Have we Seen this Movie Before?

Comparing the Crisis of 2008 with East Asia 1998

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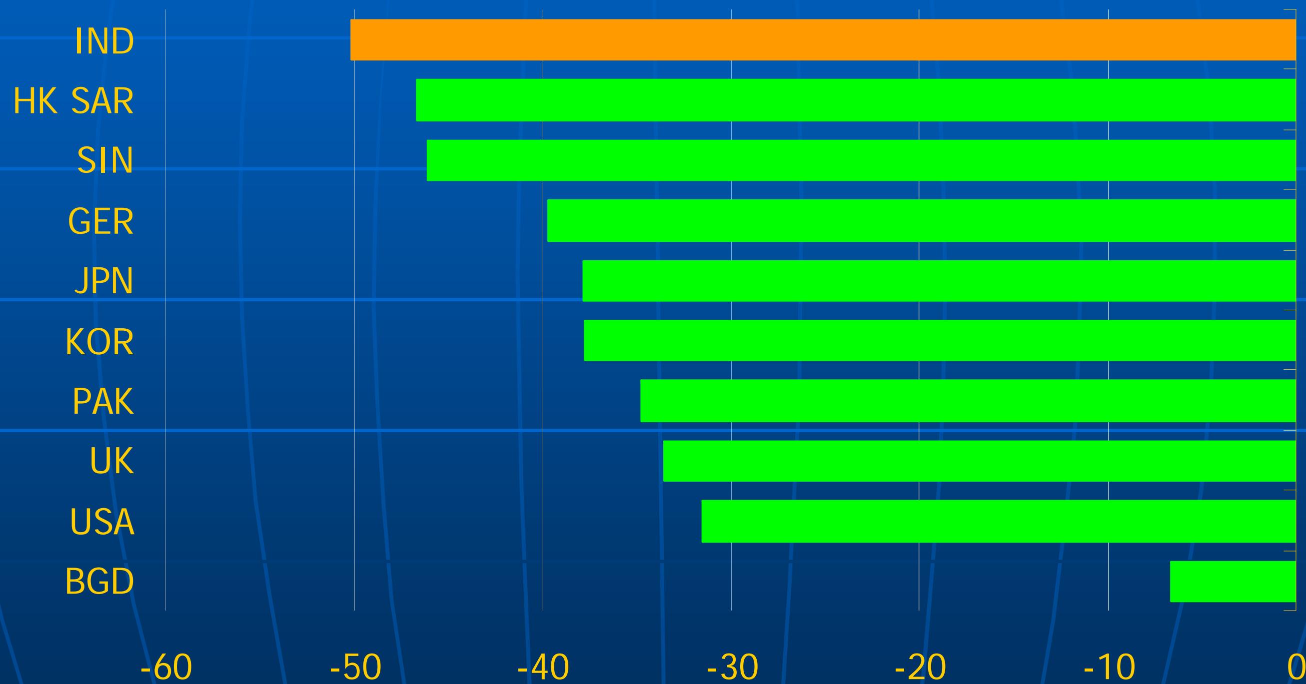
Attention!

- The views expressed in this presentation are personal. They are not necessarily shared by the IMF, its Executive Board, or its management.

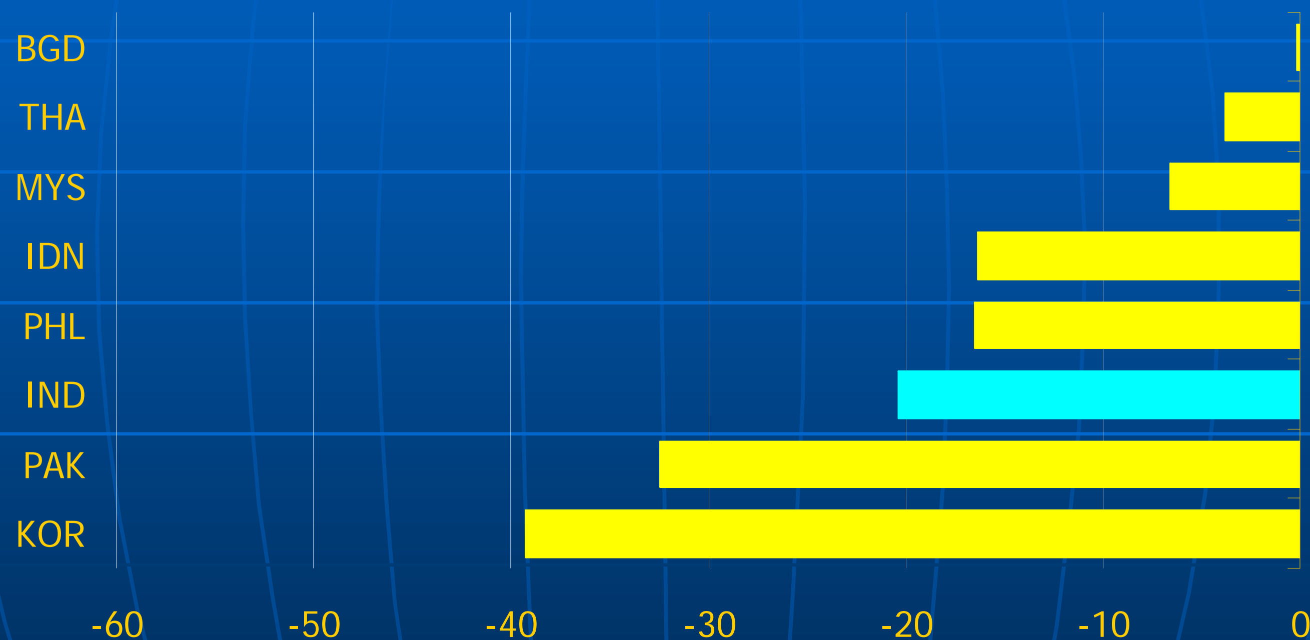
2008 has been a very bad year

- Not just for the US economy
- But for other advanced countries
- And emerging markets (EM) in Asia

