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Abstract

This particular paper attempts to answer a few questions: Does global finance in general and state and international monetary as well as financial institutions cause financial as well as economic instability for nations around the world? Is it possible to prevent the advantages of increased access to international funds markets from being reduced and even reversed by global and national monetary and financial crises. Are existing national currencies outdated?

Since 1 January 1948, the GATT and since 1 January 1995, the WTO, which, soon after eight rounds of multilateral trade negotiations, strove to lower and even eliminate barriers towards the international mobility of goods as well as services. The counterpart of the WTO (164 members) is the IMF with 189 members, initially designed at Bretton Woods in July 1944, in order to recycle surplus liquidity from developed to developed countries. Since 1973-74, this feature has been carried out mainly within developing countries (Kirrane 1995). Unlike the WTO, in its field, the IMF's charter does not require it to liberalise international capital movements. Article VI even explicitly makes it possible for the use of controls if funds flows threaten the economic stability of countries.

From a hypothetical point of view, there are indeed significant differences between the welfare factor of free trade with regard to goods and services and that which can be derived from the free international mobility of capital. In fact, there are actually two arguments that make global capital mobility less appealing and riskier for a nation than free trade with regard to goods and services.

The first argument goes back to David Ricardo (1817), creator of the theory of comparative advantage, which remains one of the foundations of international trade. Nations benefit from international trade by specialising and exporting the production for which they are either the most efficient or the least ineffective, and importing some other goods. For Ricardo, however it was clear that his theory rested on the assumption that capital required for industrial expenditure does not move from one nation to another. Ricardo approved limitations on the mobility of funds and said he was 'disappointed if they were lowered'. In fact, however, obstacles to the mobility of capital are never totally removed, especially with regard to the actual stock of industrial capital.

Global capital mobility reduces the comparative advantage of countries that have minor absolute advantage in the costs of production relative to others. The exodus of domestic capital then becomes a replacement for international trade and must be accompanied sooner or later by an exodus of labour.

The next argument for not putting free trade and capital mobility on the same footing is a monetary and financial argument: the actual international mobility of stateless capital, by its ebb and flow, can be a source of monetary as well as financial crisis for small nations that do not have sufficient resources to defend themselves against speculative attacks. In fact, long-term funds inflows can be an important factor to countries' economic development. However, if these funds are short-lived and unpredictable,

the influence they exert on exchange rates as well as interest rates can be a major cause of financial and economic lack of stability.

Thus, in the context of independent national currencies as well as independent monetary and fiscal policies, a sustained inflow of capital is a triple concern for a small country:

- Danger of a balance of payments crisis, when external debt becomes too large with regards to the national economy. This can be a long-term challenge based on the supposition that foreign capital borrowed will be invested in tradable goods industries, so that the country's capability to export or substitute imports will be sufficiently increased to pay for both the overvaluation of the exchange rate and the repatriation of interest and dividends.
- Risk of a liquidity and exchange rate crisis, when there is too much short-term external borrowing when compared with liquid external assets.
- Danger of an internal bank crisis, when the national banking institutions borrowed in hard foreign currency to lend in local currency. Any collapse of the exchange rate affects the solvency of domestic banking institutions. Indeed, in the short term, inflows as well as outflows can dominate the actual exchange rate: if the latter is fixed, the country might lack international reserves to protect it, but, if the rate is flexible, the unpredictability of capital movements might subject it to a yoyo effect.

The inflow of capital, by creating excessive demand for the national currency, almost inevitably leads to an appreciation of the national currency unless the central bank puts all its entries into its international reserves. For a while, monetary overvaluation keeps prices of imported goods lower, while high prices for export goods are offset by investments financed through foreign loans.

Before productivity and the country's export capability increases, the exchange rate will appear overvalued, and this is going to be all the more the case as the proportion of net external debt to the economy (GDP) goes up. It is at this point that any kind of error in policies, an excessive orientation of borrowed capital towards non-tradable goods, an excessive overvaluation of the currency and a large deficit in the current account, in a situation of short-term external debts, may cause a crisis of confidence in the country, a sudden and massive exodus of capital and a fall of the exchange rate. This occurred in Mexico in December 1994 and January 95, in Thailand in July 97, in Russia in August 98} and in January 99 in Brazil.

Therefore, the general term financial crisis brings these three kinds of crisis, or the balance of payments crisis, the liquidity crisis and the exchange rate and domestic banking crisis. These crises include devastating effects on the economies of the countries, since the fall of the national currency on the foreign exchange markets is combined with two deflationary phenomena, specifically a sharp rise in interest rates which often discourages investment and foreign debt denominated in foreign currencies, which threatens the balance sheets of banks and businesses. These deflationary effects caused by monetary and financial crises may be of such size as to nullify or even reverse the beneficial effects of the inflow of external capital.

