

Monetary Overinvestment and The Fall of Asian Tigers

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The author proposes that the Asian financial crisis can be traced back to the Plaza Accord of 1985, an agreement to artificially strengthen the yen and weaken the dollar. Coupled with low interest rates, the arrangement enabled the fabled speculative boom of the 1990s in East Asia. The essay illustrates, using the Austrian overinvestment theory, how financial liberalization undermined by government exchange interventions can lead to devastating consequences. Government interference in the financial sector, either for the purpose of protecting consumers or domestic manufacturers, results in instability in the long-run. Even after sacrificing the broader economy to subsidize a certain group of manufacturers or consumers, the governments and central banks failed to protect these groups they set out to subsidize in the first place.

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INTRODUCTION

Decades past the Asian economic miracle, the crisis that started with the fall of the Thai baht unfurled. While conditions were diverse among the affected economies, the majority of the problems stemmed from a combination of monetary mismatches (despite the fact that fiscal policies were generally balanced and inflation rates were low), external conditions, and poor financial structures. Before the collapse, the external mismatches were aggravated by the strengthening of the U.S. dollar, against which the currency of the affected economies was explicitly or implicitly tied. Multiple factors contributed to the vulnerabilities of the financial system: deficiencies that had already existed in banks' assets, unhedged foreign currency loans that predisposed companies to substantial risks during local currency depreciation, overdependence on short-term foreign debt, and malinvestments fueled by asset bubbles. Under these conditions, a shift in market perception might precipitate a difficult-to-break cycle of depreciation, bankruptcies, and capital flight. The baht's collapse triggered a rapid outbreak throughout the region, as investors regarded other economies to have comparable flaws that negatively impacted their credibility. In the aftermath of the crisis, many banks and enterprises in the afflicted economies declared bankruptcy.

The majority of existing plans underscore the imperative to reinforce national policy framework (financial structure) of receiver countries, but are short on the genuinely global parts of the structure. Indeed, poor regulations contribute to the issues of emerging economies, which are caused by internal factors and pro-cyclical influence. Nonetheless, volatility is a more extensive occurrence. The movements are firmly anchored in the underlying variables that drive global financial instability, such as the huge mismatch between the complexity of globalized financial systems and the structures that govern them. In such a context, emerging economies are especially susceptible to instability and contagion. They are designed as "business cycle/policy takers," relaying domestically the boom-and-bust cycles created in foreign markets. According to [Obstfeld \(2013\)](#), this structure of the global market is potentially inefficient due to coordination difficulties and institutional flaws. The system may collapse if a budgetary counterpart of the Triffin Paradox of the 1960s undermines the solvency of the dwindling number of safe haven countries.

LITERATURE REVIEW

Conventional Wisdom on Asian Financial Crisis

A cacophony of naysayers exists on both the neoclassic and Keynesians arguing that the Asian financial crisis disproves the Asian paradigm. On the neoclassic side, the Asian collapse reinforces their persistent criticism of interventionism and their warning that Asia's strong production levels were untenable. In contrast, Keynesians are racing to highlight the perils of untimely deregulation and the IMF's numerous failures. Every party, however, began to doubt the benefits of authoritarian government, as Indonesia has performed significantly worse than its democratic neighbors ([Haggard, 2000](#)).

The Asian financial crisis did not just wreaked havoc on the economy of the region, but it also placed a significant strain on the international financial system. [Mishkin's \(1999\)](#) analysis of the crisis's asymmetries in information gives some valuable insights. Firstly, there are compelling reasons to establish an international lender of last resort. Secondly, the systemic risk caused by the functioning of an international lender of last resort might increase economic uncertainty in the absence of adequate financing conditions. Thirdly, while foreign investment contributed to the collapse, it is a symptom instead of the causative agent, indicating that exchange controls are highly improbable to be an effective method for preventing future crises. Lastly, fixed exchange rate regimes are hazardous for developing economies and increase the likelihood of economic collapse.

