Financial Contagion and Vulnerability of Asian Financial Markets

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A Discussion

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“Big picture” and motivation

- Financial integration – benefits and costs
  - Diversification vs. contagion
  - Asian countries affected by a crisis not of their making
    - Without direct exposure to toxic assets
    - “Common lender” or “common investor” effects
    - a result of leverage constraints
  - Financial ties stronger than trade ties
- A model to explain the transmission mechanism
Just look at India to agree...

Transmission
Just look at India to agree...

Real effects

IMPACT OF THE CRISIS THROUGH FIVE INTER-CONNECTED AND MUTUALLY REINFORCING LOOPS

1. Deteriorating real sector performance in FY’09-11
   - 20-35% deferment of capex
   - 400-500 bps drop in ROIC
   - Risk of large scale SME failure

2. Tight external sector
   - Tight global capital and credit markets
   - Cumulative USD 45-85 bn outflow in current and capital account FY’09-11

3. Fall in domestic savings and foreign capital, slower growth
   - Corporate savings/GDP falls by more than 250 bps
   - Negative capital inflows
   - Gap in investment required for 7% GDP growth

4. Large gap in infrastructure creation
   - USD 50-60 billion shortfall in PPP/PSU infra projects

5. Financial sector
   - NPLs rise from 2.4-5%
   - 10-15 banks vulnerable
   - USD 14-22 billion Govt. recapitalisation bill

Source: McKinsey analysis
Crisis change the rules of the game
Existing literature

The spread of a crisis depends on the degree of financial market integration. If a country is closely integrated into global financial markets, or if the financial markets in a region are tightly integrated, asset prices and other economic variables will move in tandem. The higher the degree of integration, the more extensive could be the contagious effects of a common shock or a real shock to another country. Conversely, countries that are not financially integrated, because of capital controls or lack of access to international financing, are by definition immune to contagion. In this sense, financial markets facilitate the transmission of real or common shocks but do not cause them. The actions of investors that are ex ante individually rational as well as collectively rational, even though they lead to volatility and may require policy changes, should be grouped under fundamental causes.

Contagion: Understanding How It Spreads

Rudiger Dornbusch • Yung Chul Park • Stijn Claessens

Existing Literature

However, capital account liberalization is not an appropriate policy objective for all countries and in all circumstances. For poor countries with weak policies and institutions, capital account liberalization should not be a major priority. However, even this group includes some poor but resource-rich countries that are having to deal with capital inflows and their mixed benefits. These countries need a strategy, rather than just coping in an ad hoc way with the whims of international investors. Indeed, a key lesson from country experiences is that capital account liberalization works best when other policies are disciplined and not working at cross-purposes (Arteta, Eichengreen, and Wyplosz, 2003).

A Pragmatic Approach to Capital Account Liberalization
Eswar S. Prasad and Raghuram G. Rajan

Journal of Economic Perspectives—Volume 22, Number 3—Summer 2008—Pages 149–172
Concluding remarks

- Good paper on an important topic
- Suggestion: Authors may work a bit more on differentiating from the existing literature
Thank you