



Economic Letter

Asia Recalls 1997 Crisis as Investors Await Fed Tapering

by Janet Koech, Helena Shi and Jian Wang

▶ *Asian economies now appear better positioned to deal with adverse external financial shocks.*

The 2007–09 global financial crisis triggered unprecedented central bank policy intervention in the U.S. and elsewhere. The Federal Reserve, after cutting short-term interest rates to near zero, embarked upon three rounds of unconventional monetary policy known as quantitative easing, or QE. These measures involve the purchase of long-term securities and aim to stimulate the economy by lowering long-term borrowing costs.

Since the last round of QE in September 2012, U.S. economic growth has picked up amid signs of a sustainable expansion. Should this trend continue, the Fed is expected to unwind some of its monetary policy stimulus, possibly reducing the pace of asset purchases. Foreign policymakers are concerned that a reversal of the stimulus could adversely impact the global economy. This sentiment is especially pronounced in emerging economies historically vulnerable to capital outflows and asset-price corrections induced by U.S. monetary policy.

China Finance Minister Lou Jiwei has cautioned that the Fed should pay close attention to the spillover effect on the global financial markets when exiting QE.¹ Lou's concern is understandable; the painful memory of the 1997 Asian financial crisis, which was caused by abrupt capital outflows and subsequent contagion effects, remains fresh. Moreover, the discussion of

tapering QE comes as Asian economies are experiencing a slowdown that is expected to persist.

While the region's policymakers need to be vigilant regarding economic vulnerabilities that have some parallels to the period before the 1997 crisis, Asian economies now appear better positioned to deal with adverse external financial shocks. They hold more foreign reserves and exhibit healthier current account balances (the difference in the value of goods and services bought and sold abroad plus net returns on investments abroad). Additionally, they should benefit from Fed forward guidance on U.S. monetary policy, reducing investor surprises and overall market shocks.

Asset-Price Run-Ups

Several Asian economies have experienced rapid asset-price run-ups in the past four years. Stock markets in many Asian countries have significantly outperformed U.S. exchanges. From 2009 through second quarter 2013, stock market indexes rose 236 percent in both Thailand and Indonesia, 225 percent in the Philippines and 103 percent in Malaysia (*Chart 1A*). All surpassed 2007 prerecession peaks.

House prices similarly rose in a number of Asian economies—Hong Kong, up 120 percent since 2009; Singapore, up 54 percent; Malaysia, up 43 percent; Taiwan, up 39 percent; and Thailand up 38 percent (*Chart 1B*). Property prices in big cities

of India have also advanced sharply—88 percent in Delhi and 65 percent in Mumbai since 2010.

Although rapidly increasing asset prices do not necessarily indicate the existence of asset bubbles, they create a vulnerability that can trigger massive, profit-taking sell-offs following an abrupt switch in market sentiment.

Loss of Competitiveness

Depreciation of the Japanese yen against the U.S. dollar after 1995 was an important contributor to the 1997 Asian financial crisis, especially for countries that pegged their currencies to the dollar. When the yen declined, exports from these countries became more expensive relative to Japanese products, inducing sizable current account deficits in emerging economies before the crisis. This loss of international competitiveness worried international investors, prompting massive capital outflows and the subsequent financial crisis.

Asian economies regained export competitiveness following sharp currency depreciations during the 1997 crisis. However, several of these countries in the last 10 years experienced subsequent rapid real (inflation-adjusted) appreciation of their currencies, curtailing their

export competitiveness. The real exchange rate appreciated more than 50 percent in Indonesia after 2001, while its current account balance turned negative, a reversal from a current account surplus of 4 percent of gross domestic product (GDP) in the 1998–2004 period (*Chart 2*). Current account balances remain mostly positive in other emerging Asian economies, but they have deteriorated in recent years (*Chart 3*).

Recent QE policy in Japan has introduced additional risk to some Asian countries' current account positions.² Since fourth quarter 2012, when Japan's central bank began considering a radical expansion of its QE, the yen has depreciated sharply—down 24 percent against the dollar in the year since October 2012. Japanese exports benefit while other Asian economies' exports are depressed.

Subdued Growth Prospects

Emerging Asian economies grew at a slower pace in 2012—6.4 percent versus 7.8 percent in 2011—a trend expected to persist in coming years. China's double-digit average growth rate during the past 30 years is unlikely to continue, judging from the experiences of other economies following a similar growth pattern. China's export share to developing Asia is about 12 percent. The spillover from slower Chinese

growth will surely affect other Asian countries, especially those with close bilateral trade and financial links with China.