Stock markets have crashed



EM Currencies have weakened



EM risk aversion remains very high

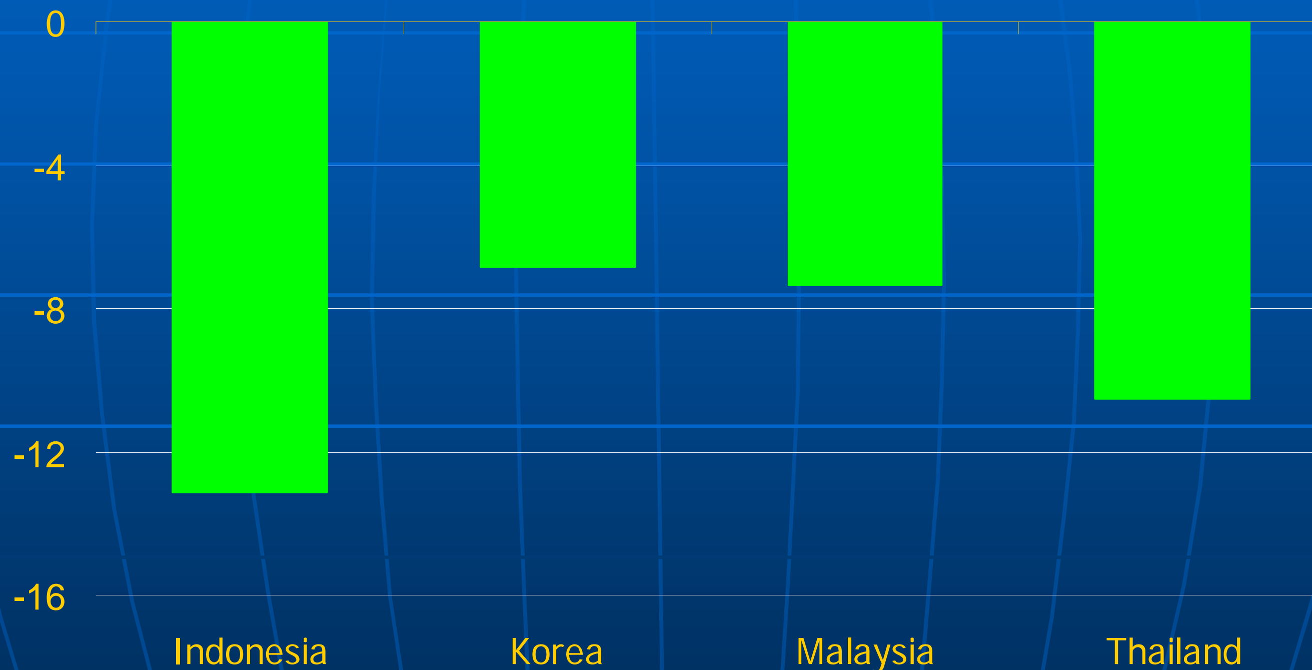
Source: Bloomberg L.P.

This brings back bad memories

- The last time we saw a similar collapse in Asian asset prices was a decade ago, during the East Asia crisis

- This proved the prelude to a collapse in East Asia's growth

Growth rates turned negative



Source: IMF, World Economic Outlook.

Is this where we are headed?

- Put another way: *have we seen this movie before?*
- Let's examine this question carefully, looking at how this crisis compares with the East Asia crisis of 1998

Structure of presentation

- Why has Asia been affected?
- How is this crisis likely to play out?
- Could financial sector reform help?

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Why Asia?

- It seems strange that Asia has been so badly affected
- Unlike in 1998, the epicenter is far away
- And this time Asia's fundamentals are in much better shape

Asia's stronger fundamentals

- Fiscal positions have improved considerably
- Inflation is generally lower
- Corporate leverage is lower
- Banks are better capitalized, with few non-performing assets (and little direct exposure to toxic ones)

