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In Silicon Valley Bank Collapse, Asia Sees 1997 All Over Again

Silicon Valley Bank panic now sweeping global markets suggests more destabilizing financial events are likely around the corner

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To understand the Silicon Valley Bank (SVB) collapse spooking markets, look no further than events in Jakarta.

The Indonesian rupiah's 3.2% drop since February 1 demonstrates how quickly Asia has resigned itself to the fact that the US Federal Reserve isn't done tightening. Another batch of too-strong-for-Fed-comfort US employment figures in February only increased the risk.

Episodes of extreme dollar strength tend to hit Southeast Asia particularly hard. And while Indonesia's financial system is far healthier than it was amid the Asian financial crisis 25 years ago, vulnerabilities abound. Not surprisingly, the region's dollar-centric economies tend to see another potential 1997-like crisis around every corner.

Case in point: the Fed's most aggressive tightening cycle since the mid-1990s, an episode that still haunts leaders from Jakarta to Tokyo. As the Fed doubled short-term rates in just 12 months between 1994 and 1995, the collateral damage really started to rack up.

Victims included Mexico, which plunged into the peso's "tequila crisis." Orange County, California veered into bankruptcy. Wall Street securities giant Kidder, Peabody & Co went extinct. Then the most spectacular pileup of all: Asia.

As the dollar skyrocketed, currency pegs became impossible to defend in Bangkok, Jakarta and Seoul. Fallout from the barrage of devaluations paved the way for the late 1997 collapse of the 100-year-old Yamaichi Securities, one of Japan's fabled big-four brokerages.

Yamaichi's demise panicked officials in Washington. Both the US Treasury Department and

the International Monetary Fund worried not that Japan was too big to fail. They worried it was too big to save.

China, too. In 1997 and 1998, US officials all but begged Beijing not to devalue the yuan. That, they feared, would spark a new wave of competitive currency devaluations and drag Malaysia and the Philippines, two nations that hadn't devalued, into the fray.

All this explains why the SVB collapse is triggering Asia's post-traumatic stress disorder over Fed austerity from the late 1990s. That PTSD was on display back in 2013 amid the Fed "taper tantrum." Back then, Morgan Stanley included India and Indonesia in its "Fragile Five" list of economies on the brink along with Brazil, South Africa and Turkey.

At the time, Bank of America strategist Michael Hartnett warned of a "repeat of the 1994 moment." Then-Goldman Sachs CEO Lloyd Blankfein admitted that "I worry now as I look out of the corner of my eye to the 1994 period."

This is the minefield that Fed **Chairman Jerome Powell** is struggling to navigate.

"Hence the canary-in-the-coal-mine fear, which has caused US bank stocks to plunge more than 15% in a week and market volatility to surge," says analyst Tan Kai Xian at Gavekal Research.

"These travails were only reinforced by Powell's Congressional testimony last week, amounting to a 'whatever it takes' declaration to crush inflation, even if that means upping the pace of rate hikes and putting people out of work."

Over the weekend, US **Treasury Secretary Janet Yellen**, the Powell-led Fed and the Federal Deposit Insurance Corporation unveiled steps to contain the fallout from Silicon Valley Bank's collapse.

With all SVB depositors being paid back in full, averting a potential collapse of the US financial system, it now falls to Powell's team to devise a way forward. And preferably one that won't send markets from Indonesia to Japan reeling.

The "action dramatically reduces the risk of further contagion," says analyst Thomas Simons at Jefferies. It's heartening, too, that SVB's mistakes in managing its balance sheet are seen as "highly idiosyncratic" to analysts at Morgan Stanley, reducing risks of broader US financial contagion.

Erik Nielsen, economic adviser at UniCredit Bank, calls SVB "a rather special case of poor balance-sheet management, holding massive amounts of long-duration bonds funded by short-term liabilities."

Economist Paul Ashworth at Capital Economics notes that "rationally, this should be enough to stop any contagion from spreading and taking down more banks, which can happen in the blink of an eye in the digital age. But contagion has always been more about irrational fear, so we would stress that there is no guarantee this will work."

Indeed, the underlying problem is that the Fed is trying to tame inflation with tools that won't get the job done. Much of this inflation is better addressed with supply-side reforms that **President Joe Biden** and Congress have been slow to implement. Anyone who thought driving the US into a controlled recession might work just had a brutal wake-up

call from California.

“While the Fed wants tighter financial conditions to restrain aggregate demand, they don’t want that to occur in a non-linear fashion that can quickly spiral out of control,” says economist Michael Feroli at JPMorgan Chase & Co. “If they indeed have used the right tool to address financial contagion risks – time will tell – then they can also use the right tool to continue to address inflation risks: higher interest rates.”

The mini-panic on global markets suggests many aren’t buying the SVB-is-an-isolated-case argument. That has economists at Barclays Plc thinking the Fed rate that had been widely expected later this month is now on hold.

“It raises risks of broader distress within the banking system that could make the FOMC (Federal Open Market Committee) reluctant to return to 50bp hikes in March,” they wrote. “Indeed, the possibility of capital losses at other institutions cannot be completely dismissed, with rising policy rates raising banks’ funding costs.”

Goldman Sachs economist Jan Hatzius agrees. “In light of the stress in the banking system, we no longer expect the FOMC to deliver a rate hike at its next meeting on March 22,” he says. More likely, the Fed will do smaller 25 basis point hikes in May, June and July, boosting rates as high as 5.5%.

Yet the fallout from SVB could further stymie America’s innovative animal spirits in ways that leave the world’s biggest economy even less productive and nimble.

“It certainly is going to have very substantial consequences for Silicon Valley — and for the economy of the whole venture sector, which has been dynamic — unless the government is able to assure that this situation is worked through,” former Treasury Secretary Lawrence Summers told Bloomberg.

It’s already having substantial consequences for Asian markets trying to read the Washington policy tea leaves. The 1990s vibe emanating from Fed headquarters in Washington is becoming harder and harder for dollar bulls to dismiss.

The more upward pressure there is on the US currency, the less capital that flows to Indonesia and other Southeast Asian economies that need investment to finance giant infrastructure projects.

Continued tight Fed policies pose their own risks to **Xi Jinping’s** China, just as the Communist Party leader is beginning his third term. Rising US rates put China’s vital export engine at risk and add to the strains facing highly indebted mainland property developers struggling to avoid default.

Fed overtightening is also a direct threat to the roughly $1 trillion of Chinese state wealth parked in US government debt.

The yen’s dwindling value, thanks to a strong dollar, is a crisis in slow motion for **Prime Minister Fumio Kishida** and outgoing Bank of Japan **Governor Haruhiko Kuroda**. Asia’s No 2 economy is importing increasing waves of inflation via food and energy markets.

For governments in Bangkok, Jakarta, Manila and Putrajaya, currencies under downward pressure make US debt harder to service. That also raises the costs of food and other vital

items.

Recently, says economist Jonathan Fortun at the Institute of International Finance, “we see clouds forming on the horizon. A renewed hawkish Federal Reserve sentiment is spilling over into some emerging markets, causing short-dated receivers to struggle as interest-rate expectations are pushed further back in time. Monetary policy uncertainty may boost demand for dollar protection, as the relationship between EM currency and US interest-rate volatility continues to strengthen.”

For now, few think the SVB debacle will trigger a 2008-like global financial meltdown. But the speed with which Asian officials have swung from guarded optimism over the US financial system to worrying about another 1997 is its own economic indicator for the year ahead. And not a good one.

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