THE ASIAN CURRENCY CRISIS AND THE AUSTRALIAN ECONOMY

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1. INTRODUCTION

Although the Asian economic and financial crisis affected all key macroeconomic variables in stricken regional economies, including interest rates, share prices, national income, employment and inflation rates, it was Asian exchange rates that fell fastest and furthest. For this reason, the Asian crisis is justifiably referred to as a currency crisis, first and foremost.

This collapse of Asian exchange rates was all the more surprising at the time, given that many East Asian exchange rates had hitherto been either fixed or strongly managed over a lengthy period. The rationale for managing exchange rates the Asian way was to provide exchange rate certainty for exporters and importers. Yet, perceived exchange rate stability also meant foreign investors in Asian financial assets focussed mainly on high relative yields and neglected exchange rate risk.

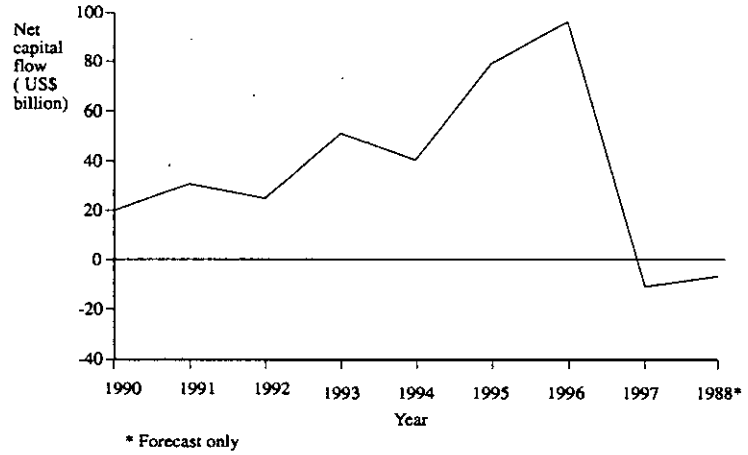
In 1996, the year before the East Asian crisis began, around $US 93 billion of foreign funds had flowed into the Philippines, Malaysia, Indonesia, South Korea and Thailand – the countries subsequently worst hit by the crisis and hereafter referred to as the 'Asian 5'. Upon suddenly realising that exchange risk exposure was much greater than judged previously, this inflow was completely reversed in 1997. In fact, the previous inflow was more than completely reversed to the extent that a $US12 billion capital outflow from the region was recorded over the crisis period as shown in Figure 1. The change from net inflow to outflow was a result of Asian investors themselves remitting funds abroad. This extraordinary international investment switch by foreign and 'Asian 5' investors was equivalent to around 11 per cent of the combined GDP of the 'Asian 5' economies.

The reversal of international capital flows that proximately caused the Asian currency crisis was not, however, the result of adverse investor reaction to poor macroeconomic fundamentals. For instance, 'Asian 5' fiscal balances had been in surplus, except for a relatively small deficit in Indonesia, inflation rates were not especially high, ranging between four to nine per cent and, except for the Philippines, domestic saving rates were high relative to advanced economies.

As is now well known, the 1997-98 re-assessment of Asian economies by foreign and domestic investors caused massive depreciations, especially against the US dollar, of the Indonesian rupiah, Thai baht, Malaysian ringgit, Philippines

FIGURE 1

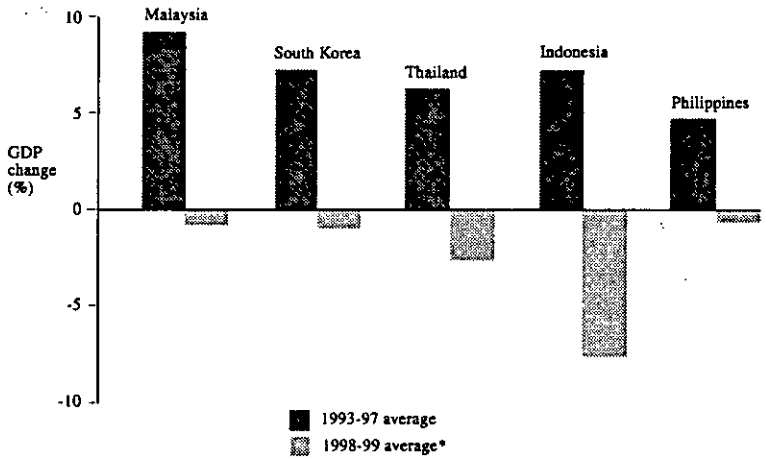
NET PRIVATE CAPITAL FLOWS TO THE 'ASIAN 5'



Source: Institute of International Finance (1998).

