Chapter 1. Introduction and definition of the problem

The Asian currency crises of 1997 caught many managers and businesses by surprise. By September 22 of that year, about two and a half months since that fateful July day when the Thai Baht was allowed to float, precipitating the start of the Asian currency crisis, the Malaysian Ringgit had fallen to a 26 year low against the US dollar (Ranjit Gill, 1998). The impact of the sudden drop in the value of the Ringgit had many repercussions: Malaysia suffered a recession – the economy contracted by –7.5% in 1998 (Bank Negara, Economic Report 1999/2000), output for 7 out of 10 companies was down (World Bank Survey, 1999) and domestic demand for goods was significantly reduced (World Bank Survey, 1999). A reduced domestic demand for goods does not make for business growth. How can managers operate in such an environment? What marketing strategies can managers employ in a crises period? These are some of the pertinent questions managers have to ask to prevent a disastrous for the company or business. If an early warning system can be devised to predict the probability of a currency crisis occurring, managers may be encouraged to factor that probability into their annual budget and sales plans. This may reduce the impact of a crisis in the event that a crisis actually does occur.

For a European speciality chemicals manufacturer with the regional office in Kuala Lumpur and supplying chemicals to the textile industry in South East Asia, the Asian financial crisis provided real world experience when a combination of ignorance, lack of information and lack of understanding led to many bad business calls. In 1996 the company managers noticed a decline in sales to the textile industry particularly in Thailand, which was previously a star performer. Many textile operations in Thailand were reducing output or simply closing down. Non of the managers in the organisation knew of the real reason for this decline though they were aware of new textile operations opening up in other emerging markets such as Bangladesh and Mauritius. In the face of worsening economic climate, the company continued to push for sales in the textile industry. A great deal of resources was thrown in to get sales back to the 1995 levels but to no avail. In fact a lot of money was lost in bad collections when textile companies simply ceased to exist.

In the meantime other sectors particularly the food sector were enjoying brisk sales despite the gloomy economic picture in the region. In light of all the current information and on hindsight we can draw the following picture. It appears that one of the reasons for the financial crisis in Asia was the loss of competitiveness (due to real appreciation of the currency, loss of productivity etc). The textile industry is an export industry where for example, goods are produced in Thailand under the directions of international brands and fashion houses and then exported to the US and Western Europe where the markets are. Loss of competitiveness on the part of the Thai operations means that it is more expensive to produce in Thailand than say, in Mauritius. This caused a shift of the industry from Thailand to Mauritius. Though many managers were able to witness the shift they were unable to understand the shift and therefore were unable to construct appropriate responses. Managers were unable to understand the loss of competitiveness because organisations have been focussing on marketing and other ground level issues. The larger economic picture was ignored.

The food sector in South East Asia is largely geared towards meeting domestic consumption (chicken reared in each country in South East Asia is for the consumption of the residents of that country). In the ensuing crisis period, imports and luxury goods consumption were greatly reduced but domestic food production was intact and in fact increased to meet the shortfall caused by import reduction. The company would have benefited had the managers the tools to evaluate the causes and impact of the crisis. Once again on hindsight, resources could have been diverted from export-oriented industries such as textile towards domestic oriented industries such as food processing which benefited from the crisis.

The currency crisis of 1997 has brought up an important consideration for managers. In future marketing strategies will have to be crafted to include the results of analyses of probabilities of a currency crises occurring. If early warning systems indicate high probabilities of a currency crisis, then marketing strategies will perhaps focus on a reduced sales effort but expanded collection effort or on training, IT, key account management, moving to a smaller office etc.

The development of currency crises predictors is well advanced already. Much work has already been done to identify and test out various determinants of currency crises and several models to track and predict crises have been proposed (for example see Kaminsky, Lizondo and Reinhart, 1997). These models have not yet been fully developed and are undergoing incremental improvements all the time. One of the biggest challenges facing research workers in this field is that the models developed so far can predict the probability of a crisis happening but cannot predict the timing of the crisis (Berg & Pattillo, 1998). In fact the very idea of predicting a currency crises has been questioned. Is it possible to systematically predict the actions of investors whose actions are diffuse and unpredictable (Berg & Pattillo, 1997)?

This research project attempts to construct a simple empirical model of an early warning system to predict the possibility of future currency crises for Malaysia. This research project attempts to analyse the behaviour of selected macroeconomic indicators prior to the currency crisis in 1997. The objective is to apply theory and empirical observation to the analysis and come up with a working model to track the probability of a crisis happening. The research project attempts to answer the question 'could macroeconomic indicators have been used to predict the currency crisis in 1997?' And further 'how can the analyses of macroeconomic indicators be used in the construction of the final model of a currency crisis predictor?'

Data generated by the Ministry of Finance, the Department of Statistics and Bank Negara were used in analysing the behaviour of the selected economic indicators and in establishing trends to determine current account deficit sustainability.

The research project will also attempt to propose a model for predicting currency crises based on economic indicators that tracks not only the performance of the national economy but also investor perception and indicators that can track the vulnerability of the national economy to triggering events. Previous models on currency crises predictors have viewed each of these components separately. The novel feature of this project is to sew all three components together with a view of creating a superior model.