



# Sudden stop and trade balance reversal after Asian crisis: Investment drought impact versus exchange rate depreciation

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## Abstract

After the Asian crisis in 1997, the respective trade balances of Indonesia, Korea, Malaysia, and Thailand reversed suddenly from deficit to surplus. By particularly addressing the sudden cessation of investment caused by the financial crisis, it is demonstrated that the IS balance adjustment dominates real exchange rate depreciation, indicating that to reform the large external imbalance of Asian countries, which is a major component of global imbalance, policymakers should target domestic absorption. Furthermore, it can be demonstrated that the large trade balance surplus of Asian countries will decrease along with recovery. Finally, policy implications related to the recent Euro crisis are provided.

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## 1. Introduction

After the Asian crisis in 1997, the respective trade balances of Indonesia, Korea, Malaysia, and Thailand reversed suddenly from deficit to surplus.<sup>1</sup>

Generally, a nation's trade balance is determined both by the Investment-Saving (IS) balance and exchange rate adjustment, although a controversy exists related to which factor plays a more

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<sup>1</sup> In general, this is designated as *current account reversal* in the literature. We are interested in IS balance adjustment. Therefore, we specifically address the trade balance. See Milesi-Ferretti and Razin (1998) for further details.

important role. According to Obstfeld and Rogoff (2005), the necessary exchange rate depreciation to correct a trade balance deficit might be large. However, according to Engel and Rogers (2006), the necessary exchange rate depreciation might be smaller. Comparing both factors, Fratzscher, Juvernal, and Sarno (2010) empirically quantify the more dominant role of IS balance adjustment. Furthermore, a notable feature of the study is the consideration of wealth and financial accelerator effects from the boom–bust cycle of asset prices.

However, in the case of the trade balance reversal of the four Asian countries listed above, because of the great declines in the real exchange rate, the impact of exchange rate adjustment might be greater than in the case described by Fratzscher et al. (2010). Joyce and Nabar (2009) report that investment dropped suddenly and stagnated because of the financial crisis: a phenomenon called *investment drought*. As reported by the IMF (2005), this balance adjustment is an important cause of the trade balance reversal of the four Asian countries. This study assesses the trade balance reversal of the four Asian countries with comparison of IS balance adjustment versus expenditure-switching effects of exchange rate adjustment.

Some preceding studies of the reversal of external balance after Asian crisis are explained hereinafter. Based on theoretical investigation, Cook and Devereux (2006) specifically examined the risk premium and negative financial accelerator effect and explained the trade balance reversal. Moreover, by particularly addressing the sudden drop of productivity, Otsu (2008, 2010) explains the behavior of macroeconomic variables, including the trade balance, theoretically. Noteworthy empirical studies include those of Joyce and Nabar (2009), which specifically examines *investment drought*, and of Kinkyo (2007), explaining the decline of investment of Korea empirically by deterioration of the terms of trade. However, these empirical studies did not consider the response of external balances.

Different from theoretical studies, empirical studies related to the reversal of external balance after the Asian crisis are scarce. This study was conducted to fill this gap. Moreover, few studies have quantified the sizes of IS balance adjustment versus exchange rate adjustment in the reversal of external balance after the Asian crisis. Therefore, because this topic is very much an empirical question, as described by Fratzscher et al. (2010), the methodology of sign restriction VAR of Uhlig (2005) is applied.

The remainder of the paper is organized as follows. Section 2 presents a description of the features of the Asian crisis by particularly addressing the financial crisis and *investment drought*. Section 3 presents a description of the econometric method of sign restriction VAR. Section 4 explains the empirical results. Lessons from the Asian crisis can provide a good education for many countries, especially for Eurozone countries. Therefore, policy implications are explained in Section 5. Finally, concluding remarks are presented in Section 6.

## 2. Investment drought after the Asian crisis

After the eruption of the Asian crisis in 1997, according to Fig. 1, investment dropped suddenly and stagnated in all four Asian countries. However, as the same figure shows, consumption and government expenditure remain stable throughout the period. Furthermore, investment is confirmed to have a negative co-movement with trade balance. Therefore, the sudden drop of investment, designated as *investment drought*, is regarded as a main cause of IS balance adjustment.

As described in this paper, two reasons for *investment drought* can be inferred. The first is deterioration of the balance sheet and bankruptcy of the private sector by the financial crisis. As presented in Table 1, the ratio of nonperforming loans rose markedly after the Asian crisis. As

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