FIGURE 2

PERCENTAGE CHANGE IN 'ASIAN 5' GDP



Source: International Monetary Fund, *International Financial Statistics The Economist*, (various).

peso and South Korean won. For instance, in US$ terms, the Indonesian rupiah was worth only 20 per cent of its June 1997 value, while the Thai baht and Korean won lost around 50 per cent of their former values; the Philippines peso and Malaysian ringgit fell some 40 per cent below pre-crisis values. The fall in foreign demand for Asian assets also led to sharp stockmarket falls in the greater East Asian region, including Hong Kong and Singapore. These asset price collapses put great pressure on banking and financial systems and ultimately depressed real activity, as illustrated in Figure 2.

This paper briefly examines the special role that international capital flows played in the Asian currency crisis. To do this, it examines exchange rate policies in Asian economies and explains how the sharp reversal of international investment led to the currency crisis. Finally, the paper canvasses the impact of the redirection of international investment on the Australian economy, concluding with a summary of the major lessons and opportunities arising from the crisis.

2. EXCHANGE RATE POLICIES IN THE 'ASIAN 5'

Economies are vulnerable to international capital reversal because of the risks associated with investing abroad. When investors' perceptions of risk exposure suddenly change, the immediate withdrawal of funds exerts strong downward pressure on financial asset values, including bond prices, equities and exchange rates. The main sources of risk relate to future adverse exchange rate movements and loan default. In the East Asian case, both default risk and exchange rate risk were badly underestimated. The main reasons foreign investors underestimated their risk exposure were a lack of awareness of structural weaknesses in the financial systems, combined with presumptions that Asian monetary authorities were bearing foreign exchange risk and that the IMF would bear some default risk.

For decades many East Asian economies either adhered to fixed exchange rates or strictly limited their flexibility, thus providing Asian borrowers and foreign lenders alike with a measure of exchange rate certainty underwritten by 'Asian 5' central banks. Under these conditions, interest differentials drove capital flows and a large proportion of foreign borrowing was unhedged against the possibility of large exchange rate depreciations.

When exchange rates in the region came under intense pressure, the monetary authorities of the affected economies had to choose between defending their exchange rates via foreign exchange market intervention or by raising short term interest rates under their control. If domestic interest rates had been raised, for instance to levels of around 150 per cent as in Russia during mid-1998, the immediate macroeconomic impact of the capital outflow would have been borne by the domestic economy through mass bankruptcy with inevitable contractionary consequences. On the other hand, letting the exchange rates depreciate would allow international borrowers and lenders to bear the brunt of the necessary external adjustment.

The monetary authorities in the 'Asian 5' quickly surrendered to market forces after initial attempts to control their exchange rates. This exposed foreign lenders to the cost of external adjustment which otherwise would have been borne more directly by Asian businesses and households through higher domestic interest rates.

3. EXPLAINING HOW THE CURRENCY CRISIS HAPPENED

The Asian 5 currency crisis itself can be modelled with reference to Figure 1. This figure in exchange rate-foreign exchange space reveals why Asian 5 exchange rates depreciated by so much in response to the switch out of Asian financial assets by foreigners and by Asian investors themselves. In the figure, the supply of foreign exchange to Asian markets, S^{fx} is drawn positively related to Asian exchange rates, e, collectively defined as Asian currency per unit of foreign currency; a rise in e therefore denotes Asian currency depreciation. Total foreign exchange supplied to Asian economies is the sum of Asian export earnings (X), recorded in Asian current accounts and foreign investment inflows (K^I), recorded in their capital accounts.

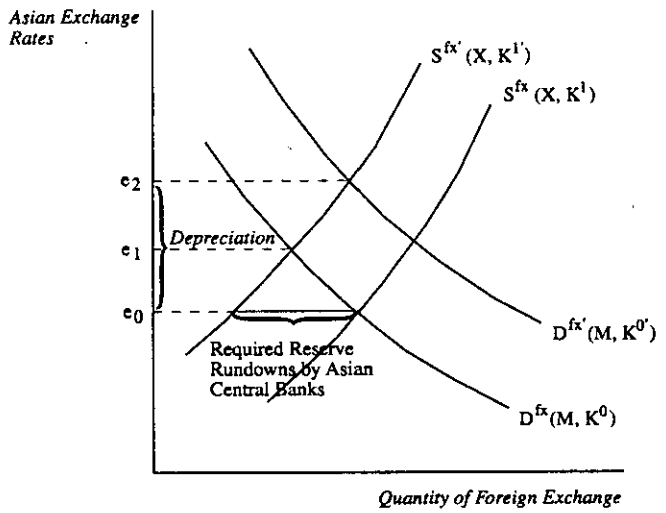
The weaker are Asian exchange rates, the more competitive are their economies' export sectors and hence the greater is the amount of foreign exchange earned. Foreign capital inflows to Asian economies on the other hand respond to differentials between Asian interest rates, i^A, interest rates in the rest of the world, i^*, and foreign investors' perceptions of the riskiness of investing in Asian financial markets, R_f^A. Hence, the supply of foreign exchange may be represented as

$$S^{fx} = X(\overset{+}{e}) + K^I(\overset{+}{i^A}, \overset{-}{i^*}, \overset{-}{R_f^A}) \qquad (1)$$

