

10 lessons from the Asian financial crisis

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QUESTION TIME | This month marks the 20th anniversary of the Asian Financial Crisis or AFC which started with the plummeting of the Thai baht in July 1997 after investors sold down the currency when they “suddenly” discovered that Thailand was using short-term inflows to fund long-term projects.

While that sudden discovery was viewed by some as an opportunistic attempt to make some quick money on trading, the revelation that the Thai central bank had lied and overstated their level of reserves opened the floodgates. The currency went into a free-fall and Thailand turned to the International Monetary Fund or IMF for help.

Almost like a disease, contagion took place with South Korea and Indonesia targeted by the speculators, both of whom turned to the IMF for help which prescribed rather harsh measures such as raising interest rates and cutting expenditure, which would cause the proverbial blood to flow in the streets.

Malaysia came under attack as well although its foreign borrowings were well-contained but with confidence hammered down and near panic in the markets, there were signs that locals were moving their money out of ringgit on an unprecedented scale. Even strong Singapore and free-market Hong Kong were not spared.

Although Malaysia never required nor sought IMF help, the initial response, under then finance minister and deputy prime minister Anwar Ibrahim was to take IMF-like measures by cutting expenditures and raising interest rates. Meantime a leadership tussle between Anwar and then prime minister Dr Mahathir Mohamad escalated, leading to further uncertainty.

Mahathir blamed speculators for the attack on the currencies and he was at least partially right about that. Large international funds basically used a two-prong approach to force markets down.

They simultaneously sold short currency and stocks of the affected currencies, that is sold them first without having them, with the intention of buying back when they fell and making on the difference. If central banks had sufficient reserves, then they could buy the currencies being sold and holding prices up, forcing the funds to buy back at a loss and halting the speculation.

Hong Kong, whose currency was pegged to the US dollar, took that route. Their equivalent of the central bank mopped up currencies being sold while government funds bought up shares of key stocks when they came into the market.

Singapore chose to ride the wave, letting the currency and stocks slide but not too much and waiting for the attacks to subside. Taiwan, India and China, all of which did not have a freely floating currency, came out completely unscathed.

Malaysia eventually opted for capital controls, following which Mahathir arrested and jailed Anwar. Malaysia recovered rapidly as it pumped liquidity into the system, lowered interest rates and increased spending to counter the downturn, in a move which predated similar measures to be adopted when developed countries faced their own World Financial Crisis (WFC) a decade later.

A lot has since been written about the AFC but for me, there were a number of key lessons from the crisis. Here are 10 of them:

1. There is no such thing as a free market. A free market is one where no single investor or group of investors can by themselves affect prices on the markets. That only works for very large markets such as the US but for small markets like Malaysia, that's not true at all. A relatively small number of investors can effectively cause a market collapse.

2. There is no perfect market. A perfect market is defined as one where everyone has equal access to information. Small markets are not anywhere near perfect with many investors having inside information not available to the general public and advance information of how people are going to trade...

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