This chapter will examine the onset and spread of the contagion effect that first started in Thailand. We shall also briefly look at other East Asian countries affected by the crisis and see how these economies came to an abrupt halt as a result of the financial crisis.

The Thai debacle

First to come under speculative attack was the Thai baht, which came under intense selling pressure in mid-May. As it fell to a 11-year low against the US dollar to 27 baht, Prime Minister Chavalit Yongchaiyudh vowed ' to fight to the death' to defend the nation's currency (see Gill. R.1998)

However, after the intervention by the monetary authorities from Singapore, Malaysia, Hong Kong and Japan costing some USD 10 billion the Thai baht strengthened to 25. (see Gill R. 1998)

Though Thailand did enjoy a short reprieve, the speculators mounted another offensive in the subsequent weeks resulting in the eventual collapse of the Thai baht and the implosion of Thailand's economy. By then, a whoping USD26 billion had already been spent defending the baht but to no avail. Following the collapse of the Thai bath, its Finance Minister, Amunas Viraman resigned from his finance portfolio. (see Gill. R.1998)

The onslaught on the Thai baht also caused jitters in other East Asian countries including Malaysia, the Philippines, Indonesia and South Korea.

The domino effect was felt by the East Asian economies with the force of a financial storm. It can therefore be summarized that Thailand was the origin of the Asian crisis. It was from Bangkok that the panic first spread to the rest of the region (see Delhaise, P.F. 1998:81)

South Korea became an early victim of the financial panic created by Thailand's woes. The currency and the stock market collapsed drastically. (Delhaise,P.F. 1998:101) The Asian panic hit Indonesia more than any other country. Its currency was the most severely affected. The banking system ground to a halt and most banks passed under government tutelage. Among the countries in distress, Indonesia was the worse case.(Delhaise,P.F. 1999: 123)

Thailand, South Korea and Indonesia with their large external debts struggled hopelessly to contain the crisis but after realizing that their efforts to fight off the speculative attack on their currencies would be futile, they resorted to the IMF for financial assistance to restore their already battered economies.

Attacks on the Ringgit

It was most unfortunate that despite Malaysia's stronger fundamentals, it had to suffer the same fate as the other regional economies and became an undeserving victim of the East Asian economic crisis. In fact, just prior to the crisis, the ringgit actually appreciated to RM2.47 to the US dollars in the first quarter of 1997 from RM2.53 at the beginning of the year. (BNM.1999). It was said that herd behaviour, led market participants to view Malaysia as having the same common problems as those faced by her neighbouring countries. In fact, based on Malaysia's macroeconomic performance at that time, Malaysia should not have been affected and drawn into the crisis. (see Montes M. F. 1999)

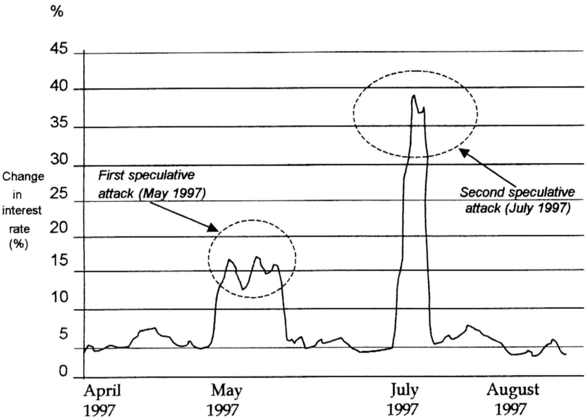
The intense speculative attack on the ringgit by the currency traders had resulted in the currency to depreciate further. The relatively stable trend in interest rates was disrupted in May and again in July due to the speculative attacks on the ringgit. Interest rates rose to support intervention operations (see BNM.1999).

The overnight rate shot up to 18.75% in mid-May. The pressure on the ringgit subsided and liquidity improved once again with interest rates drifting downward (see BNM.1999)

However a second round of speculative activity on the ringgit occurred in July 1997 soon after the depreciation of the Thai baht.

In order to defend the ringgit, BNM initially intervened in the foreign exchange markets and interbank rates rose even more sharply. On 10 July, the overnight rate rose to 40% from 7.5% the day before. (see figure 1)

Figure 1: Movements in the Overnight Interest Rate



Source: BNM 2000 : 571

Given the large volume of funds at the disposal of hedge funds and investment houses, BNM soon realised that it would be pointless to raise interest rates to support intervention. BNM also took cognisance that uncertainty in the currency market would last a long time.

Depreciation of Ringgit

The Kuala Lumpur foreign exchange and stock markets were the first to be hit by the crisis. Between the end of June 1997 and the end of December 1998, the ringgit depreciated by 33.6% against the United States dollar, while the Indonesian rupiah depreciated by 70%, Thai baht by 29.4%, Korean won by 25.5% and Philippine peso by 32.8%. The ringgit depreciated to a historic low of RM4.88 on 7 January 1998, but strengthened thereafter. From February through June 1998, the value of the ringgit was relatively stable between USD1.00=RM3.84-RM3.98.(see BNM 2000).

