EMERGING MARKETS

How the Asian Financial Crisis Reshaped Emerging Markets

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Twenty years ago, the world was standing on the brink of the Asian Financial Crisis. Here, Templeton Global Macro CIO Michael Hasenstab looks at how the response of local policymakers in the subsequent two decades has impacted emerging markets in general. And, he explains why he believes some of the most unloved local currency markets today represent some of the most exciting opportunities available.

The Asian Financial Crisis (AFC) that began 20 years ago this month had lingering effects well into 1998, casting a long shadow over many of the region's economies for several years. Since that time, the lessons of that crisis have played a critical role in broadly reshaping emerging markets, particularly in Asia but also around the world.

I was living in Asia during the height of the crisis and I saw the devastating effects it had on local economies. Countries like Indonesia, South Korea, Thailand, Malaysia and the Philippines were hit hard by massive depreciations of their currencies, rapidly magnifying their external vulnerabilities.

Now two decades on, several countries have worked hard to build up their resilience to external shocks. Many of today's policymakers that lived through the AFC and learned from it have been working to minimize the chances of repeating it.

Some of these countries have spent years increasing their external reserve cushions, bringing their current accounts into surplus or close to balance, improving their fiscal accounts and reducing their US-dollar liabilities by turning to domestic sources of funding. These adjustments have had profound effects on their economies; today there is a subset of emerging markets (EMs) that have stronger growth and healthier balances than many developed economies.

We see several undervalued investment opportunities across the local-currency markets, particularly among countries that directly learned from the lessons of the AFC and worked for decades to fortify their economies against future shocks.

An Era of Economic Resilience in Indonesia

Indonesia is a strong example of a country that has actively reduced its external dependencies since the AFC. After living through the crisis' devastating effects, Indonesia moved to an ambitious structural reform program that sought to strengthen its economy, balance its growth drivers and accelerate domestic development. These ongoing structural reforms have fortified its underlying economy and positioned it better to deflect external shocks.

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But it's not just mere speculation as to whether those structural reforms have worked—they have been actively tested by real exogenous shocks over the last decade. In 2008, the global financial crisis roiled economies around the world. However, Indonesia had far fewer external liabilities and a more balanced, domestically diversified economy than it did in 1997. Consequently, there was no repeat of the AFC in Indonesia this time around, despite the risk-off currency depreciations across emerging markets.

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More recently, Indonesia proved it could handle a sharp decline in commodity prices, such as the collapse in oil prices in the fourth quarter of 2014 and its continued deepening through early 2016. Concurrent with that substantial decline in oil prices, markets began to fear a contraction in China's economy in mid-2015 as its rate of growth moderated. The collapse in oil prices coupled with fears over China largely drove investors out of emerging markets, leading to broad currency depreciations across the asset class.

However, Indonesia's economy remained resilient throughout these events, averaging year-on-year gross domestic product (GDP) growth around 5%.[1] Twenty years ago it would have been difficult for countries like Indonesia to weather a commodity price shock, an exchange-rate shock and a trade shock all at the same time. But today, many countries have greatly reduced these external vulnerabilities. We see highly compelling value in Indonesia's local-currency market, and the country's longer-term prospects continue to look promising, in our view.

Several EMs Have Expanded Their Domestic Markets

One of the most important steps that many emerging markets have taken over the past decade is the expansion of their domestic financial markets.

In the past, the lack of a strong domestic investor base often magnified the consequences of financial volatility. In contrast, domestic institutional investors today are far more prevalent in many domestic markets, and often act as a stabilizing force when asset prices collapse by stepping in to buy assets when foreign investors may be fleeing them.

Overall, the transition to domestic funding has improved financial resilience within many countries. Additional measures taken have included:

- Keeping exchange rates flexible, which has enabled quick adjustments to exogenous shocks;
- Maintaining substantial stocks of foreign exchange reserves;
- Following prudent fiscal policies over an extended period, which reduces immediate vulnerabilities while leaving room for fiscal stabilizers to help cushion shocks;
- Supporting a balanced macro policy mix, with independent, credible central banks in better position to keep inflation anchored while supporting growth in coordination with fiscal policy;
- Strengthening balance sheets, notably at the government and financial sector level—though in some countries, corporations have instead increased debt levels; and
- Developing robust and stable banking sectors that operate in better-regulated environments.

Overall, several emerging markets in Asia and around the world have greatly reduced their dependence on external financing and strengthened their overall financial stability; we see promising futures for a number of these countries. While the AFC had painful consequences 20 years ago, the lessons of that crisis have guided many countries toward far better solutions today.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline.

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1. Source: IMF World Economic Outlook database, April 2017.

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