On the demand side, Asian demand for foreign exchange, D^{fx}, is made up of demand for foreign exchange to pay for imports of goods and services and Asian

FIGURE 3

CAPITAL FLOW REVERSAL AND ASIAN EXCHANGE RATES



investors' demand for foreign exchange to enable purchase of non-Asian assets, K^0. The weaker are Asian exchange rates, the more expensive imports become for Asian residents and firms and hence the less foreign exchange is required. At the same time, Asian investors would increase demand for financial assets in the rest of the world if financial returns abroad were relatively higher, or if they perceived a rise in the riskiness of holding their own assets, R_a^A. Hence,

$$D^{fx} = M(\bar{e}) + K^0(\bar{i}^a, \overset{+}{i}^*, \overset{+}{R}_a^A) \qquad (2)$$

Figure 1 illustrates how Asian exchange rates came under severe pressure as foreign investors quit Asian financial markets upon realising that risk exposure in these markets was much higher than previously thought. The S^{fx} schedule shifted upwards to $S^{fx'}$ as foreign investment fell from K^I to $K^{I'}$. Asian central banks initially tried to hold exchange rate steady, but were unwilling to completely exhaust foreign currency reserves for this purpose. Accordingly, Asian exchange rates depreciated from e_0 to e_1. This exchange rate correction turned into a crisis however, when Asian investors themselves switched funds out of Asian currency denominated assets to foreign currency assets. This caused Asian demand for foreign currencies to increase from D^{fx} to $D^{fx'}$ which caused substantial further depreciation, from e_1 to e_2 in the figure.

4. IMPLICATIONS FOR THE AUSTRALIAN ECONOMY

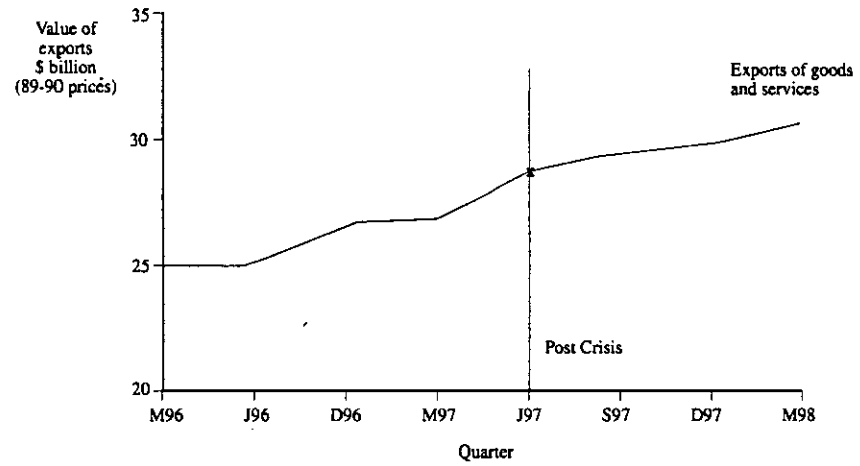
The sudden reversal of short-term capital flows to the East Asian economies has prompted calls from many quarters to restrict the quantum of foreign borrowing. This popular line of argument neglects however that the phenomenal growth rates of most Asian nations over recent years, and even longer in cases such as Hong Kong and Singapore, have been fuelled by foreign funds. Without that earlier capital inflow from abroad in its various forms, the crisis economies would now be on a considerably lower plateau of economic development. Putting this another way, the economies worst hit by the adjustment are experiencing how difficult it is to cope when the flow of foreign funds is shut off.

The exchange rate falls, share price slides and sharply reduced growth rates of East Asian economies have raised concerns about diminished prospects for Australia's exports of goods and services. Many commentators have presumed that sharp currency depreciations and faltering Asian economic growth will slow Australia's exports to the region through two related effects. First, through the so-called income effect which suggests that a dramatic slowdown of growth in regional economies will reduce their overall appetite for imports of goods and services from everywhere. Secondly, through a relative price effect, which means that exporting to the Asian region becomes that much more difficult because weaker Asian currencies have made Australian products more expensive from the Asian buyer's perspective.