According to [Corsetti et al. \(1999\)](#), there was a question of moral hazard on the conduct of international banks, which had lent substantial sums of money to the Asia's domestic financial institutions before crisis. Short-term interbank cross-border obligations, practically insured by direct government interventions in favor of borrowers or indirect bailouts through IMF assistance programs, could be the fundamental cause of the overlending phenomenon. The premise of moral hazard is that a downturn to profits does not prompt banking institutions to be more conservative with financing and to pursue investment plans that reduce the credit risk of their holdings. In fact, the possibility of a potential capital injection by the authority gives a powerful reason to incur even greater risks despite adverse conditions. Due to these circumstances of financial and real disparities, Asian countries became susceptible to the collapse in 1997, whether they were precipitated by rapid shifts in market sentiments or by worsening

anticipations regarding the broken state of fundamentals. In 1997, the decline of the housing and stock markets, where protracted bullish patterns were partially driven by capital inflows, resulted in widespread bankruptcies in the corporate and financial sectors. The general attitude deteriorated as a result of policy uncertainty resulting from national governments' inability to commit to substantial changes. Dramatic outflows, beginning in the summertime 1997, precipitated the fall of the region's currencies over the fear of domestic and foreign investors.

Johnson et al. (1999) conducted a cross-country regression, from which they concluded that corporate governance factors predict a greater proportion of the variations in exchange rates and stock market performance during the Asian financial crisis than macroeconomic factors. The finding is insensitive to the event window, the specific specification of variables, and the exclusion of outliers. However, this fact alone does not negate the significance of macroeconomic factors in the crisis. Although there remains disagreements among experts regarding the significance of the current account, reserves, foreign debt, economic policy on emerging economies in the crisis, a broad consensus exists regarding the significance of macroeconomic policies in specific cases. Nevertheless, as demonstrated by their findings, those determinants have no direct consequences on the crisis in developing countries. Their data indicates that corporate governance generally and the unofficial safeguarding of minority shareholders specifically had a substantial impact on the magnitude of currency depreciation and share price drop in 1997-1998. While their findings reveal nothing about the nations that are susceptible to a credibility loss, they imply that shareholder activism influences the magnitude of exchange rate and stock market crash in reaction to a declining credibility. Corporate governance can play a leading role in determining the severity of macroeconomic problems during times of crisis.

Hayekian Overinvestment Theory in Lieu of Asian Financial Crisis

Hayek (1931) identified three distinct forms of interest rates. First, the central bank interest rate, which affects the short-term money markets' interest rates. Second, the capital market interest rate set by private banks determine the interest rate of credits granted to consumers and businesses. The central bank interest rate virtually decides the capital market interest rate. Third and most important, the

natural interest rate, which reflects the equilibrium of the financial market, i.e., savings and investment choices are in harmony when the central bank and the capital market interest rate equals the natural interest rate.

According to the suppositions of monetary overinvestment, an overinvestment boom develops when the capital market rate goes below the natural rate as a result of monetary growth. The scenario may be the result of the central bank's efforts to increase consumer spending through the Phillips curve mechanism or normalize the capital sector. The current high savings (as a result of the low interest rate) generates the anticipation of future demand growth, thereby stimulating investment growth (Hayek 1929: 101). The graph to the left in Figure 1 depicts an investment curve shifting rightward. There is an unsustainable growth in the capital goods sector that attracts unemployed workers into the manufacturing of investment products.

Increasing employment, earnings, and income stimulates spending. As a result of low borrowing rates, the demand for consumer goods, particularly durable items, increases. Rising investments and demand offer the impetus for additional capacity expansion. The expansion in the real economy can spread to the capital market since companies' profitability projections have increased. When speculation begins, expectations for the stock prices and other real assets might become separated from actual economic activity. According to Schumpeter (2017:226), the signs of affluence become, in the conventional fashion, a determinant of prosperity. Comparable trends were evident during the Japanese speculative boom, which was characterized by rapidly expanding investment and untenable stock and housing price gains.

