Echoes of the Asian Financial Crisis in Reverse: Capital Controls and Currency Wars in the Wake of the Global Financial Crisis
Perspectives from EMEs with Comparative Case Studies of China and South Korea

June Park
Department of Political Science
Boston University

August 22, 2012 / GR:EEN GEM PhD School, Fudan University, Shanghai, PRC
I. Introduction
   - Escalation to the AFC and the GFC

II. The GFC Escalation to a Global Currency War
   - U.S. Policy Actions
   - EMEs Response to Capital Flows

III. Comparative Cases of EMEs: South Korea and China
   - South Korea
   - China
Outline

1. Introduction
   - Escalation to the AFC and the GFC

2. II. The GFC Escalation to a Global Currency War
   - U.S. Policy Actions
   - EMEs Response to Capital Flows

3. III. Comparative Cases of EMEs: South Korea and China
   - South Korea
   - China
I. Introduction

From Asian to Global Financial Crisis

The Asian Financial Crisis, 1997-1998

Escalation to the AFC...

- Hot Money, Capital Flight, Currency and Maturity Mismatch, Financial Crisis

- Thailand -> Indonesia -> Malaysia -> South Korea
  - Government and Financial Sector Corruption
    - Strongly Attached Government-Business Relations
    - Lack of Foreign Exchange Reserves
    - Premature Financial Regulatory Systems

- IMF Guidelines and Austerity Measures
  - Were they Necessary?
  - Were they Appropriate?
I. Introduction

From Asian to Global Financial Crisis

The Asian Financial Crisis, 1997-1998

Escalation to the AFC...

- Hot Money, Capital Flight, Currency and Maturity Mismatch, Financial Crisis
- Thailand -> Indonesia -> Malaysia -> South Korea
  - Government and Financial Sector Corruption
  - Strongly Attached Government-Business Relations
  - Lack of Foreign Exchange Reserves
  - Premature Financial Regulatory Systems

- IMF Guidelines and Austerity Measures
  - Were they Necessary?
  - Were they Appropriate?
Escalation to the AFC...

- Hot Money, Capital Flight, Currency and Maturity Mismatch, Financial Crisis
- Thailand -> Indonesia -> Malaysia -> South Korea
  - Government and Financial Sector Corruption
  - Strongly Attached Government-Business Relations
  - Lack of Foreign Exchange Reserves
  - Premature Financial Regulatory Systems
- IMF Guidelines and Austerity Measures
  - Were they Necessary?
  - Were they Appropriate?
From Asian to Global Financial Crisis

The Asian Financial Crisis, 1997-1998

I. Introduction

From Asian to Global Financial Crisis

Escalation to the AFC...

- Hot Money, Capital Flight, Currency and Maturity Mismatch, Financial Crisis
- Thailand -> Indonesia -> Malaysia -> South Korea
  - Government and Financial Sector Corruption
  - Strongly Attached Government-Business Relations
  - Lack of Foreign Exchange Reserves
  - Premature Financial Regulatory Systems
- IMF Guidelines and Austerity Measures
  - Were they Necessary?
  - Were they Appropriate?
I. Introduction
From Asian to Global Financial Crisis

From Asian to Global Financial Crisis
The Asian Financial Crisis, 1997-1998

Escalation to the AFC...

- **Hot Money, Capital Flight, Currency and Maturity Mismatch, Financial Crisis**
- **Thailand -> Indonesia -> Malaysia -> South Korea**
  - Government and Financial Sector Corruption
  - Strongly Attached Government-Business Relations
  - Lack of Foreign Exchange Reserves
  - Premature Financial Regulatory Systems
- **IMF Guidelines and Austerity Measures**
  - Were they Necessary?
  - Were they Appropriate?

June Park (Boston University)  Echoes of the AFC in Reverse  2012 GEM PhD School
Escalation to the AFC...

