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**ARTICLE**

## **Asian Financial Crisis 1997: An Empirical Investigation**

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### **ABSTRACT**

Multinomial Asian Financial Crises are said to happen because of financial mismanagement due to post Bretton Woods era financial liberalization, enhancement in private sector debt, currency crises, investor panic as well as inept attitude of the governments in these countries after start of the crises. Since Taiwan is the only country that was not hit as hard as the other countries in the region due to the brunt of these crises we decided to analyze its firm structure to unfold the causes of its survival.

Our analysis reveal evidence that manager operated firms finances their growth through external finance without taking into account the profitability of the firm. Contrary to this, the owner operated firms finance their growth from earned profits. This is a possible explanation of why Taiwan was not affected seriously due to 1997 Asian financial crisis because most Taiwanese firms are operated by owners or managers who are loyal to the business of the family.

**Keywords:** owner-controlled firms; management-controlled firms; control type; financial crisis

**JEL Codes:** C31, C40, D92;

**Word Count-** Main Text: 2901

### **INTRODUCTION**

East and South East Asian countries i.e. Indonesia, Republic of Korea, Malaysia, Philippines, Singapore, and Thailand encountered financial crises from July 1997 to February 1998. The worst hit among them was Indonesia whose stock market declined to about more than 80 percent and exchange rate vis-à-vis US dollar fell by almost 75 percent (Singh 1998). Although the currency crises and stock market decline was one aspect of the financial crises in these countries, the other aspects that include macroeconomic imbalances, decline in export growth, decline in property prices, as well contagion effect and state controlled financial system in these countries all are reported to be causes of the Asian financial crises.

Although there are a number of hypotheses that include capital supply shock, financial liberalization and so forth, there appeared no advance warning of such crises as international financial institution like World Bank and IMF strongly commended growth and economic development in these countries. For example, the World Bank Economist in their research in 1991 entitled “World Development Report: The Challenge of Development” claimed that East Asian countries were successful because they followed a market-friendly strategy of development and integrated their economies closely with that of the world economy assuming that governments of these countries intervene reluctantly, and if it becomes necessary, it should be transparent and should be subject to check and balances. However, later they figured it out that the governments in these countries pursue only export oriented policies and therefore, in another publication in 1993 entitled “The East Asian Miracle: Economic Growth and Public Policy” the World Bank economists significantly changed their characterization of the East Asian model because of fully acknowledged enormous government interventions in these economies.

Yilmaz Akyüz (2000) concluded that the 1997 Asian financial crises emerged due to systemic global financial instability that appeared after the collapse of the Bretton Woods systems that enhanced liberalization and mobility of international capital flows. However, some kind of financial mismanagement appeared to be common among all the East and Southeastern Asian countries that were followed by the inept attitude of the governments in these countries in implementing timely policy actions. For example, Thailand, political disarray at various times during 1996-97, including in the wake of the November 1996 general election, delayed the implementation of necessary policy measures to avert financial crises in the economy.

There are a number of arguments why 1997 Asian Financial Crises were so different and unpredictable when compared to financial turmoil experienced in other parts of the world. Most financial crises in the post-Bretton Woods era are said to happen because of a combination of currency instability with banking crises, which has historically been preceded particularly by financial liberalization of the economy. That is the reason why all episodes of financial crises started by sharp increase in capital inflows followed by a similar turnaround which caused the world economy to witness consecutive repeated bouts of financial instability in early 90s i.e. a debt deflation in the United States and thereafter the crisis in Europe in 1992–1993 which was followed by the Mexican crisis of 1994–1995 and by the East Asian crisis beginning in 1997, and thereafter crises in Brazil and in the Russian Federation. Needless to say that world economy also witnessed repeated bouts of financial crises in transition economies particularly in Finland because of liberalization of the financial sector in the economy.

Another argument why financial crises in emerging markets occurred under varying macroeconomic conditions e.g. current-account deficits, budget deficits and external

debts. For example crises in Mexico and Thailand occurred when these countries had large and unsustainable current-account deficits, although in Indonesia and the Russian Federation such deficits were very small. However, financial crises in Brazil and the Russian Federation were coupled with large budget deficits and the debts were owed primarily by the public sector whereas both Mexico and East Asia had either balanced or surplus budgets and debts were owed primarily by the private sector. Finally, Brazil, Mexico and the Russian Federation all experienced financial crises due to currency turmoil that happened in bringing down the inflation but in most these East Asian countries the appreciation of the currency was moderate or negligible.

Out of all these episodes of financial crises, the Asian crisis was generally more difficult to predict than the Mexican, Russian or Brazilian crises. This is important because these economies had been examples of prudent and sustainable economic policies. The crisis in East Asia, like crises almost everywhere else, was preceded by a sharp increase in capital flows to the region. Starting in the early 1990s, there was a rapid increase in short-term lending by commercial banks to both banks and firms in the region. Most bank lending was non-syndicated that was directed to non-financial private firms. Such transactions must have been perceived to be profitable by both international lenders and the Asian borrowers. However, it turned out that more capital flowed into these economies than could have been profitably used at modest risk; i.e. there was a misjudgment of return and risks by both lenders and borrowers. Pomerleano (1998) noted that there was an excessive investment in these countries without taking into account poor returns on these investments.

