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Asian Financial Crisis: Lessons Learned and Unlearned

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Debates are taking place on whether there will be another financial crisis, whether in some part of the world or that is global in scope. Governments draw lessons from financial crises to adopt measures to prevent their recurrence. However, such measures are often designed to address the root causes of the last crisis but not the next one. More importantly, they can actually become the new sources of instability and crisis.

Much of what has recently been written about the Asian crisis on the occasion of its 20th anniversary praises the lessons drawn and the measures implemented thereupon. But they often fail to appreciate that while these might have been effective in preventing the crisis in 1997, they may be inadequate and even counterproductive today because they entail deeper integration into global finance.

An immediate step taken in Asia was to abandon currency pegs and move to flexible exchange rates in order to facilitate external adjustment and prevent one-way bets for speculators. This has a lot to commend it, but its effects depend on how capital flows are managed.

Under free capital mobility no regime can guarantee stable rates. Currency crises can occur under flexible exchange rates as under fixed exchange rates. Unlike fixed pegs, floating at times of strong inflows can cause nominal appreciations and encourage even more short-term inflows. Indeed nominal appreciations have been quite widespread during the surges in capital inflows in the new millennium, including in some East Asian economies.

Second, most emerging economies, including those in Asia, have liberalized foreign direct investment regimes and opened up equity markets to foreigners on the grounds that equity liabilities are less risky and more stable than external debt. As a result, non-resident holdings as a percent of market capitalization have reached unprecedented levels, ranging between 20 and 50 per cent compared to 15 per cent in the US.

This has made the emerging economies highly susceptible to conditions in mature markets. Since emerging economies lack a strong local investor base, the entry and exit of even relatively small amounts of foreign investment now result in large price swings.

Third, they have also sought to reduce currency mismatches in balance sheets and exposure to exchange rate risk by opening domestic bond markets to foreigners and borrowing in their own currencies. As a result sovereign debt in many emerging economies is now internationalized to a greater extent than that in reserve-currency countries.

Whereas about one-third of US treasuries are held by non-residents, this proportion is much higher in many emerging economies, including in Asia. Unlike US treasuries this debt is not in the hands of foreign central banks but in the portfolios of fickle investors.

Although opening bond markets has allowed the sovereign to pass the currency risk to lenders, it has led to loss of autonomy over domestic long-term rates and entailed a significant exposure to interest rate shocks from the US. This could prove equally and even more damaging than currency exposure in the transition of the US Fed from low-interest to high-interest regime and normalization of its balance sheet.

Fourth, there has been extensive liberalization of the capital account for residents. Corporations have been encouraged to become global players by borrowing and investing abroad, resulting in a massive accumulation of debt in low-interest reserve currencies since 2008.

They have also borrowed through foreign subsidiaries. These are not always repatriated and registered as capital inflows and external debt, but they have a similar impact on corporate fragility. Hence the reduction in currency mismatches is largely limited to the sovereign while private corporations carry significant exchange rate risks.

Fifth, limits on the acquisition of foreign securities, real estate assets and deposits by resident individuals and institutional investors have been raised or abolished. A main motive was to relieve upward pressures on currencies from the surge in capital inflows. Thus, liberalization of resident outflows was used as a substitute to restrictions over non-resident inflows. Although this has led to accumulation of private assets abroad, these would not be readily available at times of capital flight.

Sixth, banking regulations and supervision have no doubt improved, restricting currency and maturity mismatches in bank balance sheets. However, banks now play a much less prominent role in the intermediation of international capital flows than in the 1990s. International bond issues by corporations have grown much faster than cross-border bank lending directly or through local banks and a very large part of capital inflows now goes directly into the securities market.

These measures have failed to prevent credit and asset market bubbles in most countries in the region. Increases in non-financial corporate debt since 2007 in Korea and Malaysia are among the fastest, between 15 and 20 percentage points of GDP. At around 90 per cent of GDP Malaysia has the highest household debt in the developing world. In Korea the ratio of household debt to GDP is higher than the ratio in the US and the average of the OECD.