Monetary and financial crises tend to be inherent in a system of independent currencies and free global mobility of capital. To prevent financial crises, the free international mobility of funds would in theory require conditions of stability similar to those existing within countries or within monetary unions.

These conditions are:

- The nation or region that lifts all restrictions on mobility must have a common currency with its partners or, in the case of an independent currency, must have irremediably fixed exchange rate.

-The smooth adjustment of national balances of payments requires a multi-branch banking system. In this way, a country that loses long-term capital can borrow short-term capital: bank headquarters automatically become lenders of last resort to branches with liquidity problems. For a country, what this means is allowing branches of overseas banks to operate within its borders.

-In the lack of participation in a multi-branch banking system, the country must have access to a highly liquid money market on a day-to-day basis. In this way, the banks from the surplus regions can give loans to banks in deficit regions in the very short term.

-Finally, the solvency and liquidity of the monetary and financial system requires an official lender of last resort and specific government guarantees. Before national central banks existed and government authorities guaranteed the integrity of their banking systems, episodic crises of 'bank rushes' arose.

Internationally, it is not surprising that this lack of institutional leadership to free capital mobility creates a similar phenomenon of 'bank run', that is to say 'rushes on currencies'. There is currently no predictable source of international liquidity for otherwise solvent nations around the world. The IMF provides credits from its own funds, but these loans are conditional, are generally slow in coming, and remain uncertain. The IMF is not an antidote to crises of confidence. Since these four conditions do not exist internationally, the full international mobility of capital remains a risky policy for many nations.

A closer look at the conditions with regard to capital mobility to contribute to the economic growth of nations without provoking monetary and financial crises that cancel out and even reverse the beneficial effects which flow from such mobility will now be made.

Within an economy or monetary union, even if prices may possibly diverge (because of the prices of fixed goods and non-tradable services), inflation rates are similar, and the same is true for nominal and real interest rates, adjusted for the risks incurred. That does not mean that there cannot, theoretically, be a financial crisis within a nation or monetary union. A financial crisis may appear when there is popular pressure to reduce or liquidate accumulated debts, starting with bank debts. The demand for cash to make repayments then surpasses the supply of liquidity, therefore the financial liquidity crisis that pushes interest rates upward. The explosion of interest rates and the collapse of the bond market can turn the liquidity financial crisis into a financial insolvency crisis, when the balance sheets of banks, companies as well as households deteriorate to the point of bankruptcy.

In the past, when there initially were no central banks, writers such including Thorstein Veblen (1904) as well as Wesley C. Mitchell (1941), and later Irving Fisher (1933) and Hyman P. Minsky (1964, 1977)), focused on financial panics and bank panics as agents associated with economic crises.

Within nations and currency unions, this kind of financial crisis is increasingly improbable due to the four institutional components already mentioned. First, in terms of liquidity, the central banks are ready to act as lenders of last resort, adopting the precept of the English economist Walter Bagehot (1873) according to which 'in case of banking crisis, we must rediscount and rediscount strongly'. Next, central banks exercise continuous oversight and regulation of banking activities. Third, a banking system with multiple branches as well as overnight money market are important and automatic sources of liquidity. Fourth, in terms of solvency, government authorities can increase their deficits in order to inject aggregate demand into the system and avoid an economic contraction.

Mistakes in monetary policies or fiscal policies in the course of the economy are still feasible. There is no doubt that the Great Depression in the 1930s was aggravated, and for some such as Milton Friedman and Anna Schwartz (1963), even caused by such mistakes. Today, there is no central bank governor who

is not persuaded of the need to safeguard the integrity of the banking system and the financial system at all times. Financial bubbles are still to be dreaded, but no central bank would accept cascading bank failures and sudden contractions in the money supply. That does not mean that economic cycles are actually abolished and that fluctuations in investments and their profitability will no longer influence the evolution of the real economy. It is the financial earthquakes that modern monetary institutions have in theory and in practice halted.

At the global level, when financial downturns arise from the decline in capital flows and too much external indebtedness, they become a lot more difficult to prevent and correct since they are compounded by currency crises}. Indeed, it is the fear of future devaluations of currencies, rather than the insolvency of debtors, that may lead to massive outflows of capital. These financial and external monetary crises happen in five stages.

