Asia shows unconventional monetary policy works in crisis

Hit by the 1997–1998 Asian financial crisis, economies in Southeast Asia adopted unconventional monetary policy measures to ride out the financial storm, and were the stronger for it, teaching a few unorthodox lessons to developed economies left reeling by the global crisis a decade later.

Central banks were initially at a loss about what to do, as share prices and asset values plunged, currencies and exports weakened, and investment capital fled—much as some central banks in advanced economies were during the global financial crisis of 2008.

In Asia, Thailand chose to recapitalize struggling banks, while in Hong Kong, China, the strategy was to buy falling stocks on the share market, which it later sold carefully back into the market, distributing the profit to every taxpayer as a bonus of some $1,000.

Public funding of bank recapitalizations in Thailand and the extraordinary purchase of equities in Hong Kong, China have elements of the unconventional monetary policy known as quantitative easing, which has received so much attention in major advanced economies in recent years.

During the Asian crisis, Western economists were skeptical about the macroeconomic benefits of government purchases of risky assets.

Since 2008, they have been far more sympathetic to the view that financial markets may not be efficient and may at times be destabilizing if left to themselves.

Central banks are independent of domestic public opinion and voters. A central bank purchase of risky assets from the private sector raises the price of the assets and thus lowers their yield. The lower yield encourages the further issuance of risky assets to fund investment even at a fixed level of the short-term policy rate. This enables central banks to stabilize the economy even when conventional monetary policy is set at or near zero interest rates or is committed to a fixed exchange rate.

By supplying safe assets, or cash, and buying risky assets such as bonds and equities, quantitative easing reduces the risk borne by private investors, making them more willing to spend, thus supporting growth and employment, particularly when risk aversion is high.

Public funding of bank recapitalizations in Thailand and the extraordinary purchase of equities in Hong Kong, China benefited these economies during the Asian crisis by supporting aggregate demand, while keeping inflation in check.

Thailand's bank recapitalization, in which the central bank acquired equity stakes, was more stimulating than the Republic of Korea's program, which focused on loans to banks, because it removed more risk from private portfolios.

Indonesia presents a cautionary tale in which excessive monetary expansion and the lack of a coherent framework led to a loss of monetary control and a bout of very high inflation. A key lesson is that unconventional monetary policy is not a panacea, and it must be used within the guidelines of a sound policy framework, such as flexible inflation targeting.

This episode is based on an ADBI blog post by Tamim Bayoumi, a deputy director at the International Monetary Fund, and Joseph Gagnon, a senior fellow at the Peterson Institute for International Economics.

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