International Reserves

Asian economies, like many others, are commended for building self-insurance by accumulating large amounts of international reserves. Moreover, an important part of these came from current account surpluses, not just capital inflows. Indeed, all countries directly hit by the 1997 crisis made a significant progress in the management of their external balances in the new millennium, running surpluses or keeping deficits under control.

However, whether or not these reserves would be sufficient to provide adequate protection against massive and sustained exit of capital is highly contentious. After the Asian crisis, external vulnerability came to be assessed in terms of adequacy of reserves to meet short-term external debt in foreign currencies.

However, there is not always a strong correlation between pressure on reserves and short-term external debt. Often, in countries suffering large reserve losses, sources other than short-term foreign currency debt play a greater role. Currencies can come under stress if there is a significant foreign presence in domestic deposit and securities markets and the capital account is open for residents.

A rapid and generalized exit could create significant turbulence with broader macroeconomic consequences, even though losses due to declines in asset prices and currencies fall on foreign investors and mitigate the drain of reserves.

In all four Asian countries directly hit by the 1997 crisis, international reserves now meet short-term external dollar debt. But they do not always leave much room to accommodate a sizeable and sustained exit of foreign investors from domestic securities and deposit markets and capital flight by residents.

This is particularly the case in Malaysia where the margin of reserves over short-term dollar debt is quite small while foreign holdings in local securities markets are sizeable. Indeed its currency has been under constant pressure since mid-2014. As foreign holders of domestic securities started to unload ringgit denominated assets, markets fell sharply and foreign reserves declined from over $130 billion to $97 billion by June 2015. In October 2015 the ringgit hit the lowest level since September 1998 when it was pegged to the dollar. Currently it is below the lows seen during the turmoil in January 1998.

In Indonesia reserves exceed short-term dollar debt by a large margin, but foreign holdings in its local bond and equity markets are also substantial and the current account is in deficit. The country was included among the Fragile 5 in 2013 by Morgan Stanley economists for being too dependent on unreliable foreign investment to finance growth.

Capital account regimes of emerging economies are much more liberal today both for residents and non-residents than in the 1990s. Asset and currency markets of all emerging economies with strong international reserves and investment positions, including China, have been hit on several occasions in the past ten years, starting with the collapse of Lehman Brothers in 2008.

The Lehman impact was strong but short-lived because of the ultra-easy monetary policy introduced by the US. Subsequently these markets came under pressure again during the 'taper tantrum' in May 2013 when the US Fed revealed its intention to start reducing its bond purchases; in October 2014 due to growing fears over global growth and the impact of an eventual rise in US interest rates; in late 2015 on the eve of the increase in policy rates in the US for the first time in seven years.

These bouts of instability did not inflict severe damage because they were temporary, short-lived dislocations caused by shifts in market sentiments without any fundamental departure from the policy of easy money. But they give strong warnings for the kind of turmoil emerging economies could face in the event of a fundamental reversal of US monetary policy.

Should self-insurance built-up prove inadequate, economies facing large and sustained capital flight would have two options. First, seek assistance from the IMF and central banks of reserve-currency countries. Or second, engineer an unorthodox response, even going beyond what Malaysia did during the 1997 crisis, bailing in international creditors and investors by introducing, *inter alia*, exchange restrictions and temporary debt standstills, and using selective controls in trade and finance to safeguard economic activity and employment.

The Asian countries, like most emerging economies, seem to be determined not to go to the IMF again. But, serious obstacles may be encountered in implementing unilateral heterodox measures, including creditor litigation and sanctions by creditor countries. Deepening integration into the inherently unstable international financial system before attaining economic and financial maturity and without securing multilateral mechanisms for orderly and equitable resolution of external liquidity and debt crises could thus prove to be highly costly.

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This article draws on a recent book by the author: Playing with Fire: Deepened Financial Integration and Changing Vulnerabilities of the Global South, Oxford University Press, 2017 (see https://global.oup.com/academic/product/playing-with-fire-9780198797173?q=9780198797173&lang=en&cc=gb# for more information).

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