- Hot Money, Capital Flight, Currency and Maturity Mismatch, Financial Crisis
- Thailand -> Indonesia -> Malaysia -> South Korea
  - Government and Financial Sector Corruption
  - Strongly Attached Government-Business Relations
  - Lack of Foreign Exchange Reserves
  - Premature Financial Regulatory Systems
- IMF Guidelines and Austerity Measures
  - Were they Necessary?
  - Were they Appropriate?
From Asian to Global Financial Crisis
The Interval Between the Crises, 1997-1998

Changes to the Global Economy...
- China’s Accession to the WTO with PNTR status, 9.11 / The War on Iraq and Increased U.S. Defense Spending, the Rise of BRICs, Japan’s Prolonged Deflation...

And
- China’s Rapid Economic Growth and Expansion to Other Regions of the Globe
I. Introduction

From Asian to Global Financial Crisis

The Global Financial Crisis, 2008-2012

Escalation to the GFC...


- Systemic Rescue: QE1, QE2, ZIRP by the FRB

- Impacts on EMEs: Capital Inflows from the Carry Trade, Exchange Rate Fluctuations from the Unstable USD, and the Onset of Competitive Devaluation (Currency Wars)
Outline

1. Introduction
   - Escalation to the AFC and the GFC

2. The GFC Escalation to a Global Currency War
   - U.S. Policy Actions
   - EMEs Response to Capital Flows

3. Comparative Cases of EMEs: South Korea and China
   - South Korea
   - China
U.S. Govt. Bail-Outs of Too-Big-To-Fail Institutions

- Bear Stearns
- Mortgage Giants: Fannie Mae, Freddie Mac, Ginnie Mae
- Investment Banks: Goldman Sachs, Morgan Stanley, JP Morgan Chase
- AIG
- Citigroup
- Bank of America
TBTF Bail-Outs (Unit: $USD Trillion)
Source: Government Accountability Office Audit of the U.S. Federal Reserve (July 2011)

- Bank of America
- Merrill Lynch
- Morgan Stanley
- Citigroup

TBTF Bail-Outs (Unit: $USD Trillion)
Additional Bail-Outs (Unit: $USD Billion)

Source: Government Accountability Office Audit of the U.S. Federal Reserve (July 2011)
The FRB’s Zero Interest Rate Policy (ZIRP)

- **ZIRP**: A ’non-conventional’ monetary policy used when there are no further ways to lower the interest rates to stimulate the economy.

- **The Conventional Method**: Central banks buy or sell government bonds to target at market interest rates, affecting interbank interest rates.

- **Lowering Interest Rates**: Enables cheap money borrowing -> boost borrowing from banks for investors and also increases intra-bank lending.

- **FRB (Dec. 16, 2008) and ECB**: Risk-free short-term nominal interest rates at zero, quantitative easings follow.
U.S. Federal Funds Rate, 1992-2011 (Percent Per Year)

Source: U.S. Bank of Governors of the Federal Reserve System
Japan's ZIRP: Experiences

Source: The Bank of Japan (2012)
U.S. Quantitative Easing (Q1/Q2)

- Quantitative Easing: maintain economic stability (interest rate and unemployment rate), easy borrowing, consumption, stimulation of the economy

- Why does it matter to the EMEs?: Shifts the investors to turn to countries with higher interest rates, inducing capital flows and local currency exchange rate fluctuations

- U.S. QE1 (Nov. 25, 2008 - March 31, 2010): Extraordinary Extension of Credit (Liquidity): term action facility, discount window for security firms, lending to money market mutual funds

- U.S. QE2 (Nov. 3, 2010 - June 30, 2011): Large-Asset Purchases (LSAPs): FRB purchase of longer-term treasury securities, agency mortgage-backed securities (a total of USD 1.25 trillion), agency debt purchases (USD 175 billion) - corporate bonds and equity
II. The GFC Escalation to a Global Currency War

The ECB’s Long-Term Refinancing Operations (LTRO)

