

## 67. Southeast Asian crisis from a currency perspective

The Southeast Asian currency crisis, whose beginning is dated back to the suspension of the Thai baht peg to the US dollar in July 1997, may be called *the* economic event of the closing twentieth century. It had wide-ranging impacts on the region, set off adjustments in the global monetary and financial architecture, and advanced theoretical understanding of the economics discipline. Moreover, it strongly advanced economic thinking about causes and international spillover of currency crises, paving the way for the original-sin literature and the discussion on balance sheet effects, currency mismatches, and the fear of floating (Calvo and Reinhart 2002; Eichengreen et al. 2002; Metzger 2001, 1999).

The East Asian currency crisis initiated much literature on the international spillover of financial crises. These studies examined the origin of such crises as well as contagion to other countries through various real and financial transmission channels, such as exchange rates, financial vulnerabilities, changes in interest rates, investment sentiment, and trade and remittance flows. Countries are prone to contagion particularly through financial linkages established by common creditors (Caramazza et al. 2004) and changes in global financial conditions (Eichengreen and Rose 1998).

Original sin, an expression first used by Eichengreen and Hausmann in 1999, embodies another aspect of this literature. Countries plagued by original sin are not able to borrow in domestic currency on the international capital market (foreign original sin) or to borrow in domestic currency long-term on the domestic market (domestic original sin) (Eichengreen et al. 2002). They exhibit greater volatility of interest rates, capital flows, and output. Because of the foreign currency debt, the domestic central bank can only provide a restricted lender of last resort function limited by its own foreign currency reserves.

Foreign currency debt results in currency mismatches in the balance sheets of domestic debtors. The *fear of floating* is due to negative balance sheet effects on domes-

tic debtors in case of depreciations of the nominal exchange rate. Accordingly, many countries showing original sin explicitly or only implicitly peg their nominal exchange rate to their major trading partner's currency, even in case of detriment effects on their international competitiveness (Calvo and Reinhart 2002). For these countries, monetary policy, in particular interest rate policy, is constrained to ensure exchange rate stability; the nominal exchange rate is no policy instrument for adjustments anymore.

All these elements – financial linkages across countries, original sin, and fear of floating – have been present in the run-up and outbreak of the Southeast Asian currency crisis. At first sight, the currency crisis seems to be provoked by a relatively moderate slowdown of growth prospects, especially export prospects, since the mid-1990s, when the US dollar recuperated against other key currencies, including the German mark and Japanese yen. Since some Asian currencies were loosely or even tightly linked to the US dollar via an exchange rate peg, the nominal appreciation of their currency vis-à-vis the non-dollar world resulted in a drop in competitiveness on their non-US export markets. Asian countries experienced another decline in competitiveness, this time in their US dollar markets due to the renminbi devaluation in 1994. Accordingly, the current account deficits of the five most affected countries Indonesia, Malaysia, the Philippines, the Republic of Korea, and Thailand, deteriorated further (Radelet and Sachs 1998, table 2). Nevertheless, net capital inflows into these five countries before the crisis outstripped their current account deficits.

These net capital inflows had been overwhelmingly in the form of loans from global active commercial banks or non-bank private creditors, with Asian banks being the major debtors (ibid.). A second remarkable feature of these liabilities was that they were denominated in foreign currency, most of which were in US dollars (Radelet and Sachs 1998, table 12). Asian banks at that time preferred to raise capital on the international markets to liquidity from their domestic central banks. Interest rates of US dollar-denominated loans by international institutional investors were lower than interest rates for loans in domestic currency with the corresponding central banks. Asian banks then used this capital to offer loans to other domestic banks

and companies that did not have access to international capital markets. Thus, there was a widespread currency mismatch in balance sheets of both the Asian banking and company sector, making them vulnerable to depreciations of the nominal exchange rate. Thirdly, most of these net capital inflows were overwhelmingly short-term (Radelet and Sachs 1998, table 3).

Eventually, derivatives facilitated private capital inflows by separating the risks attached to financial and physical investment and offering investors seemingly to hedge the risks. In the currency market, investors hedged by means of foreign exchange forwards and swaps against the fixed exchange rate systems in Southeast Asia. On the other side, total return swaps hedged against the interest rate differentials between the fixed currencies (Dodd 2000). Such swaps could magnify domestic financial risk as well as the potential for contagion among countries due to the use of cross-currency assets and payments.

After the continued depletion of forex reserves and increased portfolio shifts out of the country, the Thai central bank announced the de-pegging of the baht on 2 July 1997. The Thai baht, the Malaysian ringgit, the Indonesian rupiah, the Korean won, and the Philippine peso strongly depreciated in the following months (BIS 1998). The transmission channel of contagion was international private capital flows by institutional investors who withdrew their capital from Thailand and other Asian countries. These involuntary maxi-devaluations strongly affected Asian banks' balance sheets. On the one hand, commercial banks were hit by a depreciation of two different financial claims: A rise of non-performing loans as a direct result of the collapse and closure of domestic financial institutions and companies. In addition, still-operating banks and companies, who could no longer roll over their loans with domestic banks, liquidated their assets at fire-sale prices to keep up their ability to pay their loans and mitigate the drying-up of liquidity. Accordingly, all domestic asset prices, including stocks and real estate, plummeted. While the banking system's assets significantly decreased in value, their US-dollar-denominated liabilities to international investors rose in real terms. As a result, Asian banking systems became

insolvent, with non-performing loans exceeding bank capital.