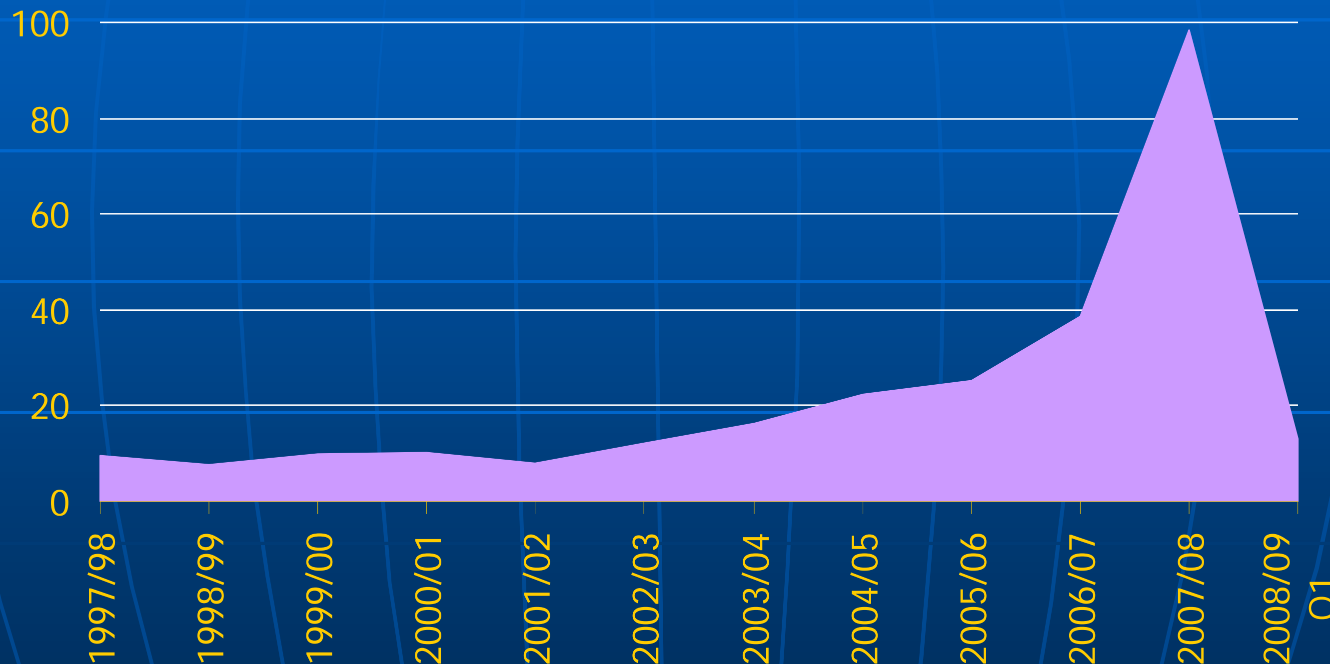
Asia’s stronger external fundamentals

- Exchange rates are much more flexible
- Foreign reserves are much higher
- Which means that Asia is less susceptible to a speculative attack – or panic
- A noticeable and important difference: this time, there’s hardly any capital flight by domestic residents

- With such strong fundamentals, one might ask why Asia was affected at all
- The answer is straightforward: Asia is highly integrated into the global economy, much more integrated than it was a decade ago

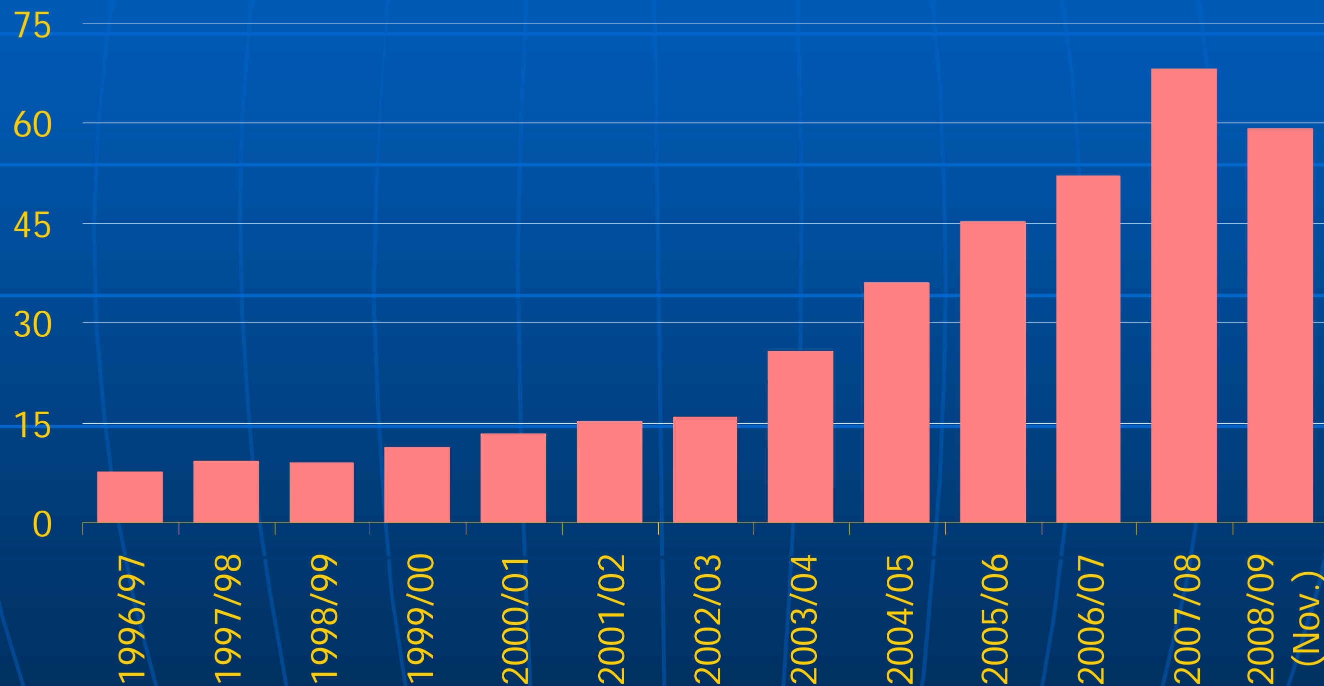
- 1st point: Asia is much more *financially* integrated than it was a decade ago

India now borrows in global capital markets…



Source: Reserve Bank of India.