Yet, thinking along these lines as a way of gauging the impact of the crisis on Australia's overall export performance, and hence future domestic economic growth, can be seriously misleading. This is because such an interpretation

FIGURE 4

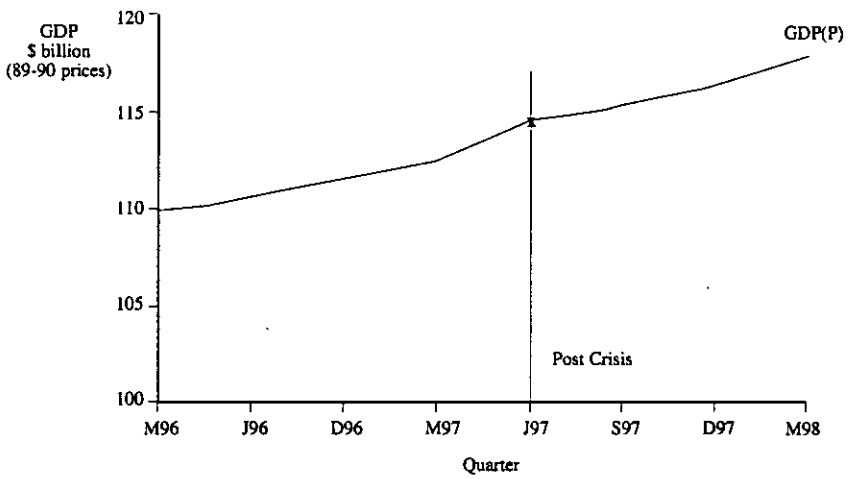
VALUE OF EXPORTS IN 1989-90 PRICES – AUSTRALIA



Source: ABS, Online.

FIGURE 5

GDP IN 1989-90 PRICES – AUSTRALIA



Source: ABS, Online.

presumes that other things will remain the same, when in reality they will not because the world economy is an inherently dynamic system.

4.1 Australian Exports and GDP

The Asian financial turmoil occurred because foreign investors adjusted their portfolios by switching out of Asian financial assets into other more attractive alternatives. Foreign investment is not likely to return to these countries until fundamental reforms of financial practices in these economies are firmly in place and recognised as such by the financial institutions which had provided billions of dollars worth of funds to the region.

However, the foreign capital that recently quit Asia has been reinvested in, for instance, Australasia, North America and Western Europe, helping to keep interest rates low and asset values high in the advanced economies. This has sustained extra economic activity and created additional trade opportunities in those regions. Hence, the international capital that has been switched from Asian markets to other destinations has been instrumental in generating alternative opportunities for Australian trade, providing a potential offset to any reduction in export opportunities in Asia.

The post-crisis strength, indeed real growth, in Australia's overall exports and GDP is readily apparent from Figures 3 and 4. At the same time, the overshooting of Asian exchange rates and other asset values has created bargain values for Australian investors and has increased scope for further direct foreign investment in the region.

4.2 Discipline for Further Reform

The last serious exchange rate crisis for Australia occurred in February 1985, when the $A depreciated by about 25 per cent in a few weeks. Though on a much smaller scale than the Asian crisis, that particular currency collapse was also the result of a significant foreign capital reversal which then signalled the need for fiscal consolidation and microeconomic reform. At the time, foreign investors exercised a useful external discipline, ensuring that sustainable economic growth enhancing policies were adopted in the late 1980s.

The Asian crisis is a reminder that foreign investors may eventually lose patience waiting for overdue growth-enhancing reforms. Increased commitment to economic reform in Australia would therefore provide stronger insurance against another exchange rate collapse in this country and the associated hike in interest rates that would result. It would also enable Australia to catch-up to the income levels of those other East Asian economies (namely, Japan, Hong Kong and Singapore) that have been badly battered by the Asian financial storm and yet still lead Australia in the national income per head stakes.

5. MAJOR LESSONS AND OPPORTUNITIES

The great East Asian capital flow reversal has taught us that international investors will respond instantly to new economic information that raises perceived risk levels or lowers expected relative rates of return. The main reason for the crisis was an

underestimation of default and exchange rate risk, combined with fragile financial systems in which both foreign and domestic investors lost confidence. Foreign investors will continue to favour those economies throughout the world that have sound financial systems and whose governments have growth-enhancing policies in place. Accordingly, the best option for minimising future financial crises is to strengthen the institutional framework, not to prohibit or tax short-term capital flows.

To sum up, the main lessons and opportunities arising from the Asian crisis are as follows:

Lessons

- With globally integrated financial markets, foreign investors can now effectively vote with their funds against economies experiencing unsustainable levels of economic activity.
- Sharp capital outflows provide the requisite signal that financial practices and domestic economic policies have to be changed if economies are to recover quickly.

Opportunities

- The redirection of foreign funds to mainly North American and European markets has improved Australia's opportunities for further trade with those regions, which have historically been Australia's major trading partners.
- At the same time, extremely low financial and real asset prices in Asian economies have improved the scope for increasing portfolio and direct investment in the financial sectors of the Asian 5 economies and for providing consultancy services to those countries as they rebuild their financial systems.

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