It is a matter of academic dispute to what extent the devastating effects on the real sector- i.e., loss of output, a slump in private investment and consumption demand, real income losses, and a steep rise in unemployment, were due to the currency crisis itself and to what extent the International Monetary Fund (IMF) amplified them. The financial support of the Fund for the crisis-afflicted countries was criticized as too low, too late, and too lopsided (Metzger 2010, 1999). The IMF's emergency finance was insufficient to stop, let alone reverse, the abysmal deterioration of Asian countries' exchange rates. In addition, the IMF provided emergency finance only after the affected countries' international reserves reached critical levels.

Furthermore, the IMF offered access to emergency finance only linked to strong economic conditionality for the debtors. Conceptionally, this one-sided approach puts all burden of adjustment on the side of the debtors, however, neglects the responsibility of international factors such as the US dollar exchange rate and international capital flows or activities by active international creditors for the crisis evolution. Although they were part of the problem, the IMF did not require them to be part of the solution. Finally, the IMF systematically underestimated the disastrous economic and social effects of its economic conditionality on the Asian countries (maxi-devaluations, closure of financial institutions, cuts in subsidies and wages) and excessively overestimated the expected economic recovery resulting from its enforced adjustment programs.

The experience of being dependent on the harsh conditionality of IMF lending let Asian countries search for alternatives to prevent a similar situation from materializing in the future. As a unilateral response, countries abandoned the widely accepted development strategy of growth-cum-debt. They fostered a development approach focusing on export-led growth with foreign exchange accumulation and capital account controls. It also gave impetus to an acceleration of regional monetary and financial integration (UNCTAD 2007). At the height of the Southeast Asian crisis, Association of Southeast Asian Nations (ASEAN)+3 member countries launched initiatives to develop broader and more liquid primary and second-

ary domestic and regional bond markets as alternatives to US dollar-denominated loans. In addition, ASEAN+3 member countries started the then bilateral and multilateral swap arrangement Chiang Mai Initiative to dampen temporary liquidity shortages.

Other deficiencies in the functioning of the international monetary architecture, which the Southeast Asian currency crisis revealed (UNCTAD 1998), are not addressed at all until now; there was—and despite many proposals (e.g. Kaiser 2010; Haldane and Kruger 2002; Krueger 2002), there is—a clear lack of an orderly debt workout. Yet, the Southeast Asian currency crisis resulted in the creation of the G20, the group of 20 leading countries from the Global North and the Global South, in an attempt of the G7 to offer emerging markets a forum of communication and involvement in the global governance architecture. The Southeast Asian currency crisis also kicked off another reform of international banking regulation in 1999, culminating in the adoption of the capital accord Basel II in 2004, intending to address serious deficiencies in what has been called *bad banking*.

Finally, the Southeast Asian currency crisis gave rise to a discussion about the prevalent catching-up model and debated shortcomings in the mainstream development approach. The mainstream development model following the savings-gap idea suggested that private net capital inflows would promote development and reduce financial and other bottlenecks in receiving countries. Indeed, Asian countries have been lavishly praised for their ability to attract private capital inflows. However, Asian debtors accumulated foreign currency debt and generated currency mismatches in their balance sheets, thereby exposing domestic debtors to risks arising from changes in international interest rates, exchange rates, and international capital flows. In addition, if not sterilized, net capital inflows create an overvaluation of the domestic currency and reduce the competitiveness of domestic production. Thus, continuous non-sterilized net capital inflows increase deficits in subsequent current accounts. The situation is not sustainable and usually ends up in the paradoxical situation of raising new foreign debt to service the old debt (Metzger 2001). Moreover, overvaluation and international net debtor positions in foreign currency

fuel growing depreciation expectations and speculative attacks.

A second misconception of the then mainstream development model was its belief that private—in contrast to public—actors on the creditor and the debtor side would ensure an efficient capital allocation. However, for prices like the exchange rate, it is entirely irrelevant whether a private or public actor performs the activities that finally lead to an overvaluation, reduce competitiveness, and depress economic prospects. It is the economic activity—here non-sterilized net capital inflows and an accumulation of foreign currency debt—which is the decisive factor in the currency crisis. The exchange rate peg aggravated this inherently unstable process, adding additional nominal appreciation to the existing overvaluation.

A third misconception was that so-called good fundamentals would ensure the stability and sustainability of exchange rates in particular and the economy in general, in particular relatively low inflation rates, public budget deficits, and public debt. Asia was celebrated for its strict adherence to single-digit inflation rates and low budget deficits. Thailand showed general government budget surpluses since 1990 (Radelet and Sachs, table 8). Yet internal stability is merely a necessary but by no means a sufficient condition for external stability. The systematic creation of depreciation expectations through continuous non-sterilized net capital imports and currency mismatches in the balance sheets of domestic actors will damage external stability and inevitably result in depreciations—with or without an exchange rate peg.

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