When the central bank raises interest rates in reaction to rising inflation, a reversal ensues. In 1988, the Bank of Japan began raising interest rates to bust the boom in Japan. Alternately, the banks tighten loan requirements due to a shift in perception over the growth's longevity. Since the central bank and capital market interest rates are increasing, it is vital to exclude investment projects with anticipated returns below the higher capital market rate. In Figure 1's right graph, the investment curve moves to the left from I_2 to I_3 . There is a decline in the stock holdings and solvency of businesses. The prices of stocks and housing decrease.

The natural interest rate dips, while the central bank maintains its rate at elevated levels (I_n I_c - I_c). At this state, savings outnumber investments since savings

appear to offer greater profits at comparatively higher interest rates than investments ($I_3 > I_2$) The economy slows down, overcapacity arises, unemployment increases, and wages go down. As demand decreases, inflation drops. Schumpeter (2017) described it as the liquidation of low-return investment projects, which coincides with the lowering incomes and prices. Hayek (1931) viewed the deconstruction of low-marginal-efficiency investment projects as a prerequisite for a sustainable economy. As a result, capital assets become accessible for new, higher-yielding investment opportunities.

The monetary overinvestment hypotheses have uncovered asymmetric monetary policy errors since the mid-1980s. Since inflation in consumer prices mirrored credit stimulus less frequently, central banks in industrialized nations could progressively pursue objectives other than low inflation, such as financial crisis management. Amid crisis, central banks drastically lowered their interest rates. On the other hand, when recovery is in effect, they were hesitant to raise their interest rate for fear of economic stagnation. The later part of this paper explains that, on the contrary, this attitude brings the economy to a stagnation.

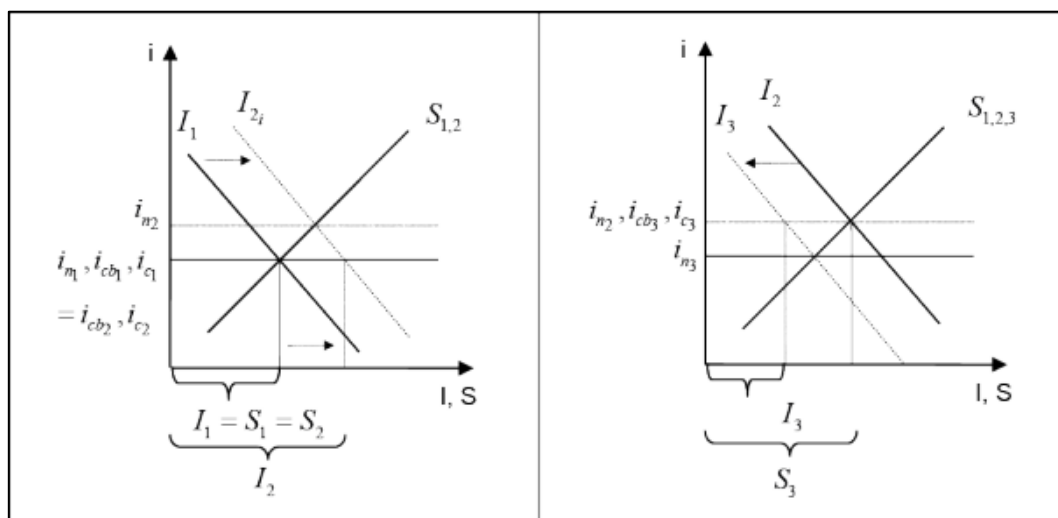


Figure 1: Monetary Overinvestment Boom-Bust

The left panel shows the capital market during the boom period. The right panel shows the capital market during the bust period. In Hayek's Austrian paradigm, there are three types of interest rate, namely I_{cb} = central bank interest rate, I_c = capital interest rate, and I_n = natural interest rate.

