This time is different

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Triggered by the likely tapering large-scale asset purchase by the U.S Federal Reserve towards the year end, the emerging-market economies have drowned into the fear of massive capital flows reversal. For the past two months, markets have been clouded with news of slashing local equity prices, rising bond yield, and free fall in the currency.

Ending an ultra-expansionary monetary policy and normalizing interest rate for an economy that says goodbye to recession are in fact as orthodox a monetary action as what we usually teach in Econ 101. Unfortunately, the United States is not any economy but simply the core country in the world economy. Like it or not, ebbs and flows of financial capital are largely driven by the monetary policy stance of the core country. If emerging-market economies have ever benefited from capital inflows pushed by the zero-interest policy in the United States, which I doubt it, they should get ready with the coming months of capital retrenchment.

Which brings me to the case of Malaysia. Net capital outflows have increased our 10-year government bond yield by more than 100 basis points and pulled down ringgit by approximately 9% as compared to that in mid-May. This sparks the déjà vu of Asian financial crisis of 1997/98.

The main culprit that drags us to the hell of contraction in 1997/98 was foreign-currency debt. In 1997, total external debt as a share of gross domestic product was 66.7%. The debt burden exploded when ringgit was nose-diving, ruining the resilience of the economy in the face of massive capital outflows and free fall in ringgit. At the same time, inapt policy responses, i.e., monetary tightening coupled with contractionary fiscal policy, though theoretically rational and last only temporarily, have internalised the external fragility, further weakening the aggregate demand. As a result, Malaysia experienced the most severe economic downturn since independence. So, are we going to repeat the history?

No, we aren’t, because this time is different.

External debt as a share of gross domestic product has fallen to 26.8%; Bank Negara Malaysia doesn’t over-react by unnecessarily tightening monetary policy; and more importantly, foreign-currency debt is only 0.66 time of the external reserves Bank Negara Malaysia has hoarded till June. Compared to the external debt-to-reserve ratio of 2.89 in 1997, we are now comfortably positioned in the face of receding waves of capital. Current capital retreat and the resulting depreciation shall pose no immediate threat to the economy. So, are we going to be immune from prolonged capital reversal?

No, we aren’t, because this time is different.

There are three critically weak spots which I believe, if not overcome, will put Malaysian economy at stake. First, our banks have held too much government securities in the balance sheet. Of total assets owned by the banking system in July, 14% are in government securities. This is exactly the average level of exposure of GIIPS (Greece, Spain, Ireland, Italy and Portugal) banks to the European sovereign debt. Sovereign default hurts banks, and banks fragility hurts sovereigns, to borrow Christine Lagarde’s words. Vicious cycle like this is the key factor that brings GIIPS down and pushes Euro area nearly to the brink of destruction.

For sure Malaysia is no way close to Greek-like sovereign default. But the hidden problem is banks' possession of government debt can be self-feeding and destructing. Holding government debt is like holding excess capital. Excess capital reduces yield spread, making private credits cheap, thereby inducing greater private demand for borrowing. In consequence, greater holding of government debt will result in growing household and/or corporate borrowings. Lending creates deposits, and deposits allow greater bond holdings in the banking system.

When markets are confident on government's solvency, bond yield is low, banks' balance sheet looks healthy, and growing leverage supports the economy. We are in self-fulfilling optimistic equilibrium. But sovereign debt market is prone to expectation shift. What if the market suddenly becomes pessimistic about our sovereign debt position?

Which brings me to the second weak spot. The federal debt is now 2.4 times higher than total tax revenue, as compared to 1.38 times back in 1997. This indicates that government debt sustainability, measured by the present value of future primary surplus (difference between tax and spending), has been deteriorating as government spends faster than what he earns. If the current capital retrenchment continues and turns abrupt, the resultant rising bond yield can encumber debt servicing that further worsens then outlook of government's solvency, which in turn, instigates new rounds of firesales of bond that further increase yield. The economy can then be trapped in the self-fulfilling pessimistic equilibrium.

Worse still, the trouble continues. Falling bond prices hurt banks' balance sheet, leading to contraction in lending. A de-leveraging economy in recession widens government's primary deficit, weakening the outlook of government's solvency. By then, sovereigns hurt banks, banks hurt the economy, and the economy hurts sovereigns. And voila! There we have it. The perfect storm!

The third weak spot is the large foreign holdings of government bonds. In 1997, it was only 2.6%. In this July, it climbs to 46.9%. Capital outflows that depreciate the ringgit erode the foreign value of holding domestic bonds. An expectation of continuously weak ringgit unavoidably results in net capital outflows that drain the liquidity in bond market, unless the capital losses are compensated with higher interest rate. To what extent large foreign holding of domestic debt resembles large foreign debt in terms of its damage? Only the time will tell.

One can still stay calm with the recent episodes of capital outflows as we are now more like in 1994 than in 1997. But it reminds me of Mark Twain: history doesn't repeat itself, but it does rhyme.

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