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Smart Money Seizes Fischer '98 Notes Amid Emerging Contagion

By Simon Kennedy - Feb 7, 2014

In October 2001, Stanley Fischer traveled to the London School of Economics to speak on the lessons of his seven years battling turmoil in emerging markets as the International Monetary Fund's No. 2 official.

Lecturing in the Old Theatre at the university where he studied in the 1960s, Fischer posed a question: What would he have done differently to thwart the Asian financial crisis of 1997-1998? Among his answers: Pushing harder for exchange-rate flexibility.

Fast-forward a dozen years and Fischer, 70, is back at the center of policy circles as the likely next vice chairman at the Federal Reserve, and developing nations are again in tumult. What's different is countries that heeded Fischer's advice and allowed markets to set currency rates are providing a shock absorber and giving some confidence that there won't be a repeat of the contagion of the late 1990s.

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Fischer "deserves a substantial amount of credit for pointing emerging markets in the right direction," said Kristin Forbes, an expert in financial contagion on the faculty of Massachusetts Institute of Technology's Sloan School of Management in Cambridge.

"The steps he recommended, such as large depreciations, interest-rate hikes, strengthening the financial system, are painful but they remain key components of the response arsenal as we've seen over the past few weeks," said Forbes, whom Fischer persuaded to study at MIT.

Most Reliable

Fischer's resume, which also includes eight years as governor of the Bank of Israel, will come in handy in his new position. With Fed Chairman Janet Yellen short of experience fighting financial tension overseas, Makoto Utsumi, Japan's top currency official from 1989 to 1991, says Fischer will be "the most reliable person to have when a contingency situation occurs."

Fischer, whose nomination is awaiting a vote in the U.S. Senate, declined a request for an interview.

Emerging-market stocks and exchange rates have had the worst start to a year since 2010. Even so, said Dominic Wilson, chief markets economist at Goldman Sachs Group Inc. in New York, "currency weakness itself is unlikely to be as sharply disruptive as it was in the late 1990s."

That's when Asian nations including South Korea and Thailand spent reserves trying to defend exchange-rate pegs, only to eventually devalue and seek IMF bailouts. As one currency after another became delinked from the U.S. dollar, investors attacked in waves that would culminate in Russia's debt default and the collapse of Long Term Capital Management.

Eased Controls

Indonesia provides an example of how policy makers in emerging markets have eased control of currencies since then. One-year implied volatility of the rupiah -- a gauge of expected swings in the exchange rate over the next year -- is almost 10 percent, compared with about 2 percent in 1996, when the exchange rate was managed, Wilson said in a Jan. 29 report.

Similarly, implied volatility in Brazil's real, which has fallen 2 percent against the dollar this year as investors eye the country's current account gap, is about 13 times greater than in 1998.

The increases show that in times of stress, currencies can fall, providing a cushion for their economies by supporting exports and narrowing current account deficits, said Eswar Prasad, a former IMF economist who now teaches economics at Cornell University in Ithaca, New York.

Fischer's Remedies

Following Fischer's prescriptions, emerging markets have made other changes to ensure they are less vulnerable than they were in the late 1990s, Prasad said. Their external debt as a share of exports has fallen to 70 percent from about 160 percent in 1998; interest payments on foreign debt have declined to less than 3 percent of exports from 8 percent; and reserves as a percentage of total debt have doubled to more than 100 percent, according to Goldman Sachs.

"Fischer played a positive role in nudging economies to take these reforms," said Prasad.

They still aren't completely crisis-proof. South Africa, Turkey, India and Brazil all jacked up interest rates in the past month as their currencies plunged. Higher rates aim to protect against an exodus of capital, spurred by signs of a slowdown in China and by a scaling-back of the Fed stimulus that had encouraged investors to seek higher risk and returns.

"Raising interest rates is the traditional way of defending a currency," Fischer said in 2001. "If capital is flowing out of a country, it does not make sense to make the currency less attractive to hold by reducing the rate of return on it."

Error-Prone

On the positive side, economists from Goldman Sachs to HSBC Holdings Plc and Wells Fargo Securities LLC say the pain may be limited to error-prone economies: those with large current account deficits, like Brazil, or those suffering political unrest, such as Turkey. They also question how much of a threat the sell-off poses to industrial economies at a time when the U.S. is gaining momentum.

"The issues in developing economies today are more idiosyncratic to each individual economy rather than systemic," said Jay Bryson, global economist at Wells Fargo in Charlotte, North Carolina. "Once Thailand devalued the baht in July 1997, investors realized that there were many other developing economies with the same type of macroeconomic imbalances and the crisis soon spread."

Differences Seen

Rather than tarring all emerging markets with the same brush, Pablo Goldberg, head of emerging markets research at HSBC, recommends differentiation. Based on indicators such as budgets, short-term debts and current accounts, his emerging-market vulnerability index shows Venezuela, Ukraine and Turkey are the most at risk, while the Philippines, Singapore and China are perceived to be relatively resilient.

There is "a series of painful but unrelated flare-ups in key EM markets, rather than a contagion," said Goldberg.

Contagion was on Fischer's mind in London in October 2001, when he delivered a series of talks dedicated to the memory of the late economist Lionel Robbins. Assessing his time at the IMF, which included bailouts topping a quarter of a trillion dollars, Fischer said the woes of the late 1990s had at one point proven so severe that they "seemed to threaten the stability of United States financial markets" and had helped dent if not derail global growth.

High Rates

In addition to supporting flexible currencies, Fischer defended the higher interest rates controversially recommended by the IMF in the 1990s as a means to control the depreciation of currencies. Turkey last week more than doubled the one-week repurchase rate to 10 percent, while South Africa unexpectedly raised its benchmark to 5.5 percent from 5 percent.

"It is difficult to fight the markets," Fischer said. "No amount of railing at this issue will change the fact that the markets are there and that their verdict has to be dealt with."

His words carry added weight because as a professor at MIT, Fischer taught the likes of former Fed Chairman Ben S. Bernanke and former Treasury Secretary Lawrence Summers.

As chief of Israel's central bank from 2005 until last year, Fischer was able to put some of his thoughts into practice. He bought up foreign currency in unprecedented amounts to drive down the value of the shekel and boost exports with the interventions helping to more than double reserves. He was also the first central banker to cut interest rates in 2008 as the global financial crisis was brewing and the first to raise them a year later when recovery began.

On Defensive

One thing that won't change from the 1990s to today is that criticism from the emerging markets means Fischer may find himself defending the Fed just as he once had to justify the IMF's actions in Asia.

In the late 1990s, the attacks were from Asian leaders including Malaysia's Mahathir Mohamad and economists such as Nobel laureate Joseph Stiglitz who argued the IMF had demanded too much austerity and too many conditions for its aid. It also rejected crisis-fighting tools such as capital controls it has since accepted.

"It ended up a success, but the costs were also huge," said Lee Ju Yeol, former senior deputy governor at the Bank of Korea. "Many people still have vivid memories of the acute pains -- closing businesses and losing jobs."

The complaint now is that the Fed's slowing of stimulus is hurting emerging markets by prompting investors to withdraw capital, drawing calls from policy makers such as Reserve Bank of India Governor Raghuram Rajan for more global policy cooperation.

A hope among emerging markets is that while Fischer will be mandated to help drive the U.S. economy, he may do so with some empathy for other economies, said Amando Tetangco, governor of the Philippine central bank and head of its treasury during the Asian crisis.

"The breadth of his experience should provide the Fed a unique perspective on the spillover impact of Fed policies," said Tetangco. "Dr. Fischer can be expected to bring greater balance in Fed views."

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