The Origin of The Crisis

The Asian financial crisis originated in Japan a decade prior. Japanese account surpluses between 1975 and 1985 caused a pushback from its trading partners, notably the United States. The response led to the well-known Plaza Accord of 1985, where the G-5 members shared a commitment to align their monetary policy for the purpose of strengthening the yen. The increasing trajectory of the yen, coupled with Japan's lowering of the interest rates and the deregulation of financial sector, laid the foundation for massive asset bubbles (Nakamura, 1995). The artificial boom had three fundamental features: an outpouring of capital from Japan, making it the biggest creditor in the world; the consequent foreign investment into the housing

and equities that raised stock and property prices; and an economic upswing powered by such speculative gains.

Prior to the 1985 Plaza Accord, the Reagan administration in the US publicly implemented its limited intervention plan, the dollar experienced steady, wide ranging nominal and real gains. Along with rising deficit spending, a tighter US monetary policy brought up interest rates in the economy and drew considerable foreign investment. From July 1980 to March 1985, the US dollar strengthened about 55% against the currency of the other large industrialized nations. Meanwhile, the dollar appreciated by 89% against the German mark, the primary intervention currency of the US and the fulcrum of the European exchange rates. Development against the yen, at the time was the second significant US intervention currency, was more modest. Throughout the same period, the dollar's appreciation against the yen was barely 17%. The majority of the currency's rise occurred on real terms, indicating that the market advantage of the US real-goods sector has deteriorated significantly. Between the middle of the 1980s and the beginning of

1985, the dollar rose nearly half against the yen. The rise was due to a tighter US monetary policy. When Paul Volcker was appointed as chairman of the Federal Reserve in August 1979, the Fed originally continued the tight monetary policy to end inflation. 2 Soon after, however, the Federal open market committee (FOMC) introduced specific methods to enhance the Federal Reserve's credibility with respect to its monetary objectives. Instead of the previous emphasis on the federal funds rate, the Fed is now targeting on a reserve aggregate (Hetzel 2008, pp. 166– 69). 3 At the behest of the Carter administration, the Federal Reserve also boosted marginal reserve requirements, along with imposing credit controls (Schreft, 1990). In January 1980, the market crashed.

Although the capital influx moderated the typical, interest-sensitive crowd outs that economists anticipated from the evolving US policy framework, the real currency appreciation that ensued exposed US exporters to fierce global competition. Challenged with increasing mercantilist provocations and the scrutiny of legislators and scholars who still viewed government interference, especially US involvement, as essential for maintaining an organized economy, the government settled back into interventionism at the start of 1985, evidence on intervention as an inefficient method to control exchange rate notwithstanding, thereby unresolving the basic trilemma.

In 1989, Japan held forty percent of financing worldwide, an incredible increase from four percent in 1984. Between 1985 and 1988, foreign investments in the American economy jumped from \$1.9 billion to \$16.6 billion. Consequently, there was a considerable rise in property and stock prices. In 1987, the gross national product of Japan reached 345 trillion yen, with a surge in financial assets of 382 trillion yen. The property sector was inflated by 345 trillion yen. At the peak of the artificial upturn, the Imperial Palace grounds were worth as much as California. To put things in perspective, each square inch of Canada and the United States was equivalent to Tokyo's land prices. Big firms instigated and jumped on the bandwagon of speculation since rising assets enabled high indebtedness. Roughly 30% of the population profited from speculation, resulting in a significant brief rise in Japan's economy. During the same period, trade unions' pay rises rose marginally. Later in 1989, the Japanese central bank began to restrict the monetary base, resulting in the bursting of the bull market. The value of properties plummeted, turnover rates rose, and real estate firms liquidated. The Nikkei

index fell by more than fifty percent and did not rebound. Japan went into a downturn in 1991, the effects of which have persisted. Many started to suspect that Japan's economic miracle was merely a result of a speculative boom. In 1991, the Economic Planning Agency (EPA) issued an interim review on social policy that criticized Japanese corporatism and advocated the abolition of work quotas and an increase in overtime pay to reduce overtime work (asawa, 1994). The government endorsed the EPA's plan to reduce working hours, increase affordable housing, and optimize welfare systems.