A number of researchers that include Radelet and Sachs (1998), Marshall (1998), and Chang and Velasco (1999) demonstrate that the Asian crises in 1997 propagated over time mainly because of sudden shifts in market expectations and confidence followed by regional contagion. While admitting the worsening of the macroeconomic performance of some affected countries in the mid-1990s, this view suggests that the extent and depth of the crisis should not be attributed to deterioration in fundamentals, but rather to panic on the part of domestic and international investors. According to this view, fundamental imbalances triggered the currency and financial crisis in 1997 even after the crisis started; market overreaction caused the plunge in exchange rates, assets prices, and economic activity more severe than what one would have expected because of initial weak economic conditions in these countries.

In the present research, however, we argue that Asian crises and any other crises can be averted with macroeconomic policy that has microeconomic foundations. As mentioned in the previous paragraphs, most debts were owed by private sectors and government policies of intervention were not followed and as such the policy actions were inept at the start of the crises. We do not argue for financial liberalization nor

we have a counter proposal on it but we think that there should be some kind of financial discipline at firm level that should be related to a typical external financing that might help a situation where excessive financial mobility would be minimized to support the related macroeconomic policy that could avert a future financial crises like 1997 Asian Financial Crises. For the same reason, we study conservative financial firm structure of Taiwanese firms if that was the reason why Taiwan was not much affected by the 1997 Asian Financial Crises as hard as other countries in the region did.

### **RELATED LITERATURE**

Despite substantial growth in corporate culture in developed countries especially in North America, the question whether ownership should be separated from control is still un-answered although researchers since Berle and Means (1932) have been trying to explore whether firm ownership should be separated from control because managers tend to obviate from profit or present-value maximization of the firms (Lee 1990) and set other goals such as lifetime income (Mosen and Downs 1965), sales volume (Baumol 1959), growth rate (Marris 1964), or staff expenditure (Williamson 1964). Indeed, managers' profit-satisficing behavior might be acceptable to some owners (Colli 2003) who operate family-run and closely-held firms because they might have additional goals distinct from pure profit-maximization. That is why Penrose (1995) characterizes firm owners in two categories, which are product-minded entrepreneurs and empire builders.

Although this is the main principle in the context of agency theory, its innovation is the result of a misaligning of interests between Berle and Means, as Berle saw a project with a new conception of property, contrary to Means who recommend separation of management from control (Nodoushani and Nodoushani 1999). Because of asymmetric information due to separation of ownership from control, highly dispersed stockholders will not be able to evaluate managers' performance (Jensen and Meckling 1976). Moreover, separation of ownership from control is the cause of asymmetric information in corporate relationships, which could lead to different business behaviors. To solve this problem, Leibenstein (1966) suggests tying managers' compensation with their performance. However, managerial performance is more likely to become unsatisfactory when a corporation attains significant market power (Williamson 1964), or capital market imperfections develop (Smiley 1976), or managers do not receive ample incentives in their contracts (Williamson 1985), or when it is difficult to replace managers (Fama 1980).

Compared to the United States of America, Taiwan has family-owned or controlled corporate enterprises that tend to have a large degree of separation of ownership from control in the Asian region (Claessens, Djankov, and Lang (2002). Separation

of ownership from control in large firms in Taiwan is evident but is often illusory because managers may be picked on the basis of loyalty to the family than competence. In addition, corporate governance structures in Asia are not very well organized and there is a great risk of minority shareholder rights expropriation (Claessens and Fan, 2002; Johnson *et al.* 2000). This can lead to higher profitability but reduces accountability, which can be attributed to be one of the factor that caused late 1990s Asian financial crises (Lu and Batten, 2001).

Indeed, separation of ownership and control can lead to an inability to monitor managerial performance in the context of highly dispersed stockholders (Jensen and Meckling 1976). Thus, a firm can be thought of as a nexus of contracts and the growth of the corporation could be attained through reduction of transaction costs (Coase 1937). However, the complexity of corporate relationships leads to asymmetric information that is why New Institutional Economics argues that the separation of ownership from control may lead to different business behaviors.

In the present research, we focus on the possibility of growth maximization of the firm as well as investigate if the interests of managers and owners are misaligned. Therefore, in the analysis, a managerial growth constraint is incorporated to anticipate the possible impact of control type on financial crises. Moreover, we investigate how Taiwan was able to weather the storm of the Asian financial crises in 1997, a problem that others including Wang (2000) have investigated at more macroeconomic rather than firm level. The remaining paper is organized as follows. Section 2 incorporates related literature, and in section 3 we present an overview of corporate governance in Taiwan. Section 4 presents our empirical approach and discussions. Finally section 5 incorporates conclusion that can be drawn from the paper.

