Strong Currency, Hot Stock Market No 1997 Replay

James Castle

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Asian financial markets are once again flushed with hot money with regional stockmarkets recording new highs almost daily. But while some believe the current situation is reminiscent of 1997, another regional crisis is not around the corner.

Just one month before the 10th anniversary of the onset of the Asian crisis, Indonesian markets are reaching new highs, attracting a renewed influx of hot money and prompting some to worry that history might be on the verge of repeating itself. The Jakarta Stock Index (JSX) passed the 2000 level for the first time in its history on 1 May. And although the rupiah is far from the 2250 US$ rate it enjoyed until July 1997, it reached a 12-month high of 8765 just one week later.

While there is little doubt that global markets are somewhat overheated and a correction may well be due, no regional collapse is in the offing. Even legendary former US Federal Reserve Chairman Alan Greenspan was recently quoted as saying in Singapore "The chance of 1997 happening again is virtually non-existent."

Rather the rupiah's recent strength is simply part of a global currency realignment that the IMF has been calling for the past two years. While a bit late in coming, the realignment is finally underway and it is now moving at a faster rate than predicted.

The long-expected weakening of the US$ is boosting most Asian currencies sharply as the Euro and the Pound Sterling also reach new highs. Indonesia is not immune and, after 12 months of relative calm, the Rupiah is now also experiencing mild appreciation, despite steady interest rate cuts. Indonesian bonds still offer attractive yields with an appreciating currency and high interest rates in relation to its neighbors, so offshore investors continue to buy Rupiah.

Stronger Domestic Demand

The rise of Asian currencies does not mean the end of Asian export growth. It does, however, point to firmer domestic demand in the region and less dependence on big net export surpluses to drive growth. With a sharp fall in US consumer demand looming in Q2 and Q3 the lift in Asia's domestic demand will help maintain regional (and global) growth. Indonesia, as usual, is more a commodities and domestic growth story, so it will be even less vulnerable to the US slowdown than the rest of the region as domestic consumption grows.

Although the Rupiah has strengthened over 3% in the past five weeks despite a drop of 1% as this article is being written, it actually depreciated almost 2% against the US$ in the first quarter this year from 8950 where it closed 2006 to 9120 at end March. While the rupiah probably will not strengthen much further, we could be entering another period of currency volatility because the global realignment is far from over. Significant appreciation of both the Yen and Yuan, the region's two most important currencies, is highly likely at some point in the next 18 months. While it is not clear if the Rupiah would strengthen in unison or weaken as Yen and Yuan speculation drew money away from the Rupiah, volatility is virtually assured in such a scenario.

While capital inflows should continue to be a net positive here through year end, the influx of hot money should slow. If inflation continues to stay in the 6% range, we have at least one and quite possibly two more rate cuts in store before December, with year end SBI rates at 8.25 % to 8.5%. This will also help curb the rupiah's appreciation.

While there is some worry about the impact of a strong rupiah, it should be a net positive for the economy as it will reduce the inflationary impact of imports and encourage consumption and promote growth.

The greatest rupiah crisis risk would be a sudden decline in regional sentiment causing capital flight. Some analysts think the China stock market is heavily over-bought, for example, and a sharp sell-off is likely sometime this year. This would only be a short term phenomenon. Regional markets tumbled suddenly earlier this year when the Shanghai Composite Index plunged 8.8% on 27 February. The hot money panicked and regional markets slumped. Indonesia was not immune. JSX fell to its yearly low of 1698.8 shortly thereafter and the Rupiah wobbled slightly as the US$ strengthened from 9085 to 9200 over the same five-day period.

But the impact was short-lived. Here and elsewhere, currency and equity markets recovered rapidly. And in Indonesia neither was roiled on 19 April, when Shanghai dropped again, off as much as 7% before ending the day down 4.5%. The JSX, however, passed the 2000 mark for the first time a few days later on 1 May and is now at 2047 up 20% from its 2007 low.

Flush with Foreign Exchange

In the bigger picture, both Indonesia and the region are flush with foreign exchange. Indonesia's reserves are now almost $50 billion, the equivalent of over nine months of imports. And, led by China with over $1,000 billion, the region now holds the bulk of the world's foreign reserves with $2.7 trillion in its central banks.

It is always wise to be cautious. Clearly there is a huge amount of liquidity coursing through the immature financial and regulatory systems of some of the world's most rapidly developing economies. This constitutes a serious risk. Nevertheless, the region's financial institutions, including Indonesia's, are much stronger today than they were in 1997 and foreign borrowing is down. Indonesia's foreign debt is less than 40% of GDP and its budget deficit is barely one percent of GDP. As a result, any crises are likely to mild and short-lived compared to 1997.

And despite the slow pace of reform and the lack of adequate investment in the nation's physical infrastructure, investment reached 24% of GDP last year and will exceed 25% this year. While this is below an optimal level of 30 to 35%, these are the highest levels since the crisis and well up from 19% as recently as 2003. Moreover, capital equipment imports in 2006, a real time indicator of investment growth, actually matched the 1997 level when investment was at an all time high. While we have not regained the 7% plus GDP growth levels we enjoyed pre-crisis and are now being enjoyed by Asian leaders China, India and Vietnam, growth will exceed 6% this year and will be close to 7% in 2008. If this occurs, poverty levels will start to drop later this year and job creation will increase.

The Indonesian economy is still not running on all cylinders. But it is not sputtering. The old problems of anti-consumer protectionism and bureaucratic hostility to open markets still bedevil us and the new challenges of regional autonomy and decentralized governance confront us. But the Asian Crisis has passed. It is time to look to the future and invest with cautious optimism.