From June to August 1998, the downward pressure on the ringgit intensified following the depreciation of the Japanese yen, the contraction in the domestic economy and increased speculative activity (BNM. 2000)

The immediate impact of the ringgit depreciation was on the stock market. The foreign fund managers began to off-load their positions causing the Kuala Lumpur Stock Exchange Composite Index to decline by about 44.8% in the second half of 1999. As the contagion spread in the region, investor confidence was further eroded. The reversal of short-term capital flows caused the ringgit to depreciate further by as much as 20% on 7 January 1998. (BNM. 2000)

Manipulation in the Ringgit Market

Malaysia was the first to highlight the destructive role currency traders could assume in the foreign exchange market. For Malaysia and other affected countries the impact had been devastating.

The adverse effects of currency speculation far outweighs the benefits that can be derived from such activities. In small and open economies like Malaysia, these can be better understood by examining how the speculative activities were carried out. (BNM.2000)

Currency trading activities in the ringgit market originate both from the **domestic** as well as the **offshore markets**. In the **domestic market**, currency transactions can arise from either trade activities or position –taking activities. Currency trading activities that arise from trade and its related transactions are rather stable flows supported by real economic activities. Position-taking activities in the domestic market, with its highly speculative elements, however, is confined to sporadic pockets of activities, but this is contained through guidelines governing the operating framework of banking institutions.

The net open position limit on foreign currencies set by BNM for the Malaysian banks effectively restricts any possible leveraging on their part in transacting currency trading activities. The size of the net open position limit of each individual authorised dealer takes into account the size of the authorised dealer's capital and its dealing capacity. (see BNM. 2000)

The dealing capacity is determined by the fund manager's volume of foreign exchange business and the capability of the staff to manage the dealing activities. (see BNM.2000)

In the **offshore ringgit market**, currency traders can broadly be categorised into non-banking institutions such as hedge funds and portfolio funds, and banking institutions.(see BNM. 2000)

Other than the provision of foreign exchange services for trade as well as non-trade related transaction for their customers, the banking institutions also undertake proprietary trading in foreign currencies. These non-trade related transactions, which are undertaken by both group with a view of profiting from the exchange rate volatility, are speculative in nature and constitute highly unstable flows. Under normal market conditions, the size of each transaction typically ranges from USD 3 million to USD 5 million (see BNM.2000).

During the period of currency attacks, the size of each transaction was in the region of USD50million and USD200million. There were even cases of transaction orders to buy U.S. dollars against ringgit ranging from USD200million to USD500million, originating from offshore centres, particularly New York, London and Singapore. (BNM. 2000)

Under conditions where offshore trading involved the dumping of ringgit of such enormous amounts, the downward pressures on the ringgit exchange rate would naturally increase. When the ringgit slid further to USD1= RM3.93 on 7 December 1997, it became obvious that the slide was due to the huge transactions which were highly speculative in nature.

Subsequently, another round of massive attack took place on 7 January 1998, which weakened the ringgit exchange rate to its all time low of USD1 = RM4.88. (BNM. 2000)

Effects of currency crisis on Malaysia

Despite strong fundamentals, the East Asian crisis affected the Malaysian economy in numerous ways. In addition to instability of the financial markets, the crisis affected the real sector and weakened the financial sector. Towards the end of 1997, real GDP growth began to moderate. While in 1997, real GDP still increased by 7.5% (10% in 1996), in 1998 real GDP declined by 7.5%, the first negative growth registered since 1985. (BNM, 1999)

The trough was reached in the third quarter of 1998.The crisis affected all the broad sectors of the Malaysian economy including the financial, real and external sector. (BNM. 2000)

The effects of the currency crisis on the various economic indicators will be discussed in chapter five together with the effects of selective capital controls and fixed exchange rate policy on Malaysian economic performance.

Although the government had been proactive in managing the negative impact of the crisis on the economy and in containing the ringgit's depreciation, its efforts were constrained by the vulnerability of the ringgit to sustained speculative activity, especially in the offshore markets.(BNM. 2000)

When the ringgit was being attacked aggressively, there was absolutely nothing conventional that the government could do to stop the onslaught and like other affected East Asian countries, Malaysia was at the mercy of the hedge fund managers and currency speculators.

However, Thailand, South Korea and Indonesia later resorted to the IMF, the lender of last resort, in order to revive and restore their economy . Malaysia, which initially appeared to follow the stance reversed gear as the government felt that adopting the IMF prescription was not in the best interests of the nation, as it would impede the social and economic agenda of the country.

It was on September 1, 1998, that the Malaysian Prime Minister, Dr. Mahathir Mohammad took everybody in the domestic and international financial community by surprise when he announced the imposition of selective capital controls and a fixed exchange rate policy. The exchange rate was fixed at RM3.80 to the US dollar. This represented a 34% depreciation from the level prevailing prior to the crisis. (BNM.2000)

In short, the rationale is to insulate Malaysia from currency speculation and manipulation as well as to protect the country against the adversity of the free market. This unconventional policy is also meant to promote and revitalise the country's growth during the currency crisis. (A more indepth discussion on the rationale for capital control will be dealth with in chapter four).

The announcement received a mixed reaction, while the Malaysian business community hailed the move as a renewed hope for their business prospects, the advocates of the free market vilified the move as counter productive and warned of the imminent danger that it would bring to the Malaysian economy.

By then, the financial storm already had had a disastrous effect on the other East Asian countries such as Thailand, South Korea and Indonesia. Today, about one and a half years after the imposition of capital controls and a fixed exchange rate regime, the Malaysian economy is said to be on the road to full recovery. (BNM, 2000)

In the following chapters, we will examine the impact of capital controls on some of the macroeconomic indicators and see how these indicators have performed ever since the imposition of capital controls.