Nonetheless, any opportunity for meaningful reform vanished with the establishment of a neo-liberal plan of deficit reduction, liberalization, and institutional reforms at the outset of the Liberal Democratic Party's return to power (LDP). Liberalization would have been desirable had it not been for the existing interventionist policies. Such policies and the escalating unemployment levels have led to Japanese consumers' reluctance and the continuing decrease in household consumption. Japan is under enormous pressure to reinvigorate its economy due to the increasing downturn, the advent of the Asian crisis, and international financial instability. The circumstances prompted a humiliating U-turn by the administration. Upon passing a bill to restrict deficit financing, the Hashimoto administration introduced a series of tax breaks, along with cuts in income and residential property taxes. In addition, the government provided substantial bailouts. The subsequent leadership intensified this strategy. More cuts covered the deficit resulting from decreased receipts and rising spending on social services.

Response in The East Asian Market

Basing our assumptions on the Hayekian monetary overinvestment theory, we are able to dissect the anatomy of the crisis. If we look back at monetary history, we will find what the overinvestment theory deduces as the cause of an unsustainable boom: the central bank's action of lowering the interest rate. Indeed, history corroborates the theory. The following interest rate cuts after the 1991 engendered a continuing overinvestment in East Asia that must and will be liquidated (through a recession) at some point.

The Plaza Accord increased the prosperity of American manufacturers because the G-5 countries decided to support U.S. exports by arbitrarily devaluing the currency. The Plaza Accord and the concomitant credit stimulus in Japan initiated Japan's own

Austrian boom-and-bust cycle. The U.S. economy emerged from the crisis of 1990–1991 in reasonable condition, with certain 1980s boom-era maldistribution addressed. In 1995, Japanese industrial companies were struggling. The yen achieved a record high of 79 per dollar in April 1995. Due to the dollar's extreme value, Japanese manufacturers were unable to meet their variable costs. Numerous Japanese banks faced bankruptcy. The United States had just endured the bailout of Mexico, and regulators were anticipated to appear more optimistic around a comparable bailout of Japan.

The "Reverse Plaza Accord" of 1995 played a crucial role in the creation of the late 1990s explosive growth: Under the terms of this deal, the United States, Japan, and Germany rescued the Japanese industrial base that had come to a standstill under the strain of the yen's all-time high appreciation. They accomplished

this by reversing the substantial decrease in the dollar that had occurred during the past ten years. In essence, the Reverse Plaza Accord stipulated that the governments of the United States, Germany, and Japan would "subsidize" American buyers' expenditures on Japanese and German manufactured products. The reversal of the currency pattern was achieved by bringing down Japanese interest rates relative to U.S. rates, in addition to significantly increasing Japanese payments of dollar assets in the financial market. The Germans and the Americans also increase their purchase of dollars. Increasing the dollar's value versus foreign currencies would enable the U.S. government to sustain a monetary easing policy without increasing the consumer price inflation, because the unnaturally reduced cost of imported products would likely offset the impact of the greater liquidity on inflation.