Initially, a country is leaving its level of external indebtedness at critical levels relative to its gross domestic product as well as its ability to export; second, the negative current account stops to be fully covered by net capital inflows; third, a crisis of confidence in the steadiness of the external value of the currency precipitates a liquidation of debts, an exodus of volatile capital along with a collapse of the exchange rate; fourthly, the central bank is being forced to let rates of interest go upwards in order to retain capital and avoid a rise in domestic inflation, with unfavourable results for the real economy and, fifth, the fall of the exchange rate makes the relative cost of external funds borrowed in foreign currencies also explode, threatening the solvency of local borrowers (banks or firms).

To some extent, any wave of international investment into a convertible country, whether or not its exchange rate is fixed and defended through international reserves, or flexible, involves some sort of Ponzi scheme. Indeed, the more the current account is in deficit, the more funds inflows must be significant. However the more capital inflows are abundant, the more the current account is in deficit, either because domestic monetary supply increases, or because capital inflows appreciate the exchange rate of the currency. It is when this particular external financing mechanism is reversed that there is a crisis.

Whenever capital inflows slow down or even reverse with the liquidation of external debts, the country encounters a current account deficit, only sudden and violent exchange rate adjustments and in interest rates can quickly correct it. Persistent deficits in the current account were observed in Mexico prior to the 1994-95 crisis, and in Asia before the 1997-98 crisis.

The experience of countries in crisis appears to show that deficits in the external current account which exceed 3% of GDP for several years may be followed by some sort of slowdown or a reversal of net external capital flows and thus provoke a monetary and financial crisis. Before a crisis, peaks in the deficit ratio of the current account/GDP going above 6% can be observed. For this reason, international finance can be, in some instances, so destabilising for the real economies of small nations.

The example of the monetary and financial crisis experienced in 1997-98 by several Asian countries, starting with Thailand, Indonesia, Malaysia, South Korea and the Philippines, by the crisis experienced by Mexico in 1994- 95, by the Russian crisis of August 1998, as well as the Brazilian economic crisis of January 1999, testifies to the danger of having independent currencies and of resorting simultaneously to external portfolio funds (Kirrane 2017). These almost inevitably lead to monetary as well as financial crises if this alternative is too important and lasts too long. There is even some inevitability to these crises in the present international institutional framework.

At the institutional level, these monetary and financial crises crop up from the incompatible combination, for small open economies, of three phenomena, namely:

- free international mobility of capital, especially short-term portfolio capital and bank loans, as part of a financial liberalisation of the capital account of the balance of payments;
- independent national currencies with fixed or flexible exchange rates, but usually with inadequate official international reserves to pay for short-term external debts
- and national autonomy of monetary and fiscal policies.

One must not make too much distinction a fixed but adjustable exchange rate situation and a flexible exchange rate situation with intervention by the central bank. In the first case, it is the depletion of official foreign exchange reserves that triggers the crisis of confidence in the currency and the flight of capital. In the second situation, it is the fall in the forward exchange rate, added to the decline in official reserves which precipitates the flight of capital and the currency crisis.

The experience of several nations around the world shows that even relatively big official reserves do not by any means prevent the sudden exodus of capital as soon as a depreciation or devaluation of the currency is anticipated. In the 1997-99 financial crises, the two most volatile forms of external fund were external bank credit and portfolio capital. The two most stable forms of external capital were direct funds and commercial credits. For that reason, a first lesson emerges from recent experience for developing countries that aspire to own an independent convertible currency in a context of international funds mobility. Short-term bank loans are classified as the most volatile and, to a lesser extent, portfolio investment in the form of bonds or securities. This category of short-term external capital is attracted to emerging countries by the generally increased interest rates that are found there, despite the current currency risk.

Conversely, the most stable external capital is direct funds, which comes in the wake of the establishment of foreign companies and the commercial credits that flow from the normal course of export-import activities. Any country with short-term external debts in excess of its reserves and international lines of credit might be subject to a speculative currency attack.

The 1997-1999 financial crisis is the first currency as well as financial crisis of the 20th century when private capital dominated and mostly credit banking, and where the main debtors were private sector borrowers, including national banks. In 1996, just prior to the start the crisis, for example, global bank lending to Asian countries accounted for 60% of outstanding debt, while short-term portfolio capital accounted for 13% of the total. In 97, these two categories of volatile funds reversed and became negative, causing the crisis.

Developing countries adopting the path of financial liberalisation are faced with a conflict between independent convertible currencies, full international funds mobility and macroeconomic stability of their economies. This study makes it possible to make some observations for countries wishing to open up to external capital, while maintaining a high degree of monetary autonomy along with a high degree of fiscal autonomy.