- LTRO (Dec. 2011): A 3-year Longer-Term Refinancing Operations that enables European banks for a cheap loan to avoid liquidity trap, credit crunch or banking system collapse

- Equivalent to the QEs of the FRB and the BOE - previous cases (Japan, Hong Kong)

- The overlap of FRB and ECB QEs together impacted the EMEs considerably.
ECB Interest Rates
Source: The European Central Bank (2012)
II. The GFC Escalation to a Global Currency War

EMEs Responses to the GFC

Outline

1. Introduction
   - Escalation to the AFC and the GFC

2. II. The GFC Escalation to a Global Currency War
   - U.S. Policy Actions
   - EMEs Response to Capital Flows

3. III. Comparative Cases of EMEs: South Korea and China
   - South Korea
   - China
EMEs Response to the GFC and Capital Flows

The G20 and the Move for Capital Controls

- Asia showed the fastest recovery from the GFC, equipped with financial stability means and excess reserves

- In Response to Capital Flows: Voiced the risks and irregularities of capital inflows and outflows (hot money)

- In the Global Policy Platform: IMF position reversal on capital flows, G20 Summits call for regulation of capital flows
Currency Wars
The Revival of 'Beggar-Thy-Neighbour' Policies

- 'Beggar-Thy-Neighbour' (Kindleberger): remedying domestic economic troubles by measures that worsen economic troubles of other countries

- ZIRP and Subsequent QEs -> US Dollar Weakens -> EMEs local currencies closely linked to the U.S. economy via the dollar peg -> EMEs strive to defend their currencies by competitive devaluation
Rethinking Global Imbalances
The Advent of an EMEs-Based World Economy

- 'The Triffin Dilemma' a Reality for the U.S.: A national currency that also serves as an international reserve currency compels the country to have conflicts of interests between short-term domestic and long-term international economic interests.

- Predestined Fate of the Dollar: serving foreign economies with ample supply of the global reserve currency to fulfill the demands, resulting in a current account deficit
Source: IMF Statistics (2011)
Outline

1. Introduction
   - Escalation to the AFC and the GFC

2. II. The GFC Escalation to a Global Currency War
   - U.S. Policy Actions
   - EMEs Response to Capital Flows

3. III. Comparative Cases of EMEs: South Korea and China
   - South Korea
   - China
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

South Korea’s 5 Stages of Financial Reform
- 1950s-1960s: fundamentals build-up
- 1970s-1980s: adoption of legal and institutional measures
- 1980s-1990s: financial autonomy in a booming period
- 1990s-2000s: financial liberalization and the AFC
- 2000s and beyond: advancement of the financial system after subsequent reforms

Measures after the AFC Experience
- Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
- Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
- Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

South Korea’s 5 Stages of Financial Reform

- 1950s-1960s: fundamentals build-up
- 1970s-1980s: adoption of legal and institutional measures
- 1980s-1990s: financial autonomy in a booming period
- 1990s-2000s: financial liberalization and the AFC
- 2000s and beyond: advancement of the financial system after subsequent reforms

Measures after the AFC Experience

- Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
- Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
- Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

South Korea’s 5 Stages of Financial Reform
- 1950s-1960s: fundamentals build-up
- 1970s-1980s: adoption of legal and institutional measures
- 1980s-1990s: financial autonomy in a booming period
- 1990s-2000s: financial liberalization and the AFC
- 2000s and beyond: advancement of the financial system after subsequent reforms

Measures after the AFC Experience
- Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
- Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
- Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

South Korea’s 5 Stages of Financial Reform
- 1950s-1960s: fundamentals build-up
- 1970s-1980s: adoption of legal and institutional measures
- 1980s-1990s: financial autonomy in a booming period
- 1990s-2000s: financial liberalization and the AFC
- 2000s and beyond: advancement of the financial system after subsequent reforms

Measures after the AFC Experience
- Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
- Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
- Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