..and foreigners invest in India



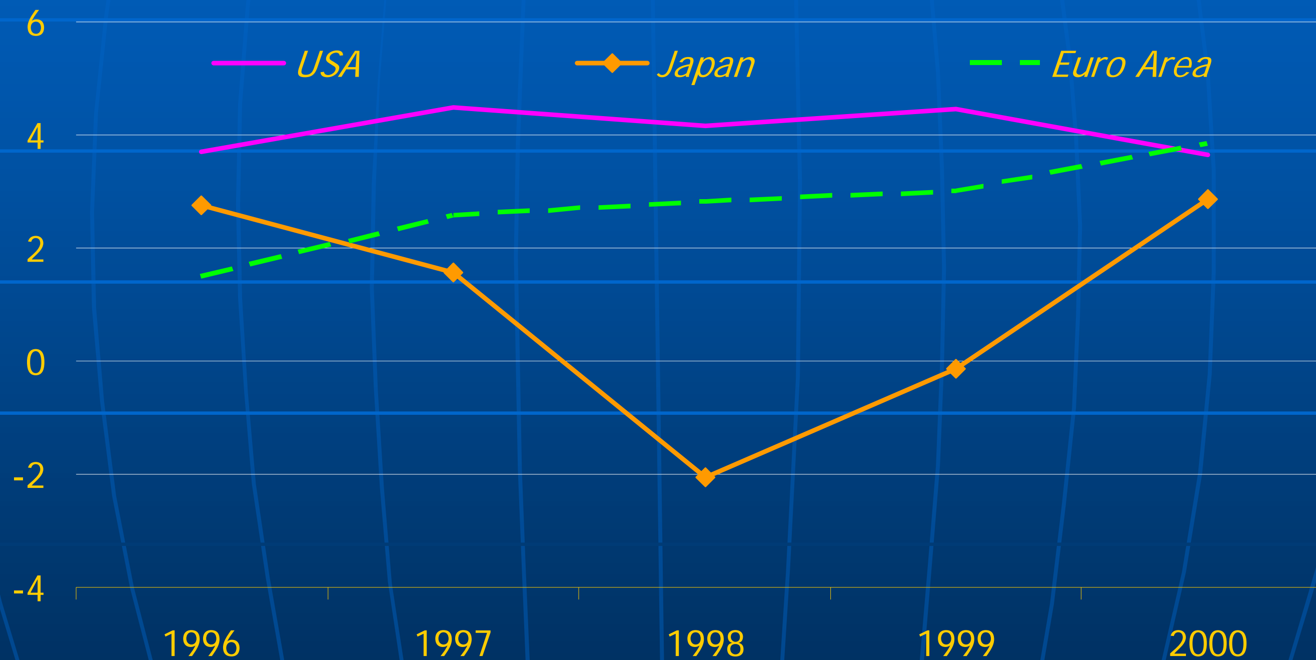
The implications

- When global risk aversion increased:
  - Foreign investors sold off their holdings of Asian equities and debt
  - Banks cut credit lines to Asian banks operating overseas
  - Banks refused to roll over fx debts of Asian corporates (including trade credit)
- This created “dollar shortages”, as demand for dollars soared but the supply dried up
- As firms scrambled to repay their foreign debts, they turned to domestic sources for financing
- That caused local market conditions to tighten as well

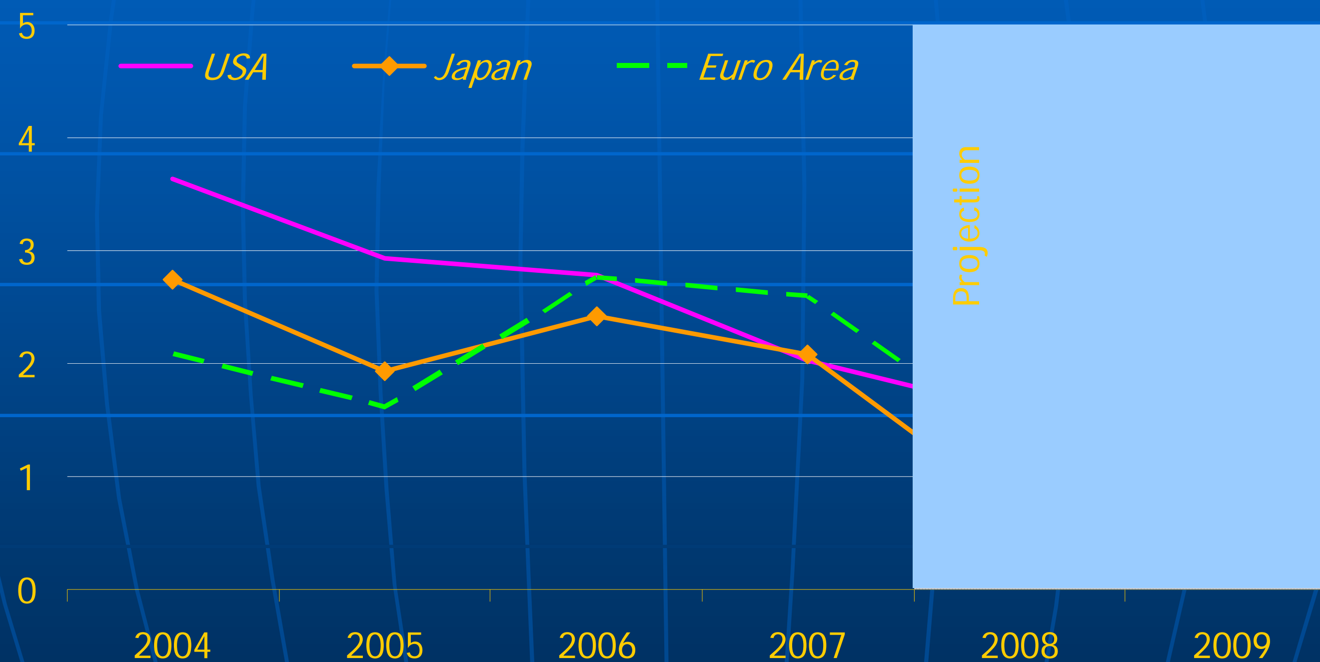
- Second point: Asia is also more highly integrated into the global *trading* system

India is much more reliant on exports...