Given the high amount and high speed of movement of international portfolio capital, a fixed and adjustable exchange rate removes any possibility for a country to pursue an independent interest rate policy. In theory, the central bank might want to sterilise the effects of capital movements on the domestic money supply. In doing so, however, it is likely to be able to artificially drive up interest rates

as well as accelerate capital inflows, additionally increasing the risk of future funds outflows and an exchange rate crisis.

If it wants to have a convertible currency, the minimum for a nation integrated in international funds markets is to adopt a flexible exchange rate with official intervention in the foreign exchange market. This does not prevent confidence crises in central bank monetary policy and government fiscal policy, but one-way speculative assaults and capital outflows tend to be partly absorbed by the exchange rate. The price to pay is a volatile exchange rate, which goes up and down. And as the experience of South Korea in 1997 illustrates, using a floating exchange rate and along with a positive current balance is not an insurance against speculative attacks. If a country becomes too illiquid, that is, if it has too much short-term external debt relative to its short-term availabilities, it is vulnerable to a currency crisis caused by speculators.

A condition sine qua non for maintaining a particular level of monetary autonomy, is to invest in important external official reserves. The higher the reserves relative to external debt in the short term, the more the central bank is able to absorb abrupt exchange rate and interest rate variances. Recent experience shows, however, that this is not enough to avoid abrupt exchange rate crises when there are liquidations of external debts and a massive exodus of capital.

Banking authorities should pay special attention to the vulnerability of national banks that have borrowed in hard currency to lend in local currency. Such vulnerability only shows up once the national currency is heavily devalued.

The only real definitive way for a country that wants to have both a convertible currency and complete integration into international funds markets is to free itself from the game of uncovered interest rate parity and speculation by transforming its central bank into a formal issuing institution or *de jure* joining a monetary union (Kirrane 2003). This is what Argentina did in April 1991, with the transformation of its central bank into an issuing institution. An issuing institution guarantees a fixed exchange rate against an anchor currency, as well as automatic external convertibility.

An issuing institution system, however, does not provide a hermetic insurance against currency crises. The example of Hong Kong in 1997-98 and that of Argentina after the Mexican crisis of 1994-95, and after the Brazilian crisis of 1998-99, are proof. Fixing the exchange rate of a currency to a key currency such as the US dollar.

In order to minimise the political factor, the International Monetary Fund should act as an intermediary in the development of enlarged currency unions around a few anchor currencies. The IMF should develop a special fund for the use of key currencies. This special fund would have two features, that of receiving annual interest on the amounts of key currencies in circulation in the participating nations and that of constituting a stabilisation fund and financial loans of last resort for the nations of each monetary zone.

Countries whose economies are generally not diversified and relatively unmarked by foreign trade, and whose national labour markets are too inflexible, may come to the conclusion that their full integration into global markets capital and the external convertibility of the currency are not worth the abandonment of monetary and financial sovereignty. Whether the exchange rate of the independent currency is fixed, adjustable in a range or flexible, the country must shield itself against currency crises by holding adequate foreign reserves and by controlling or imposing short-term transactions on the

capital account. The central bank must ensure that the financial obligations of the domestic banking system in foreign currencies (bank deposits certificates, etc.) are covered by sufficient short-term liquid external assets.

Some control over volatile short-term funds, especially those that pass through the national banking system, is required if the country is to be free from destabilising currency and financial crises. Countries that have come to this conclusion, such as Chile and Colombia, manage to steer clear of being dragged into unmanageable crises. Others learn tough way. The experience of the last few years has shown that it is the short-term capital, and especially the external bank credits, which are the most destabilising.

For emerging countries, the real choice is not between fixed exchange rates or flexible exchange rates, but rather between a monetary regime based on an anchor currency (US dollar or Euro), with credits as a final option, and a fixed or floating rate national currency regime, but with appropriate taxation or control of short foreign borrowing.

It must be concluded that the IMF and the G7 nations, led by the United States, might have put the cart before the horse by encouraging the globalisation of the money and financial markets and by development to liberalise all capital movements. It would have been more cautious and wiser to carry out exhaustive reform of the international monetary and financial system beforehand, to be able to regulate the most volatile and destabilising stateless capital flows, and to establish a stable and credible source of international liquidity for solvent countries. The monetary and financial crises in many countries are the result of this imprudence and this improvidence.

Instead of amending its statutes in order to outlaw capital controls, the IMF should instead take the lead to create the necessary political and monetary mechanisms to allow nations that wish to achieve monetary stability. The current institutional structure is indeed too primitive and too fragile to support a heavy traffic of stateless and volatile international capital, as the new communication technologies make it possible for.

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