- South Korea’s 5 Stages of Financial Reform
  - 1950s-1960s: fundamentals build-up
  - 1970s-1980s: adoption of legal and institutional measures
  - 1980s-1990s: financial autonomy in a booming period
  - 1990s-2000s: financial liberalization and the AFC
  - 2000s and beyond: advancement of the financial system after subsequent reforms

- Measures after the AFC Experience
  - Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
  - Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
  - Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

- South Korea’s 5 Stages of Financial Reform
  - 1950s-1960s: fundamentals build-up
  - 1970s-1980s: adoption of legal and institutional measures
  - 1980s-1990s: financial autonomy in a booming period
  - 1990s-2000s: financial liberalization and the AFC
  - 2000s and beyond: advancement of the financial system after subsequent reforms

- Measures after the AFC Experience
  - Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
  - Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
  - Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

South Korea’s 5 Stages of Financial Reform
- 1950s-1960s: fundamentals build-up
- 1970s-1980s: adoption of legal and institutional measures
- 1980s-1990s: financial autonomy in a booming period
- 1990s-2000s: financial liberalization and the AFC
- 2000s and beyond: advancement of the financial system after subsequent reforms

Measures after the AFC Experience
- Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
- Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
- Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
South Korea’s Post-Asian Financial Crisis and Post-Global Financial Crisis

- South Korea’s 5 Stages of Financial Reform
  - 1950s-1960s: fundamentals build-up
  - 1970s-1980s: adoption of legal and institutional measures
  - 1980s-1990s: financial autonomy in a booming period
  - 1990s-2000s: financial liberalization and the AFC
  - 2000s and beyond: advancement of the financial system after subsequent reforms

- Measures after the AFC Experience
  - Capital and Financial Market Liberalization: privatization and restructuring, foreign banks’ presence
  - Excess Reserves and the Advancement of the Financial System: ensuring liquidity and stability of the market
  - Macro-prudential Measures (Post-GFC): macro prudential levy, ceilings on foreign sales of derivatives, etc
Foreign exchange reserves in Asia

Sources: CEIC and Deutsche Bank CIB Research. “A-9” is Hong Kong, India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand.
South Korea's Capital Flows, 1995-2010
Source: Figure created based on Ministry of Strategy and Finance statistics, the Republic of Korea
III. Comparative Cases of EMEs: South Korea and China

Outline

1. I. Introduction
   - Escalation to the AFC and the GFC

2. II. The GFC Escalation to a Global Currency War
   - U.S. Policy Actions
   - EMEs Response to Capital Flows

3. III. Comparative Cases of EMEs: South Korea and China
   - South Korea
   - China
China’s Post-Global Financial Crisis

China’s 5 Stages of Financial Reform

- 1978-1984: establishment of institutional means
- 1985-1996: opportunities of changes in the financial system
- 1997-2005: adjustments and solidification of the financial system
- 2006-2008 (GFC): further developments in the financial system according to 2001 WTO accession
- 2008-Present: drive for financial liberalization

Condensed Form of Financial Market Development

- Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
- Financial Reforms after the AFC call for more Financial Reforms: NPLs
- Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
China’s Post-Global Financial Crisis

- China’s 5 Stages of Financial Reform
  - 1978-1984: establishment of institutional means
  - 1985-1996: opportunities of changes in the financial system
  - 1997-2005: adjustments and solidification of the financial system
  - 2006-2008(GFC): further developments in the financial system according to 2001 WTO accession
  - 2008-Present: drive for financial liberalization

- Condensed Form of Financial Market Development
  - Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
  - Financial Reforms after the AFC call for more Financial Reforms: NPLs
  - Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
III. Comparative Cases of EMEs: South Korea and China

China’s Post-Global Financial Crisis

- China’s 5 Stages of Financial Reform
  - 1978-1984: establishment of institutional means
  - 1985-1996: opportunities of changes in the financial system
  - 1997-2005: adjustments and solidification of the financial system
  - 2006-2008 (GFC): further developments in the financial system according to 2001 WTO accession
  - 2008-Present: drive for financial liberalization