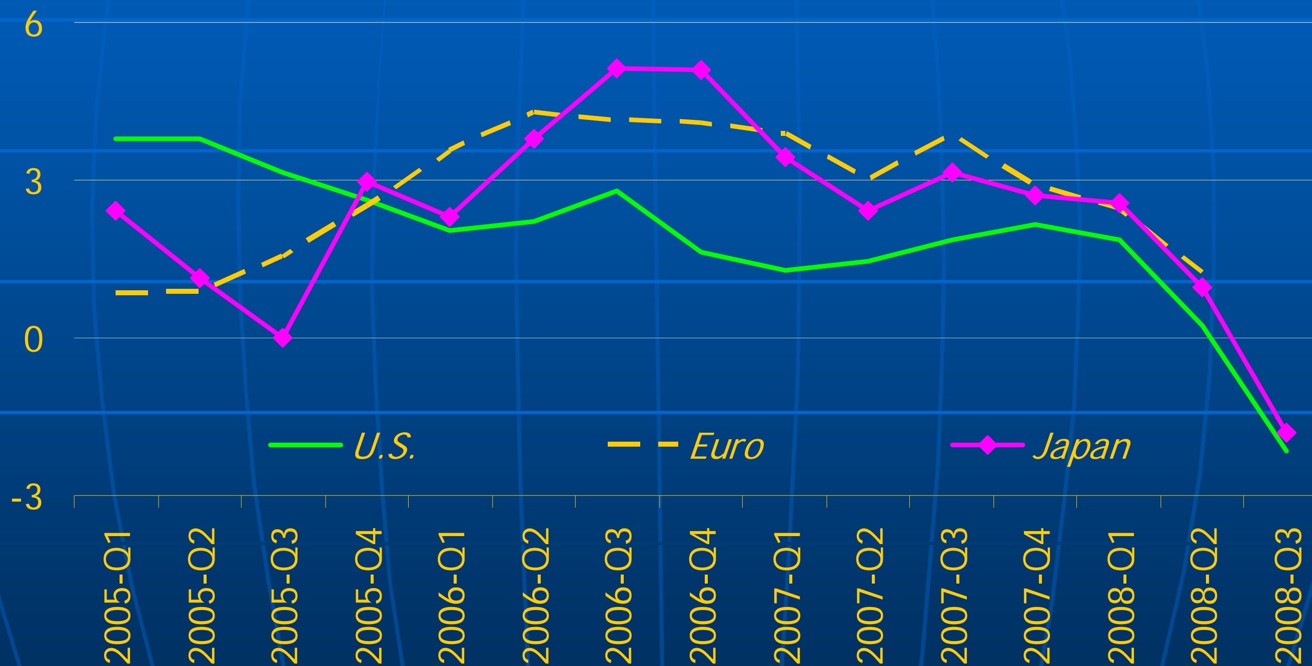
In 1999, Asia exported its way out of recession



…but now the export outlook is dire

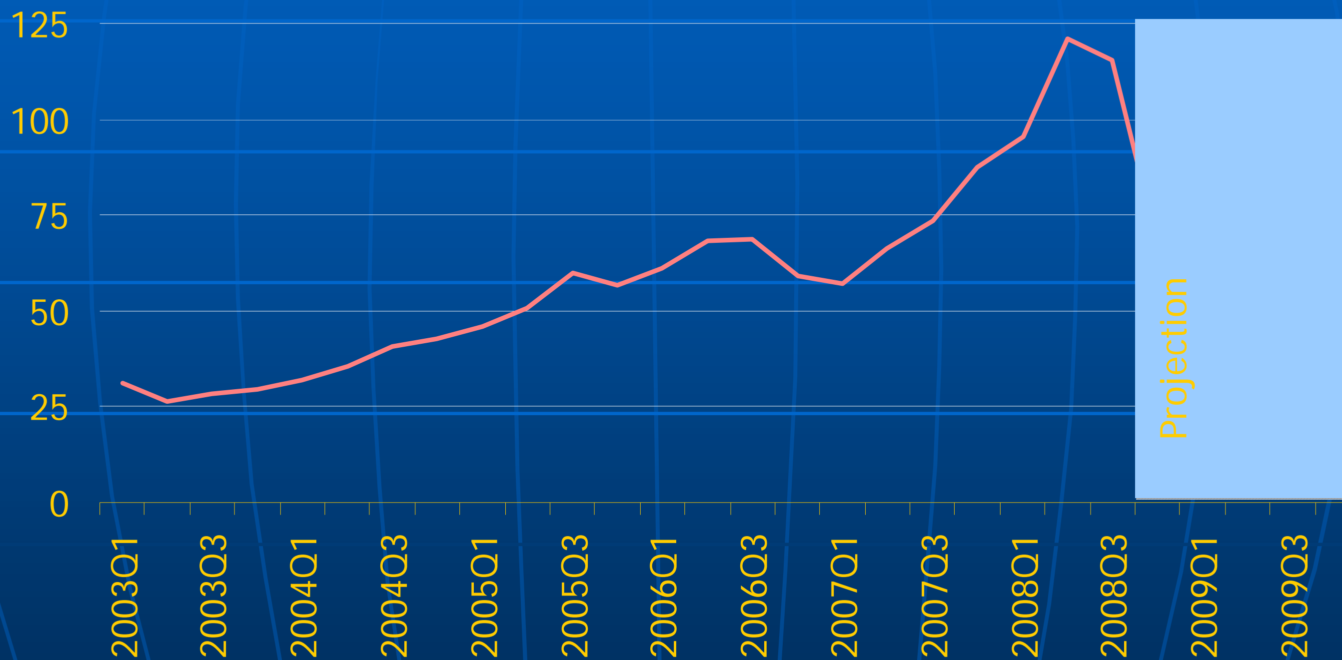


Industrial production is shrinking



Source: Haver Analytics.