By comparison, sentiment and growth prospects in the U.S. are improving, leading to an increased likelihood of the Fed's QE tapering. This may dampen the Asian economic outlook by generating further capital outflows as returns in the U.S. appear more attractive.

These developments parallel some of the events leading up to the 1997 Asian crisis, including strong credit growth that led to asset-price booms, current account deterioration and large capital inflows. With rising confidence in the region's future growth prospects and strong local currencies in the mid-1990s, businesses borrowed heavily in foreign currencies to fund ambitious long-run projects in fast-rising local property markets.

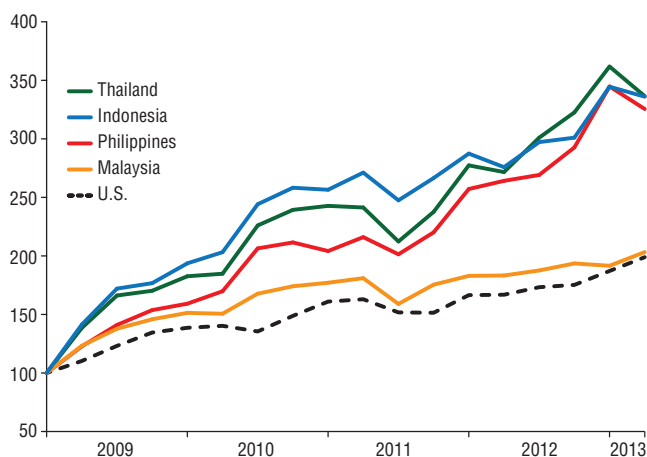
The region's market conditions worsened when U.S. policymakers raised interest rates in March 1997; international liquidity positions began tightening. In response, foreign investors moved their funds out of the region. Depreciation of the Japanese yen contributed to a loss of international competitiveness in the region, further deepening the crisis. Massive capital outflows from Thailand, Malaysia, Indonesia and South Korea led to currency

Chart 1

Stock and House Price Indexes Rapidly Rise in Select Asian Economies

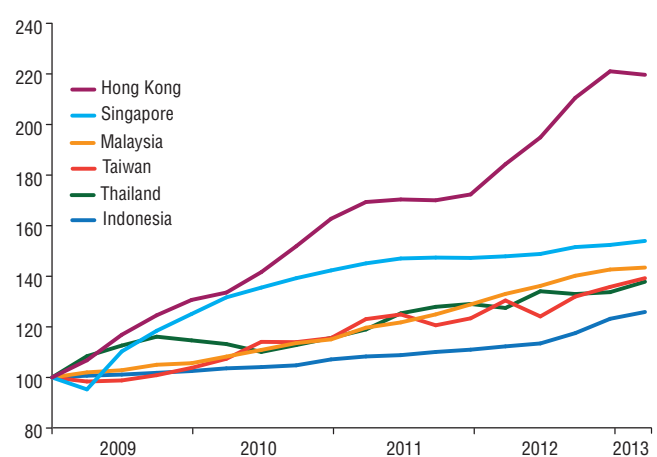
A. Stock Prices

Index, 2009:Q1 = 100



B. House Prices

Index, 2009:Q1 = 100



NOTES: Stock market indexes are the Jakarta Composite Index for Indonesia, Bangkok SET Index for Thailand, Manila Composite Index for Philippines, the FTSE Bursa Index for Malaysia, and Standard & Poor's 500 Composite Index for the U.S. The reported house price data for Thailand is the price index for condominiums.

SOURCES: *Financial Times*; *Wall Street Journal*; national statistical offices/Haver Analytics.

devaluations, steep stock and property price corrections and bank failures.

A Different Scenario

Asia confronts a situation significantly different from the one it faced prior to the 1997 crisis, making a repeat of the previous capital-outflow-driven calamity unlikely.

In the late 1990s, Asian countries were extremely vulnerable to any reversal in capital flows because they had large short-term external debt and limited internationally liquid assets.³ South Korea and Indonesia, for example, had built up large amounts of short-term debt relative to foreign reserves. When international investors stopped financing the short-term debt, these countries ran into a liquidity crisis.