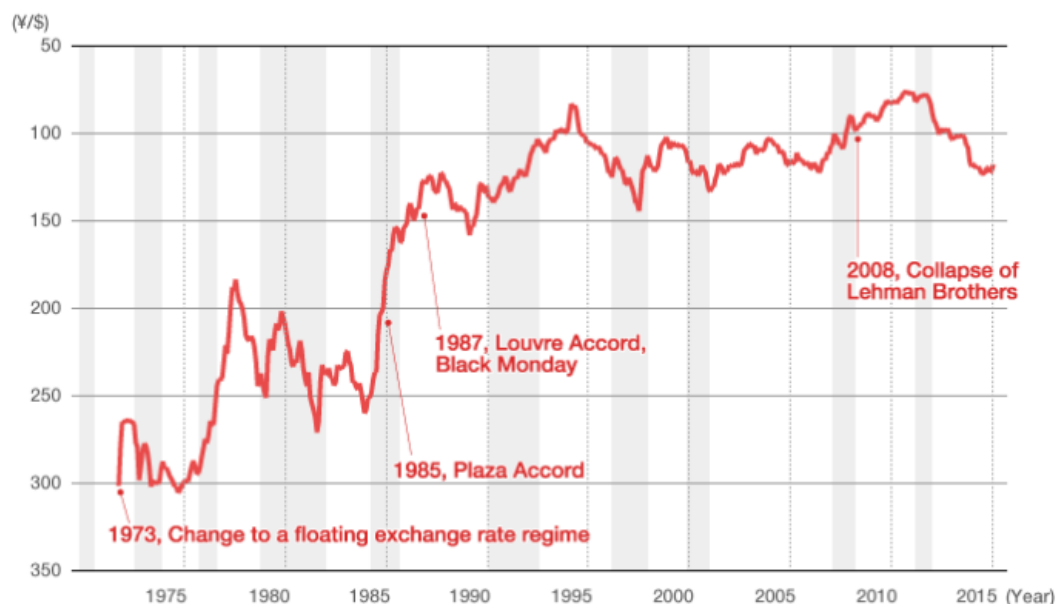


Figure 2: Yen/Dollar Exchange Rate

Source: Bank of Japan

At the same time, Japan had been lowering interest rates. After the severe cutbacks during the recession of 1991, the Bank of Japan hesitated to raise the interest rate due to (an unfounded) fear of economic stagnation. The result was a progressive drop in the interest rate of the central bank approaching zero. Figure 3 illustrates the arithmetic mean of the interest rates established by the Bank of Japan. According to the monetary overinvestment hypothesis, when the interest rates on capital markets in the major developed countries fell near zero, the possibility that the central bank interest rates would fall behind the natural interest rates arises. After short-term interest rates hit the zero level, central banks bloated their

balance sheets by purchasing assets (especially government bonds) to further reduce long-term interest rates. In effect, excess liquidity and overinvestment surged. Figure 3 below shows interest rate policy in Japan before the Asian crisis.

The excess liquidity due to the Yen/Dollar behavior must be allocated. Thus, excess liquidity traveled to the U.S. stock market. Another liquidity destination was the financial market of East Asia which countries' currencies were pegged to the dollar. Even as the manufacturing profitability of American and East Asian producers eroded as the price of their imported capital goods and exported production increased, American and East Asian stock

prices experienced an additional upswing, as Japanese and European investors profited from fluctuations in exchange rates and the rise of the American and East Asian equities. A large chunk of the tremendous rise in global liquidity, which originated mostly from the central banks of the United States and Japan, had been invested in this region. East Asia received 74.5 percent of all financial flows to developing nations between 1990 and 1995. Figure 4 below shows the huge upswing in capital flows to Asia. Using the Japanese protectionist growth model, countries funded a swift industrial expansion, which was frequently directed towards "key areas" like high-tech industry. Due to the fact that they least in part financed the subsidy with dollar liabilities, they were hesitant to weaken their

anchors, as doing so would raise the price of repaying dollar debts with the local currency.

Between April 1995 and April 1997, the yen depreciated against the dollar by sixty percent. To retain their dollar peg, East Asian nations have to allow their currencies to appreciate against the yen. However, this resulted in a constant increase in the cost of their exports relative to their Japanese competitors. The East Asian nations had agreed to the U.S. policy of bankrolling German and Japanese producers and their consumers by sacrificing their own producers. East Asian countries were unable to continue the program as long as the U.S. were able to, because their weaker economy, with industrial sectors previously warped by substantial subsidies, and inability to issue the reserve currency at command (Callahan & Garrison, 2003).

