# Some positive lessons from the Asian financial crisis. Hyun-Song Shin, BIS

Developing country economies are proving to be a competitive market for investment in local bonds because they offer relatively high yields and long maturities, which limit the risk of fluctuations in the US dollar, although not the risk to the developing economy.

The lessons of the Asian financial crisis 20 years ago have shown that the movement of capital can be a gamble.

The reality of international finance is complex, said Hyun-Song Shin, economic adviser and head of research at the Bank of International Settlements (BIS) at a recent Asian Development Bank and ADBI conference, 20 Years After the Asian Financial Crisis.

> **Here the picture, instead of islands, is a very dense connected network of nodes. The nodes are balance sheets, and the connections are balance sheet claims and liabilities. In this picture, exchange rates do more than simply determine a trade balance. They also affect various financial prices and risk taking, which have financial stability implications but also, through risk taking, have a real-economy set of implications, as well.**

A depreciation, far from being expansionary, turns out to be contractionary. When a currency depreciates, especially against the US dollar, it will depress economic activity rather than stimulate it, Shin said.

Twenty years after the Asian crisis, the financial system has changed, he said, but one constant is the role of the US dollar as the currency that underpins the global banking system. Some fourteen trillion dollars in assets and liabilities are in play.

Developing country bonds, which offer relatively high interest rates, have become attractive to capital, but financial systems should avoid currency and maturity mismatch. The local bond markets offer good, secure returns in terms of US dollars because the bonds are issued in the local currency with long maturities. The Asian Development Bank has played a major role in developing local currency bond markets, Shin said, adding that the ADB website was a good resource for the types of initiatives on offer.

Sometimes the effect of currency appreciation and currency depreciation can be the very opposite of the traditionally expected effects on the trade balance. This is because, Shin said,


Copyright © 2017 ADBI. All rights reserved.

the change in a currency value relative to the dollar has an effect on the risk-taking pattern of institutional lenders and banks.

> The risk-taking channel, so-called, operates in a very different way, where, if there is a large stock of dollar-denominated liabilities that are financing assets that depend on the value of the dollar, then as the dollar depreciates, the liability shrinks relative to the assets. Therefore, the balance sheets of the borrowers appear to become stronger and, from the point of view of the creditors, this increases the perceived credit-worthiness of the borrowers, will result in a decreased measured tail risk of any kind of credit risk model, and will tend to result in an increase in the credit supply.
>
> Even in the case of a local currency bond, provided there is a stock of assets that may be sensitive to the dollar in this way, we can imagine that the risk-taking channel will affect the broad range of financial assets.

Shin said the BIS has found that when there is a dollar appreciation shock, there is less buying of US dollars with foreign currencies. And when that happens, a government has less to spend on internal investment.

A crucial question is how government should orient monetary policy when it faces an appreciating or a depreciating currency. Traditionally, government plays on the level of interest rates in such situations. But here again, there is no easy answer, because acting on the interest rates can also hurt the domestic economy, said Shin.

> It's not at all obvious how monetary policy should be modified as a result of the exchange rate channel. For example, if you have the local currency depreciating very sharply against the dollar as we saw in the last couple of years, what should be the exchange rate response? If it's a purely exchange-rate pass-through effect to inflation, we should be raising rates to counter inflation.
>
> But we also know that when the domestic currency depreciates very sharply against the dollar, this also tightens financial conditions very sharply. And what could be the domestic response to that? Again, the answer is not clear. You may want to raise rates to defend your currency and therefore mitigate some of these effects, but equally you may want to keep interest rates low in order not to allow the tightening to have a big impact on your domestic economy. So there are no easy answers. But we have another set of issues which are put on the table as the result of the risk-taking channel.

Shin said the bond market has become important in many emerging markets but especially in countries where the local currency sovereign bond market has become an important asset


Copyright © 2017 ADBI. All rights reserved.

class. The amount that can be captured from mutual funds has grown tremendously over the past few years.

One argument you hear is that long-term bonds in local currency should not cause great financial stability risks because they're long term. Therefore, the runs will not be that damaging and because it's local currency, the currency mismatch should be much lessened. Both arguments are very strong. They are the lessons that we've learned from the Asian financial crisis.

But let me focus on one potential channel which could act as an amplifier. This is the action of asset managers who are reacting to local financial conditions. We tend to think of mutual funds as being passive investment vehicles which are purely managing their portfolio in response to their own investors who, when investors put in more money, then they purchase more bonds. When the investors take out more money, they sell the bonds. Although that is largely true, I think an important element is also the discretionary element of portfolio management and especially the discretionary sales and purchases of the fund managers themselves.

In other words, do the sales and purchases reflect just the inflow and outflow, or do they reflect more the active decisions? If so, which way does it go? Does the discretionary management of the managers act as a stabilizer or does it act as an amplifier? When would it act as a stabilizer?

It would act as a stabilizer when in the face of redemption pressures the asset manager would reduce his cash holding and meet the redemption without selling the bonds. That would be when it's acting as a stabilizer. On the contrary, when it's acting as an amplifier, this is when the manager is selling more than is necessary to meet the redemption pressures.

Empirically, it turns out that the discretionary management is amplified. In other words, the asset managers tend to sell more than is necessary when there are redemptions and buy more than necessary when there are inflows. The cash balance is moving in a way where the cash balance increases during episodes of redemptions and cash balance decreases during episodes when there are cash inflows.


Copyright © 2017 ADBI. All rights reserved.

That was Hyun-Song Shin, economic adviser and head of research at the Bank of International Settlements, speaking at a recent conference, 20 Years After the Asian Financial Crisis, held at ADBI.

*Listen to podcast*

- https://soundcloud.com/adbinstitute/some-positive-lessons-from-the-asian-financial-crisis

*Watch the full presentation*

- https://www.youtube.com/watch?v=ZA6l-aBJ44Y&feature=youtu.be

*Know more about the conference*

- https://www.adb.org/news/events/20-years-after-asian-financial-crisis-lessons-challenges-and-way-forward

*Know more about ADBI's work on the Asian financial crisis*

- https://www.adb.org/adbi/search/year/2017?keywords=asian%20financial%20crisis


Copyright © 2017 ADBI. All rights reserved.