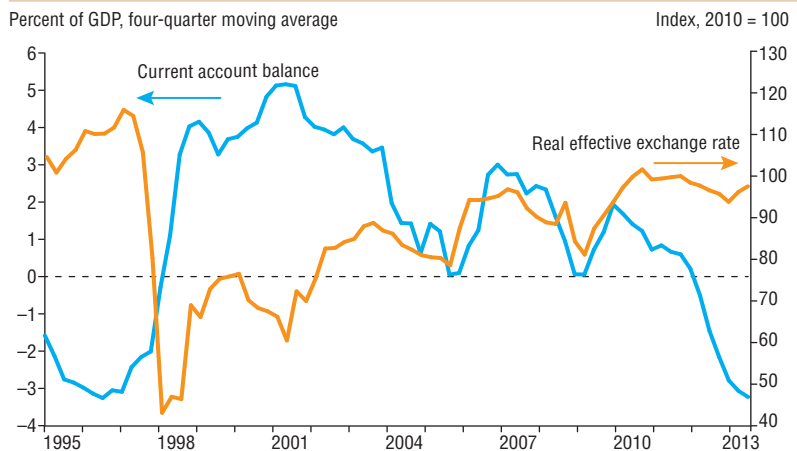
Today, net foreign debt as a share of GDP is much lower than it was in 1997 in most Asian economies, including Indonesia, Malaysia, the Philippines and Thailand (*Chart 4A*).

Most Asian economies, drawing on their crisis experience, have accumulated large amounts of foreign exchange reserves that can help cover temporary shortfalls in exports or capital inflows. Foreign exchange reserves relative to GDP have doubled in most countries since the end of the 1997 crisis. Today, the ratio of short-term debt to reserves is consistently below 1 across developing Asian economies (*Chart 4B*).

The region's countries are also better able to cope with external headwinds since many have flexible exchange rates. After the Asian crisis, South Korea, Thailand and Indonesia shifted from targeting the exchange rate to targeting the inflation rate and allowing the exchange rate to float. This helps avoid speculative attacks on currencies and provides greater domestic flexibility in response to external shocks.

Additionally, the Federal Reserve's forward guidance on monetary policy may help to avoid suddenly changing market expectations. The Asian financial crisis represented a crisis of confidence. Sudden shifts in market expectations and confidence were key sources of initial financial turmoil, its propagation and regional contagion. This collapse of investor confidence is evident in the dramatic reversal of capital flows. In 1996, net capital inflows to the Asian crisis countries amounted to \$93 billion. These flows quickly reversed to a net

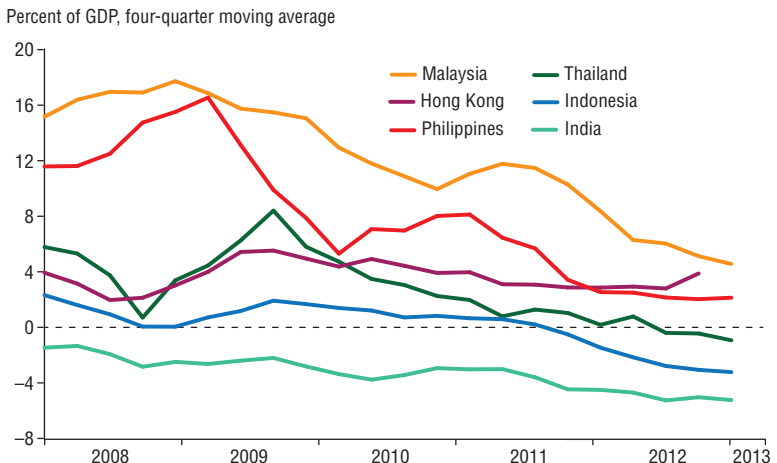
Chart 2 | Indonesia's Current Account Balance Turns Negative as Real Exchange Rate Appreciates



NOTE: Higher index numbers indicate currency appreciation.

SOURCES: Bank of Indonesia, Bank for International Settlements/Haver Analytics.

Chart 3 | Current Account Balances Deteriorate in Many Asian Economies



SOURCES: National central banks, national statistical offices/Haver Analytics.

capital outflow of \$12.1 billion in 1997 and \$9.4 billion in 1998.⁴

A Better Position

To be sure, some emerging Asian economies are exhibiting vulnerabilities resembling the ones displayed before the 1997 Asian crisis, making them susceptible to financial crises triggered by suddenly changing market sentiment. An expectation that the Fed will gradually unwind QE in the near future has generated concerns that the 1997 Asian crisis could recur.

Such apprehension may be misplaced because emerging Asian countries are now better positioned to deal with adverse external financial shocks. They hold more

foreign reserves, they have less short-term foreign debt and their current account positions are better. Further, the Fed's forward guidance policy informs markets of its future policy path, helping limit abrupt changes in expectations such as what preceded the 1997 turmoil.