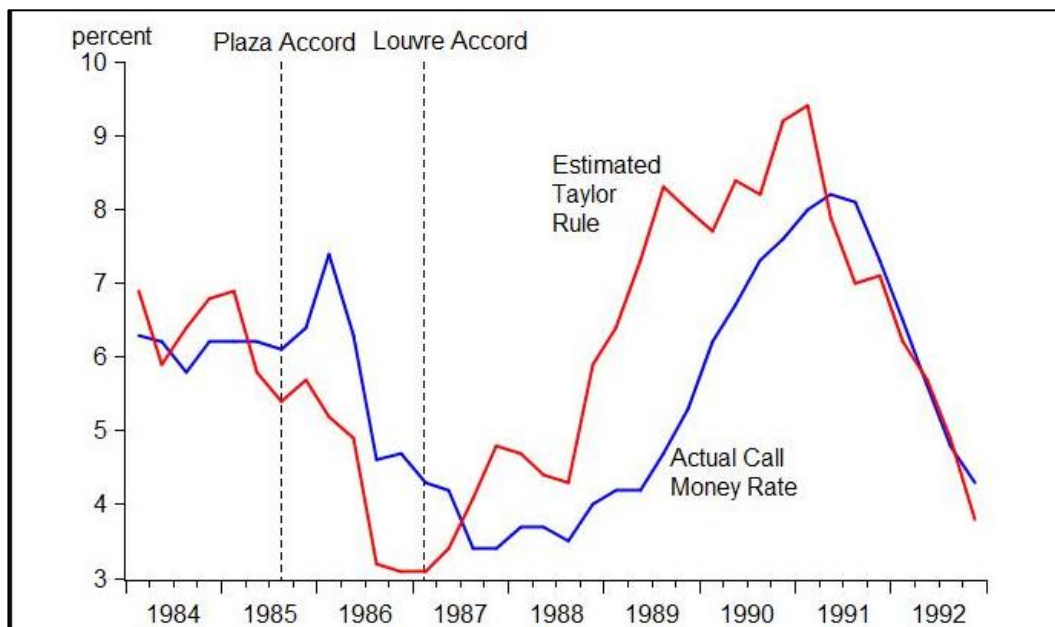


Figure 3: Interest Rate Policy in Japan (1984-92)
Source: IMF (2011)

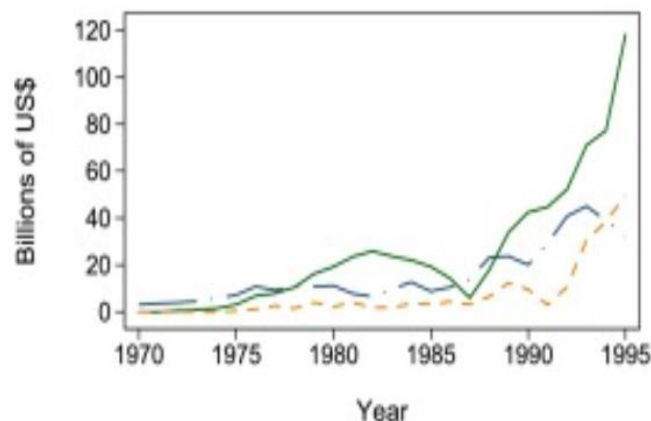


Figure 4: Capital Import in Asia
Source: Steiner (2016)

Policy Implications

Foreign reserve buildup and, consequently, money creation in the burgeoning East Asian economies have been attributed to the ultra-low interest rates of the major industrialized nations. For a long period, developing East Asia was accompanied by a decline in interest rates. According to the monetary overinvestment theory, the low-interest rates in the region became the seeds of financial meltdowns and structural imbalances that hindered long-term development. Bloated stock values and declining growth indicate the downturn. As it would reestablish private price signals, a gradual but dramatic increase in interest rates in developed countries might be the foundation for a global recovery. Emerging East Asian economies should encourage this approach by maintaining tight money policies and avoiding the depreciation of their currencies.