…though some help will come this time from lower oil prices



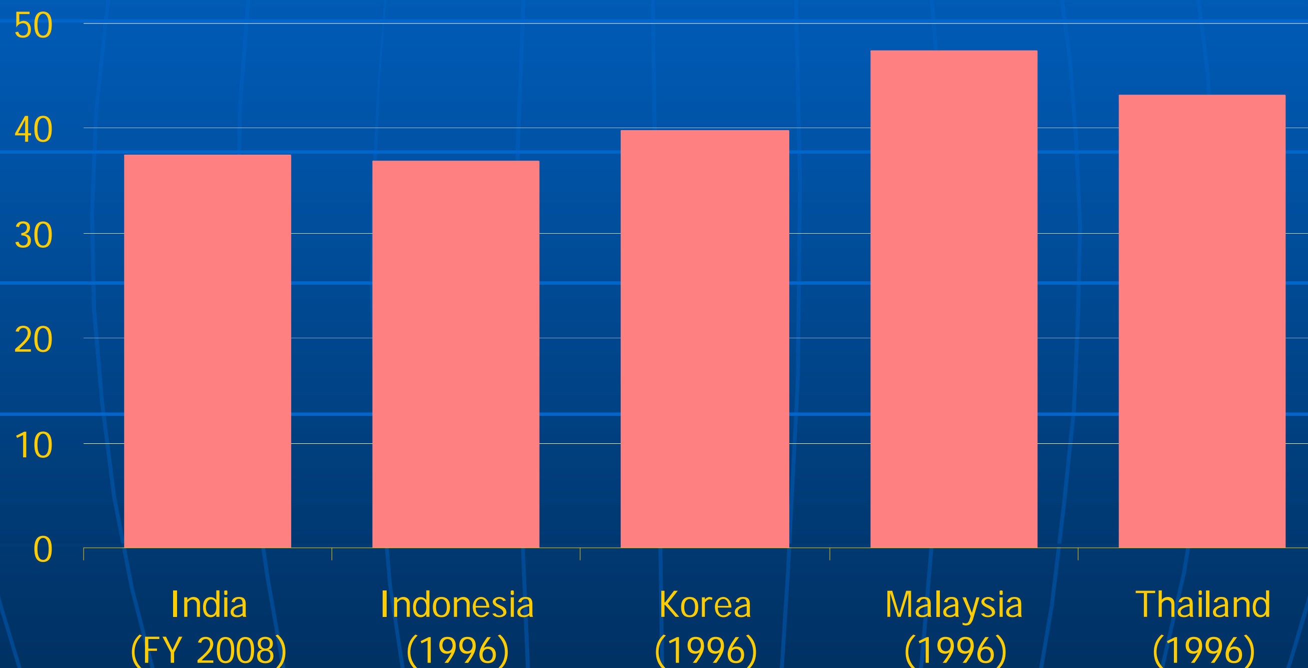
Source: IMF, Commodity Price System.

