capital to overexpose themselves to risky local projects. There was also an abrupt reversal of massive capital flows in late 1997. Finally, the deterioration in GDP and exchange rate forecasts was very sharp. The initial impression one gets is that the inability to engage in complex, farsighted optimization had made agents focus only on the immediate past and exhibit herd behaviour. This would imply exuberance with a subsequent me

to implicate such policies as significant contributors to economic distress. The empirical work on the Asian crisis also confirms our conjecture – domestic financial liberalization did make countries vulnerable.

It is necessary for us to specify how financial liberalization can cause systemic myopia. In this thesis, we break up the discussion into three issues. These are as follows:

a) Reckless financial allocation: A necessary condition for excessive risk in financial allocation – lending booms or overexposure to the property and household sectors - is a short-term focus. If banks care about their long-run survival, they will not follow such strategies. Therefore, the first question to ask is:

Why did banks assume so much risk **?**

We try to demonstrate that the answer lies in the domain of domestic banking competition. The intuition is that the erosion in market share can make future crises irrelevant for competing banks. They might be tempted to reduce client supervision and attract high-risk borrowers from their rivals. In Chapter 2, we elaborate on this theme to show why banking competition, rather than bailout guarantees or capital account liberalization, could be problematic.

b) Role of the government: It is instructive that the high rates of growth in East Asia during the 1980s were financed by long-term foreign and domestic debt. Given the reputation of the East Asian developmental states, it is natural to relate such outcomes to public policy. So, the next question is:

*In what circumstances can the government ensure allocative efficiency without making an economy susceptible to crises***?**

In our opinion, the government has to use self-selecting subsidies, as incentives

To sum up, our basic motivation was to study the strong systemic myopia in East Asia on the eve of the crisis. This dissertation tries to show that government intervention, during the 1980s sought to contain such myopia. In contrast, domestic financial liberalization stimulated it in the 1990s. In this sense, we suggest that government subsidies or capital account liberalization are peripheral while financial liberalization takes the lead in making the corporate and financial sectors vulnerable to panics.