SouthViews

No. 151, 6 July 2017

SOUTHVIEWS is a service of the South Centre to provide opinions and analysis of topical issues from a South perspective.

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The Asian financial crisis - 20 years later

By Martin Khor

It's been 20 years since the Asian financial crisis struck in July 1997. Since then there has been an even bigger global financial crisis, centred in the United States starting in 2008. Will there be another crisis in the near future?

The Asian crisis began when speculators brought down the Thai baht, making fortunes in the process. Within months, the currencies of Indonesia, South Korea and Malaysia were also affected. The crisis was to turn the East Asian Miracle into an Asian Financial Nightmare.

Despite all the accolades showered onto the East Asian emerging economies before the crisis, weaknesses had built up in the affected countries, including current account deficits, low foreign reserves and high external debt.

In particular, in a few years before the onset of the crisis, the countries liberalised their financial system, in line with the international advice provided at that time. This enabled local private companies to freely borrow from abroad and in foreign currency, mainly US dollars. Companies and banks in Korea, Indonesia and Thailand had rapidly accumulated over a hundred billion dollars of external loans in each country, prompted by these loans' lower interest rates compared to the local rates. This was the Achilles Heel that led their countries to crisis.

These weaknesses made the countries ripe for hedge funds and other speculators to bet against their currencies. When the value of the local currency devalued very significantly against the US dollar, and when governments spent their already low reserves in a vain attempt to stem the currency fall, three of the countries ran out of foreign exchange to service their external loans.

They went to the International Monetary Fund for bail out loans that carried draconian conditions including high interest rates, drastic cuts in government spending, no bailouts of failing banks and companies, whilst allowing continued freedom for capital to exit. These IMF policies worsened their economic situation, leading to recession, job retrenchments and bank and corporate bankruptcies, besides the loss of economic sovereignty. Protestors in Korea held signs: "IMF equals I Am Fired!"

Malaysia was the fortunate country that did not have to seek IMF loans. The country's foreign reserves had gone to a dangerously low level but it was still adequate to finance imports and service foreign debt. If the ringgit had been allowed to fall a bit further, the danger line would have been breached.

After a year of self-imposed austerity measures, Malaysia dramatically switched course and introduced a set of unorthodox policies. These included pegging the ringgit to the dollar, selective capital controls to prevent short-term funds from exiting, lowering interest rates, boosting bank loans, increasing government spending and rescuing failing companies and banks.

This was opposite to the prevailing economic orthodoxy and the IMF policies imposed on the other three countries, and the global establishment predicted the sure collapse of the Malaysian economy.

But surprisingly the economy recovered, even faster and with less losses than the other countries. In fact the IMF had to relax some of its conditions on the other countries to avoid their performance being poorly compared to Malaysia's. Today the Malaysian measures (or some of them at least) are cited as examples of a successful anti-crisis strategy.

The IMF itself has changed, a little. For example it now includes some capital controls as part of legitimate policy measures in certain situations.

The Asian countries, vowing never to have to go to the IMF again, built up strong current account surpluses and foreign reserves to protect against bad years and keep off speculators. The economies recovered, but not back to the spectacular 7 to 10 per cent pre-crisis growth rates.

In 2008, the global financial crisis erupted, with the United States as its epicentre. The tip of the iceberg was the collapse of Lehman Brothers and the massive loans given out to house-buyers that were not credit-worthy, thus the term "sub-prime crisis."

The underlying cause was the deregulation of US finance and the freedom with which financial institutions could devise all kinds of shady "financial products" to draw in investors and unsuspecting customers. They made many billions of dollars with all the layers of financial intermediation and manipulative schemes, but with the Lehman collapse the house of cards came tumbling down.

To fight the crisis, the Unite States, under President Barrack Obama, embarked first on expanding government spending and when that had its political limits he relied on financial policies of near-zero interest rates and "quantitative easing", with the Federal Reserve pumping trillions of dollars into the US banking system.

It was hoped that the easy availability of huge and cheap credit would get consumer and businesses to spend and lift the economy. But that only partly happened. Instead, a significant portion of the trillions went via investors into speculative activities, including abroad to emerging economies.

Europe, on the verge of recession, followed the US with near zero (in some cases below zero) interest rates and large quantitative easing, with limited positive results.

The US-Europe financial crisis affected Asian countries too, but in only a limited way. The main effect was on trade, with declines in export growth and commodity prices, as demand fell in Western markets.

The large foreign reserves built up after the Asian crisis plus the current account surplus situation acted as buffers against external debt problems and kept speculators at bay.

Just as important, hundreds of billions of dollars of funds annually poured from developed countries into emerging economies in Asia and other regions, in search of higher yield since interest rates in the originating countries were very low.

These massive capital inflows helped to give a boost to the Asian countries' economic growth but have resulted in problems of their own. First, they lead to asset bubbles, or rapid price increases of houses and the stock markets, and the bubbles may burst when they are over-ripe.

Second, the inflows may only cause short-term relief rather than being long-term solutions. Much of the funds are short-term portfolio investors looking for quick profit, and they can be expected to leave when conditions change, such as a rise in interest rates in the US making that market now more attractive.

Third, the countries receiving capital inflows have thus built up new vulnerabilities to financial volatility and economic instability. If and when investors pull some or a lot of their money out, there may be problems including price declines, inadequate replenishment of bonds, decline in currency and foreign reserves. A few countries potentially face a new financial crisis.

A new vulnerability in many emerging economies is the rapid build-up of external debt in the form of bonds denominated in the local currency.

The Asian crisis two decades ago taught the lesson that over-borrowing in foreign currency like the US dollar is dangerous for a country as it may face difficulties in servicing the debt if the local currency falls; more money in local currency would then have to be forked out to repay the same volume of US-dollar debt.

To avoid this, many countries sold bonds denominated in the local currency to foreign investors, so that the repayment will be predictable and stable in terms of the local currency, thus avoiding the risk of a change in the foreign exchange.

However if the bonds held by foreigners are large in value, the country will still be vulnerable to the effects of a withdrawal when conditions change, such as a rise in US interest rates or a crisis in a major emerging country that changes investor perception of emerging-market risk.

As an example, almost half of Malaysian government securities, denominated in ringgit (the local currency) are held by foreigners, the result of the wave of capital inflows in recent years. Though the country does not face the risk of having to pay more in ringgit if there is a fall in the local currency, it may still face difficulties if foreigners suddenly withdraw a lot of their bonds.

What is the state of the world economy and what are the chances of a new financial crisis? Big and relevant questions to ponder over, 20 years after the start of the Asian crisis and nine years after the global crisis.   But we will have to consider them in another article.

Author: Martin Khor is the Executive Director of the South Centre.

This article was also published by Inter Press Service (IPS) on 5 July 2017.

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For more information, please contact Vicente Paolo Yu of the South Centre: Email yu@southcentre.int**, or telephone +41 22 791 80 50.**