- Point 3: Asia still has its own vulnerabilities

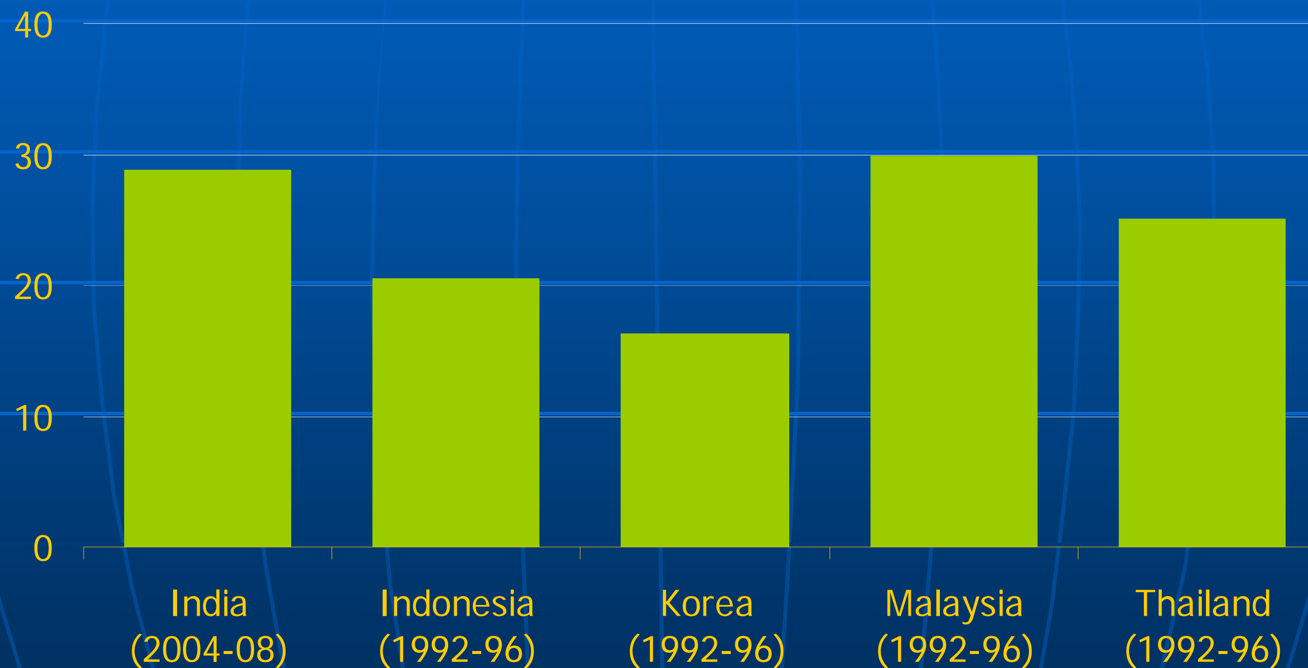
Booms and busts

- Research has shown that crises often follow investment and credit booms
- Companies and banks take on too many risks, become overextended, and suffer the consequences
  - That's what happened in East Asia 1998
  - And in the US 2008
- India has been enjoying its own boom

India's historic investment boom is similar to 1990s East Asia



…and so is its credit boom



Sources: CEIC Data Company Ltd; IMF, International Financial Statistics.

Summing up

- Asia is generally in stronger shape than in the 1990s
- But it is more integrated into the global economy
- And it is facing a much more severe shock -- global, not just regional
- While it has some vulnerabilities of its own

Structure of presentation

- Why has Asia been affected?
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The 1990s Experience

- East Asia 1998 demonstrated that crises normally go through two phases

Phase I

- Financial strains appear
  - Liquidity dries up
  - Asset prices fall
  - Exchange rates depreciate

Phase II

- The strains take their toll on growth
  - 3-6 months later in Asia crisis
  - Direct impact
    - Investment slows
    - With India's investment near 40 percent of GDP, a 10 percent decline will knock 4 percentage points off GDP growth!
  - Indirect balance sheet impact
    - Corporations begin to default
    - Non-performing loans rise
    - Banks become impaired
    - A negative feedback loop emerges, as the poor corporate performance hurts banks, which then find it difficult to support the corporates

Dealing with Phase I

- We are now in Phase I
- The priority is to provide adequate liquidity
  - Inject liquidity into the domestic money market
  - Provide foreign exchange to ease the dollar shortage
- This is known as “reverse sterilization”
  - When the inflows came in, the RBI built up reserves and issued Monetary Stabilization Bonds (MSS)
  - Now it is using reserves and redeeming the MSS

A painful dilemma

- But the East Asian crisis demonstrated there's a problem with reverse sterilization
- If the central bank injects liquidity into the system, while intervening to slow the exchange rate depreciation, it is providing the fuel needed to sustain capital outflows
- Reserves can then erode very rapidly
- This can create a painful dilemma:
  - If the intervention is wound back, the exchange rate could depreciate sharply
  - If the liquidity injection is halted, domestic interest rates could soar

Dealing with the dilemma

- Is there any way out of this dilemma?
- Everything depends on how long the financial strains last
- If the strains ease quickly, the loss of reserves under reverse sterilization will remain manageable

What if Phase I lasts a long time?

- In the East Asia crisis, it lasted for more than a year
- Then the "reserve sterilization" policy will need to be abandoned, and a choice made between low interest rates and defending the exchange rate
- East Asia's choice was highly constrained: they had to defend the exchange rate because firms had so much foreign borrowing
- India Inc's foreign borrowing is much smaller, so there is more room for maneuver
- An exchange rate that has found a market floor could create incentives for capital reflows

Dealing with Phase II

- The problems will get even more intractable when we reach Phase II, that is when the corporate sector comes under stress
- As corporate profits decline, financing needs are going to rise sharply
- But foreign and equity funding has dried up
- How will corporates be able to replace this lost financing?

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Reforms could help in four ways

- East Asian experience suggests that reforms should aim at four key objectives
  - Increasing banks' lending capacity
  - Expanding non-bank financing, e.g. the bond market
  - Sustaining trade finance
  - Ensuring banks' solvency

Task 1. Increase banks' lending capacity

- There are only a few ways that banks could give more resources to the private sector
- The supply could come from:
  - The RBI
  - The non-bank public
  - Abroad
  - Government
- Let's consider these sources in turn

The RBI

- Banks have to place 5.5 percent of their deposits at the RBI as a cash reserve requirement (CRR)
- If this requirement were reduced further, the funds could be used for lending
- But there is a limit to this – some CRR is necessary for prudential reasons

Non-bank public

- If banks can convince the public to hold more of its wealth in bank deposits, it will have more resources to lend
- But to do this, banks need to *raise* their deposit rates

Foreign resources

- Banks could try to attract inflows (NRI deposits, remittances)
- But this also requires increasing interest rates
- To facilitate this, the caps on NRI deposit rate rates need to be eased further or eliminated

Another dilemma!

- So we have another policy dilemma:
  - Higher deposit rates could alleviate the credit crunch
  - But this would push up lending rates, which would further damage corporate profits
- So, let's look at the other alternatives

The government

- Right now, much of the credit flow of banks is being pre-empted by the financing needs of the PSUs, particularly the oil and fertilizer companies
- Lower global oil prices have reduced their financing needs – but not eliminated them
- Abandoning subsidies will give more room for lending to the private sector
- So would scaling back the priority sector lending targets
- These reforms have long been economically *desirable* – they now are urgently *necessary*

Reducing the government's claims/2

- It's often argued that if the Statutory Liquidity Requirement (SLR) were cut, banks could sell their government bonds, freeing up resources to lend to the private sector
- But someone needs to hold the government bonds
- If banks hold less, other financial institutions have to hold more, reducing the funds they can give to the private sector
- So, this strategy doesn't work for the financial system as a whole – unless the bonds can be sold to the non-bank public
- How can this be done?

