Managing Financial Integration and Volatility

Korea must take national and regional measures to manage and insure itself against cross-border financial volatility

Since the Asian financial crisis, Asian governments have promoted cross-border financial transactions through financial market deregulation and capital account liberalization. Asia has taken great measures for financial integration; its foreign portfolio asset holdings have been increasingly invested abroad, both regionally and globally. Cross-country government bond yields, overnight interbank rates and stock prices have also been closely interrelated.

But greater financial integration is likely to increase the chances that external shocks will have financial effects. The global financial crisis in 2008 and 2009 showed that tighter financial integration translates into increased spillovers from external shocks that impact the returns and volatilities of local equities and currency values in Asia.

One major uncertainty Asian economies will face is generated from the U.S. Federal Reserve’s (the Fed’s) monetary policy change. The Fed’s tapering makes Asian financial sectors remain significantly vulnerable to volatile cross-border capital flows.

The bust of Lehman Brothers in 2008 caused financial turmoil across the globe. To stabilize the financial market and boost the economy, the Fed used expansionary policies, lowering its target rate to zero percent in December of that year. As the Fed could no longer lower its interest rate and wanted to further expand money supply, it implemented quantitative easing by purchasing large amounts of financial assets from financial institutions and long-term treasuries. Massive funds created through quantitative easing not just in the United States, but also Europe and Japan had poured into emerging economies.

Last year, the Fed announced its tapering-off of the program and stopped buying financial assets, destabilizing global financial markets. The announcement by Fed Chairman Ben Bernanke on the possible tapering in May of 2013 triggered fears of capital outflows, causing a substantial drop in emerging-market currencies and asset prices. In Indonesia, for example, stock prices and exchange rates fell by about 15 percent over a few months.

The time for the Fed’s target rate rise is coming. Funds have already begun leaving emerging Asian economies, threatening financial and foreign exchange markets and assets.

How to manage cross-border financial volatility is an important challenge for an open economy like Korea. Although the International Monetary Fund’s analysis in the Asia and Pacific Regional Economic Outlook report last April predicted Korea would be the least hurt from the U.S. rate hike among Asian countries, this is no comfort.

In Korea, huge household and corporate debt poses serious risks to the economy. Rising international interest rates and dollar value will inevitably increase borrowing costs in companies and financial institutions with heavy dollar borrowings. Tightening domestic monetary policy will raise the debt-service burden of low-income households.

Korea must continue to amend financial vulnerabilities, strengthen financial supervision and regulation and develop more effective macroeconomic frameworks, including better macroprudential regulation and capital control measures. It must keep its eye on household and corporate debt to maintain the stability of the financial system and mitigate the impacts of financial shock to the real economy.

From the Asian financial crisis and recent global crisis, Korea has learned the importance of well-constructed responses at not just the national level, but also regional and global levels in order to effectively manage cross-border capital flows. Korea, along with the ten ASEAN countries, China and Japan, have actively pursued a USD 240 billion regional currency swap arrangement called the Chiang Mai Initiative Multilateralization (CMIM) to provide short-term liquidity to members in an emergency. The swaps will help Korea and other Asian economies cope with possible currency turmoil caused by the Fed’s monetary policy change. However, with the relatively small fund size, they may not be effective in convincing markets that the situation is under control and ensuring adequate emergency support for crisis countries, especially in the case of large-scale systemic shocks. Korea must continue to cooperate with its neighbors to improve Asia’s financial safety nets.

With appropriate national and regional collective measures, Korea can better insure itself against possible financial turmoil caused by the reversal of the Fed’s monetary policy and any future financial crises.

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