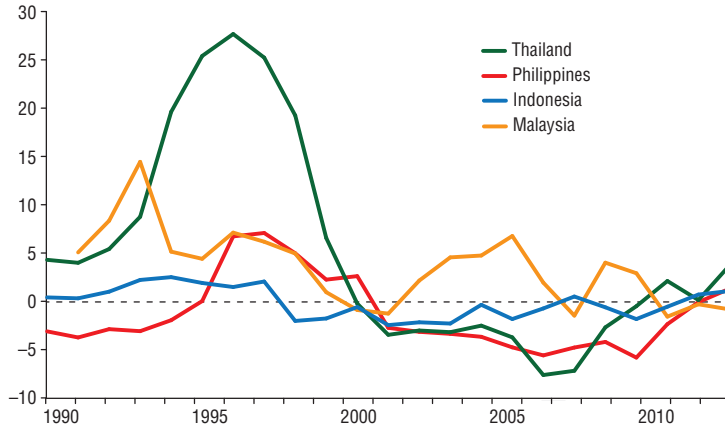
However, elevated asset prices in some Asian countries still pose serious challenges to financial stability. Run-ups in asset prices were mainly the product of expectations of continuing low interest rates and optimistic growth prospects. Both have recently shifted, so many emerging Asian countries are likely to experience asset-price corrections. Some may be steep in countries that experienced sharp run-ups

Chart 4

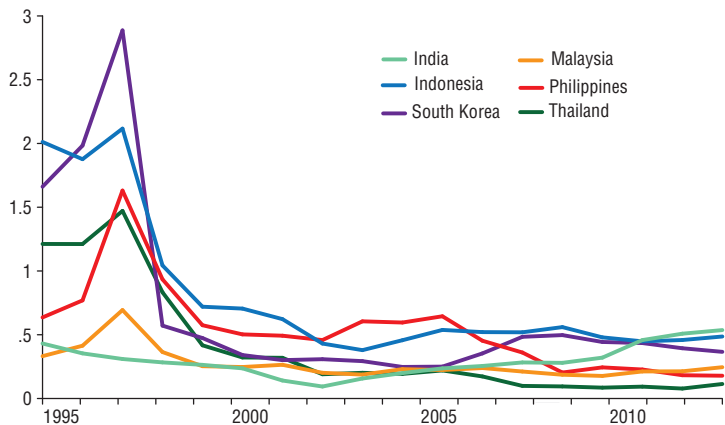
Exposure to Short-Term Foreign Debt Improves Post-1990s

A. Short-Term Net Foreign Debt

Percent of GDP



B. Ratio of Short-Term Debt to Reserves



NOTE: Short-term net debt refers to debt owed by domestic financial institutions to foreign banks computed as foreign assets minus liabilities. Short-term debt has maturity of less than one year.

SOURCES: International Monetary Fund, Bank for International Settlements, national statistical offices/Haver Analytics.

in prices in recent years. For instance, India and Indonesia have recently experienced downward pressure on their currencies and domestic asset prices. Plummeting asset prices could cause the failure of domestic financial institutions and induce a crisis, even in the absence of sudden, massive capital outflows.

To reduce the chances of such a scenario, policymakers should consider using macroprudential policy tools to reduce domestic financial market risk, and central banks should stand ready to provide market liquidity should a crisis hit.

Koehn is an assistant economist, Shi was a research intern and Wang is a senior research economist and advisor in the Research Department at the Federal Reserve Bank of Dallas.

Notes

¹"We support the consideration of the Fed of its QE exit, but we should pay high attention to the impact of the policy on the international financial system and properly handle the timing, tempo and intensity of its QE monetary policy exit while guarding against the possible financial risks," Lou Jiwei said at the fifth China-U.S. Strategic and Economic Dialogue in Washington, D.C., as quoted July 12, 2013, in *China Daily*, the official newspaper of China.

² Earlier this year, the Bank of Japan adopted an aggressive asset purchase program aimed at ending a deflation spiral the country has faced since the 1990s. The program will double the monetary base.

³ See "Short-Term Capital Flows" by Dani Rodrik and Andres Velasco, National Bureau of Economic Research, NBER Working Paper no. 7364, September 1999.

⁴ "Capital Flows to Emerging Market Economies," report by the Institute of International Finance, Jan. 29, 1998. The Asian countries included in these totals are Indonesia, Malaysia, the Philippines, South Korea and Thailand.

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