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US Contagion is the Worry of the World, 10Yrs Ago It Was Asian Contagion

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Ten years ago, everyone was worried about Asian contagion and now ten years later, that concern has turned to US contagion. Last week, some traders have thought that the sharp liquidations in the currency and equity market meant the end of the world, but the rebound in the past few trading sessions have brought back hope that the worst of the credit crunch of 2007 may be over. But is it? A look back at the Asian Financial crisis of 1997 to 1998 could provide us with a good history lesson that may help to determine how the Federal Reserve may respond to the current financial crisis as well as how currencies could behave in the coming weeks.

The Lessons Learned from the Asian Financial Crisis

The events that led up to the financial crisis in Asian economies are far too similar to what has been happening in the world's largest economy, the US. During the 90s, capital was flowing into the region as investors and speculators saw vast opportunity in countries like Thailand, Indonesia, South Korea and the Philippines. For the record, private capital flow amounted close to $100 billion in 1996, equivalent to almost one third of worldwide money, as portfolio equity investment quadrupled within a year. The resulting investment was so enormous that it was comparable to percentages in total gross domestic product.

Capital Flows As A Proportion Of GDP

Economy	1993	1994	1995	1996
Indonesia	3.1	3.9	6.2	6.3
Korea	1.6	3.1	3.9	4.9
Philippines	2.6	5	4.6	9.8
Thailand	8.4	8.6	12.7	9.3

Source: IMF, "World Economic Outlook: Interim Assessment"

At the time, the boost in foreign capital subsequently supported expansion in the Asian Tiger economies as the countries were able to attract massive amounts of direct investment, spurred by higher interest rates in order to curb corresponding inflationary pressures. Once again investors turned to credit markets and instruments in boosting up speculation for assets in the region. This helped to support elevated levels in respective stock markets and housing sectors as investors sought rates of return at a cost of a forming bubble. Incidentally, demand was so great speculation led the Philippine stock index to advance by 60 percent in 1995-96 while boosting the Jakarta benchmark higher by 58.5 percent during the same period.

Completely overleveraged and over invested, the region was ripe for disaster as the unthinkable occurred on July 2nd 1997. On that day, the Thai government, a central body who relentlessly promised not to revalue its currency, allowed the Thai baht to float. Now with speculation constituting a majority of the market, sellers were moving faster as buying demand dried up leaving some in the market holding massive losses. The tragedy didn't stop there as the effects were far reaching. Beginning in Southeast Asia, the contagion effect spread throughout the global markets as regional and benchmark indexes went down like dominoes. Although the effect was reduced to a more mild "Asian flu" by the time it landed in America, the damage could also seen in the Dow Industrials, which was severely hit by a 554 point plunge on October 27th. The loss equated to 7.2 percent as the New York Stock Exchange briefly halted trading amidst the panic. In the currency markets, no currency pair can capture the visual display as perfectly as shown in the downturn in USDJPY. Shortly after the contagion effect and impending exodus of risky loving speculators, the pair was rocked lower on grounds of a carry trade exit. In a matter of a week and a half, the USDJPY fell almost 1500 pips to a hard landing at 114.00.

Source: FX Trek Intellicharts

The Shakeup in the US Financial Markets

Fast forward 10 years later and we see a similarly harsh drop in the currency and equity markets. The Japanese yen currency pairs, used to fuel the ubiquitous carry trade theme, declined to historic levels. The Pound Sterling versus the Japanese yen for example fell 1000 pips over five trading days. This time, investors were overleveraged on credit assets as the US housing sector seems to be built more on sand than concrete. With credit derivatives, including mortgage back assets, being revalued lower, the market may be in for another downturn as riskier assets once again go out of style. In the currency markets, the implications can be linked with the yen currency pairs. As risk appetites grew, the yen currency was a benchmark for risk taking in the market. The higher the investor was willing to take risk, the more leveraged the investment would be in higher yielding pairs like AUDJPY and NZDJPY. Now, with credit market concerns, these pairs may be due for further drawdowns as risk is being taken off the table, along with other investments in equities. Ultimately, one thing is for certain, with markets skittish, volatility is back in the picture and will help in shaking things up in the market.

The Tables Have Turned

As American central bankers and policy makers dismiss any major exposure to the financial crisis in 1997, it seems that their Asian counterparts are claiming the same this time around. However, as we have seen in the past, the notion of no risk or exposure to such a global phenomenon is pretty much a fool's claim. Global markets have become more integrated since 1997, as a result making them thoroughly interrelated and doubly exposed to volatile occurrences. This will make markets in major industrialized countries like the US, Japan and Europe openly at risk should further downside be achieved. However, the market that may see the least damage could be China. A country that has been ridiculed for its iron fist approach in controlling its domestic system, it is this system that is minimizing the potential damage a duplicate crisis can inflict. Why? First off, the Chinese government insulates its investors by restricting the amount of exposure to global markets. Although they have recently relaxed that restriction, previous investment were made in incremental amounts, thus not offering the type of speculative capabilities found in other markets. In comparison, and a subsequent reason, the government also limited the amount of investment flows into the economy. Although we've all heard of the Shanghai index skyrocketing to all time highs, the gains have been made through domestic investment and speculation, not foreign speculation. This has limited the amount of withdrawals should risk be tightened in the near term.

Potential for Fed Rate Cut

Given the lessons of the past, it seems that markets are headed for another round in volatility and market turmoil, even if central banks know how to soften the blow. This time around, at least, leaders are being a little bit more precautionary by attempting to pump liquidity in the market. The Federal Reserve did not cut interest rates after the Asian financial crisis. Instead, they waited until the LTCM collapse and the Russian debt default to cut rates. When they did it was three back to back 25bp of easing. This time around, the market is also expecting three interest rate cuts by the end of the year. Whether they will be "back to back" is dependent upon how long its takes to restore calm to the credit markets.

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