- Condensed Form of Financial Market Development
  - Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
  - Financial Reforms after the AFC call for more Financial Reforms: NPLs
  - Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
China’s Post-Global Financial Crisis

- China’s 5 Stages of Financial Reform
  - 1978-1984: establishment of institutional means
  - 1985-1996: opportunities of changes in the financial system
  - 1997-2005: adjustments and solidification of the financial system
  - 2006-2008 (GFC): further developments in the financial system according to 2001 WTO accession
  - 2008-Present: drive for financial liberalization

- Condensed Form of Financial Market Development
  - Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
  - Financial Reforms after the AFC call for more Financial Reforms: NPLs
  - Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
China’s Post-Global Financial Crisis

- China’s 5 Stages of Financial Reform
  - 1978-1984: establishment of institutional means
  - 1985-1996: opportunities of changes in the financial system
  - 1997-2005: adjustments and solidification of the financial system
  - 2006-2008 (GFC): further developments in the financial system according to 2001 WTO accession
  - 2008-Present: drive for financial liberalization

- Condensed Form of Financial Market Development
  - Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
  - Financial Reforms after the AFC call for more Financial Reforms: NPLs
  - Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
China’s 5 Stages of Financial Reform
- 1978-1984: establishment of institutional means
- 1985-1996: opportunities of changes in the financial system
- 1997-2005: adjustments and solidification of the financial system
- 2006-2008 (GFC): further developments in the financial system according to 2001 WTO accession
- 2008-Present: drive for financial liberalization

Condensed Form of Financial Market Development
- Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
- Financial Reforms after the AFC call for more Financial Reforms: NPLs
- Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
China’s Post-Global Financial Crisis

- China’s 5 Stages of Financial Reform
  - 1978-1984: establishment of institutional means
  - 1985-1996: opportunities of changes in the financial system
  - 1997-2005: adjustments and solidification of the financial system
  - 2006-2008 (GFC): further developments in the financial system according to 2001 WTO accession
  - 2008-Present: drive for financial liberalization

- Condensed Form of Financial Market Development
  - Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
  - Financial Reforms after the AFC call for more Financial Reforms: NPLs
  - Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
Non-performing loans

Source: Bloomberg (2012)

http://www.alsosprachanalyst.com
China’s Post-Global Financial Crisis

- China’s 5 Stages of Financial Reform
  - 1978-1984: establishment of institutional means
  - 1985-1996: opportunities of changes in the financial system
  - 1997-2005: adjustments and solidification of the financial system
  - 2006-2008 (GFC): further developments in the financial system according to 2001 WTO accession
  - 2008-Present: drive for financial liberalization

- Condensed Form of Financial Market Development
  - Startup of a Financial Market in Acceleration: 4 Major Banks and the PBOC, Commercial Banks and Stock Exchanges
  - Financial Reforms after the AFC call for more Financial Reforms: NPLs
  - Financial Liberalization amidst Contest with Advanced Economies: expansion of channels, issue of international transactions remains, RMB internationalization, SDR, SWFs
Countries’ quotas in IMF

Who pays:
Each country’s IMF quota determines how much it contributes, how many votes it has and how much it can borrow

EU member states 32%
US 17%
Japan 6.1%
China 3.7%
Saudi Arabia 3.2%
Canada 2.9%
Russia 2.7%
India 1.9%
Switzerland 1.6%
Australia 1.5%
Mexico 1.5%
Brazil 1.4%
Korea 1.4%
Others 23.2%

Source: IMF (2012)
Summary and Policy Recommendations

- A Shift in a Leaderless Economy: Advanced economies and EMEs must work towards plausible agenda together in the G20 platform.
- Capital Controls and Regulation of Competitive Devaluation: Speculative behavior and currency wars must be avoided.
- Regulations and Surveillance: Strengthened Roles and Reforms of Key Economic International Institutions are needed.

Outlook for Further Research
- Evaluation of Effectiveness of Capital Controls (ongoing)
- The Current Hurdles of China’s Financial Reform