Gold from the storm

The Economist

2007.6.30

Asia's financial crisis

- July 2, 1997
- Thailand ran out of foreign-exchanges trying to defend its currency from a huge speculative attack
- It was forced to float the Thai baht
- Capital flight from Thailand, Indonesia, Malaysia, and South Korea

Flaws

- a combination of weak financial systems
- a hasty opening of economies to foreign capital
- a policy of tying local currencies to the dollar

Fixed exchange rate

- The expectation that currencies would remain fixed encouraged banks and local firms to borrow heavily in dollar
- As the dollar rose between 1995 and 1997 so did East Asian currencies, causing current account deficits to widen
- Capital took flight and the country's foreign reserves dwindled
- In 1998, Indonesia, Malaysia, South Korea and Thailand's real GDP per head fell by 11%

Why recovers quickly

- High saving rates
- IMF bails-outs
- But, could it happen again?
- Roubini argue that the build-up of reserves is itself creating new hazards
- Exchange rate are once more, in effect, tied to the dollar
- Developing Asia's total reserves have jumped from $250 billion in 1997 to $2.5 trillion in 2007

Impossible trinity

Roubini's argument: an economy cannot

- control domestic liquidity
- manage its exchange rate
- capital account is open

Impossible trinity

- If central bank holds down its currency, capital inflow will boost money supply. Central bank may sterilize by bond sales, but this will push up interest rate, and attract more capital inflows.
- Roubini believes that the room for sterilization is limited

Fact

- Only Hong Kong still pegs to the dollar
- South Korea won has risen by 42% since 2002
- Sterilization has been successfully
- but, Thailand was in trouble again in late 2007

China

- China may have drawn the wrong lesson—keeping the exchange rate stable and build up massive reserves
- East Asia's government need more flexible exchange rate
- This will also help to shift growth towards domestic demand and away from exports