## **CORPORATE GOVERNANCE IN TAIWAN**

Compared to the U.S.A., Taiwan has a higher degree of family-owned or controlled large corporate enterprises. Claessens, Djankov, and Lang (2002) noted that there tends to be a large degree of separation of management from control within family firms in the Asian region, especially in Taiwan. This separation of management from control is evident within the larger firms in Taiwan, exhibiting a similar pattern to that of the United States, but this separation is often illusory because managers may be picked more on the basis of loyalty to the family than due to managerial competence. Thus, while in the United States, managers may rise due to managerial competence but have little loyalty to the interests of the corporation, Taiwanese managers may be more loyal but less managerially competent. In addition, corporate governance structures in Asia are not very well organized and there is a great risk of minority shareholder rights expropriation (Claessens and Fan 2002; Johnson *et al.* 2000). This can lead to greater profitability in some respects but it reduces

accountability, which has been noted as one factor causing the East Asian economic crisis of the late 1990s (Iu and Batten 2001).

We would expect that there will be differences between management-controlled firms and owner-controlled firms. Given that members of families tend to exhibit similar preferences on risk and that family owned businesses may be seen as having an importance to the family that goes beyond profit considerations, we would expect that family controlled businesses would engage in practices that would be more risk averse and thus would lead to reduced profitability in the short run, but greater likelihood of survival. We do not directly test the profitability question in this paper but if firms undertake a conservative approach to financing growth this would be consistent with our hypothesis that owner controlled firms will finance growth out of profits while manager controlled will use equity and leveraging strategies for firm growth.

#### **EMPIRICAL APPROACH**

Our analysis draws heavily from the results contained in Chen, Kiani, and Madjid-Sadjadi (2007) wherein they employed data from 300 Taiwanese corporations which were they obtained from the publications of the Taiwanese Management Securities Commission volume 20, No.1 2002, and the Review of the Investment Information No. 12, 2000. In their analysis, Kiani and Madjid-Sadjadi (2007) segregated the selected Taiwanese firms in various groups using discriminant analysis, and incorporated managerial resource constraint in the analysis due to Penrose (1995) to discipline managers. Further, they concluded that control type had significant effect on the firm growth in Taiwan.

Taiwanese firms are controlled by family relationship. In this context Godajlovic and Shapiro (2005) maintained that Taiwanese firms are controlled more by family relationships than would be obvious by merely looking at the extent of holdings by these individuals. Thus, the control of Taiwanese firms is maintained through cultural norms and placement in management from the members of the family or those who are loyal to the family.

The chief hypothesis of interest of this research is whether control type has an impact (if any) on the growth of the firms as well as if the firm data would be advantageous to explain the reasons how Taiwan escaped from the 1997 Asian financial crises whereas other did not. Our results that are based on the results drawn from in Chen, Kiani and Madjid-Sadjadi (2007) show that because of conservative corporate structure most Taiwanese corporations are controlled by the owners or the manager loyal to the family. These firms finance their growth from earned profits rather than borrowed funds. This is crucial in understanding why Taiwan suffered for less in the 1997 Asian Financial crises that did other economies in the region.

## **DISCUSSIONS**

Glancey (1998) notes that among entrepreneurs who have not ceded control, larger firms grow faster than smaller firms and younger firms grow faster than the well-established firms. James (1999) suggested that family firms where management and control are interwoven allow them to have longer time horizons than firms where management-control is present. In addition, agency costs are reduced, enabling greater profitability.

Managerial-controlled firms are more likely to exhibit a tendency towards a shorter time horizon associated with a need to address maximization of the present-value of the firm via stock price changes (the traditional mechanism for determining profit maximization of corporations within the neoclassical framework), while family firms may be more concerned with riskier long-term goals (Harris, Martinez and Ward 1994). At the same time, arguments between family owners may provide a greater degree of managerial autonomy even with close corporate supervision as managers align themselves with one faction or another (Davis and Harveston 2001). Alternatively, when managers see themselves serving the interests of the family, or when they come from the family itself, this can lead to greater strategy cohesion compared to non-family firms (Ensley and Pearson 2005).

Most Asian countries that faced the 1997 financial crisis borrowed heavily for financing their growth because a common reason for sustainability of high growth in these countries was excessive investment through debt financing without taking into account the poor returns on these investments (Pomerleano 1998). However, because of the conservative corporate structure where most firms have a strongly binding growth constraint, Taiwan was able to weather the storm better than the other East Asian countries.

## **CONCLUSION**

This paper is an extension to Chen, Kiani and Madjid-Sadjadi (2007) wherein the empirical validity of the growth hypothesis due to Berle and Means (1935) is investigated. The analysis includes managers' resource constraint that impedes the managers' actions to deviate from shareholders goals. Therefore, the present research investigates the reasons that made Taiwan get away from the 1997 Asian financial crises.

Since most Taiwanese firms are owner controlled or controlled by the managers loyal to the family, management of these firms finance their growth from the earned profits. Interestingly, such firms willingly obviate opportunities for risky short term profits in exchange for steady long term sustainability. Based on these observations,



we can conclude that most Taiwanese firm did not finance their growth from external borrowings; Taiwan was saved from the brunt of the 1997 Asian financial crises.

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