Task 2. Develop the bond market

- How can the bond market be developed -- at a time when risk aversion is so high?
- It can be done – Korea developed its bond market in the middle of the 1998 crisis
- Two key requirements:
  - Reduce the SLR to create a true market in government bonds, with interest rates that entice voluntary holdings
  - Open the market fully to foreign participation
- As the market for government bonds expands, investors may be willing to purchase corporate bonds as well

Task 3: Sustain trade finance

- All across Asia, trade finance is drying up
  - Importers, exporters can't get Letters of Credit (L/Cs)
  - They are defaulting on contracts
- Something needs to be done
- During the East Asian crisis, countries established special facilities to provide such credit
  - The central bank could accept Letters of Credit (L/Cs) as collateral, or even purchase them
  - Alternatively, the facility could be established at a state bank

Task 4: Ensure banks' solvency

- Maintaining liquidity is a necessary condition for lending
- But it may not be sufficient
- If the situation truly deteriorates, and bank solvency becomes seriously eroded, banks will no longer be able to lend
- Where can the banks secure new capital?
- The government has limited fiscal room
- The solution during the East Asian crisis was to liberalize FDI
  - Banks that needed capital were sold to foreign investors
  - Non-bank sectors (e.g., insurance) were also opened up
- We know that foreign banks are not as adept at managing their risks as once thought – but what is the alternative?

Conclusion

- The immediate reaction to the crisis of 2008 is bound to be: this is not a time for financial sector reform

- But that reaction would be wrong

- Some types of reform are needed more urgently than ever

- The East Asian experience suggests that reforms are needed to:
  - Mobilize banks' resources, including by winding back subsidies and directed lending that limit their ability to support the private sector
  - Develop the bond market, by reducing the SLR and opening it up to FIIs
  - Sustain trade finance
  - Ensure banks' solvency, including by opening it up to foreign investment

- More generally, the period of capital abundance that fueled India's investment boom has ended
- The world is now entering a period where capital is scarce and competition for it fierce
- To minimize the impact this will have on investment and growth, India needs to respond by removing the obstacles that it has erected to capital inflows

Conclusion

- Put another way, the movie does seem familiar
- But it is a remake, not the original
- And we still have time to write a different ending!

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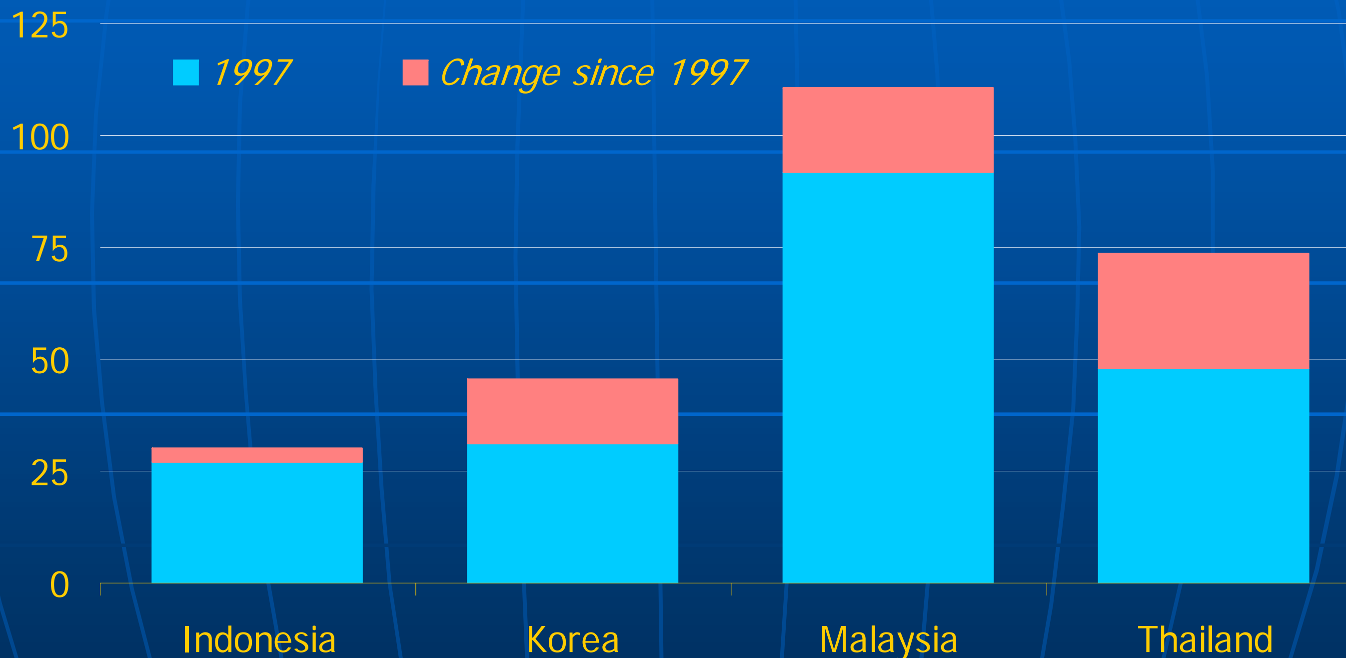
Asia's export-dependence has *increased* over the past decade



Source: IMF, World Economic Outlook.

China won't save the day

Source: CEIC Data Company Ltd; and IMF, staff calculations.