Islamic Prescriptions

Since the author is studying at an Islamic academic institution, a portion of the paper must be dedicated to Islamic discourse. However, this extension is not inconsequential. Islam has a very straightforward and distinct position on the principle of economic policy: that only God determines prices¹. This general rule stipulates that no government is allowed to set prices. The famous hadith on which the rule is based has additional expressions to explain the wisdom behind the rule. "Allah is the one Who fixes prices, Who withholds, gives lavishly and provides...". In other words, only nature, and nature's God, can fairly determine the winners and losers in the market. Otherwise, the hadith continues, "...and I hope that when I meet Allah, none of you will have any claim on me for an injustice regarding blood or property." when human beings dictate the market order, instability occurs.

Undoubtedly, exchange rate controls fix the price of the currency. In turn, the controlled exchange rate will influence the prices of goods and services. Therefore, when the government implements monetary interventions, they violate the divine rule. Under Quranic normative assumption, this infringement engenders corruption on earth. Before reviewing the empirical evidence in support of this hadith, however, the author inquires whether it is a question that exchange rate controls are not a fair rule. That the policymakers framed the rules of the market in such a way to promote a certain portion of the population (the

Japanese consumers and American manufacturers in the case of the Plaza accord) is enough evidence that the government did not treat everyone equally before the law. Indeed, the guiding principle of Islam is equality before God (the law), and therefore, prices should not be set arbitrarily by man, for that would violate the principle.

The classical Islamic view on exchange rates and interest rate controls is free markets. A policy framework where the government only provides rules and protection against fraud and leaves the financial sector otherwise untouched. Scientific evidence supports this position. First, during the 1990s, the East Asian countries pursued exchange rate anchors to stabilize the exchange rate in favor of cheaper external debt and higher capital inflows. This policy proved disastrous, as the paper outlines. When the economy, in reality, had to reverse the capital flows, the anchor became a "bottleneck." The meltdown had already begun when the markets only began to disillusion. In a free market economy, i.e., free capital mobility and flexible exchange rate, such a condition is much less likely to occur because there is no "bottleneck" to prevent capital from exiting an overcrowded market. Several papers discuss about economic freedom and monetary stability. [Blau et al. \(2014\)](#) found that the components of economic freedom promote price stability in individual securities: secure property rights, sound money, and free trade. Meanwhile, some studies found the link between economic freedom and higher foreign direct investment in [\(South Asia Nasir & Hassan, 2011\)](#) and Latin America [\(Bengoa & Sanchez-Robles, 2003\)](#).

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

The Asian financial crisis can be traced back to the Plaza Accord of 1985, an agreement to artificially strengthen the yen and weaken the dollar. Coupled with low interest rates, the arrangement enabled the fabled speculative boom of the 1990s in East Asia. The essay illustrates, using Austrian overinvestment theory, how financial liberalization undermined by government exchange interventions can lead to devastating consequences. Government interference in the financial sector, either for the purpose of protecting consumers or domestic manufacturers, results in instability in the long-run. The paper details in the third section how even the countries responsible for the

¹ Sunan Abi Dawud, "Al-Ijarah", 36

Plaza Accord did not benefit from their large-scale monetary interventions. In fact, even after sacrificing the broader economy to subsidize a certain group of manufacturers or consumers, the governments and the central banks also failed to protect those groups they set out to subsidize in the first place.

Recommendations

According to the monetary overinvestment theory, the low-interest rates in the region became the seeds of financial meltdowns and structural imbalances that hindered long-term development. By reestablishing private price signals, a gradual but dramatic increase in interest rates in developed countries might be the foundation for a global recovery. Emerging East Asian economies should encourage this approach by maintaining tight money policies and avoiding the depreciation of their currencies. The Islamic approach to this ordeal requires a commitment by the government to promote economic freedom, where every market actor is equal before the law, and nobody receives special subsidies. The government must secure property rights, maintain sound money, and protect free trade. This environment would enable the capital market to smoothly adjust inflows and outflows.

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