Chapter 4
The Contagion Effect

During the first half of 1997, speculators began to speculate the Thai baht on the foreign exchange. They suspected that Thailand possibly had to devalue its currency to reflate the economy. Initially, speculation against the baht focused on fundamentals of the country, not destabilising nature. The growing suspicion increased the pressure by adding deflationary stimulus and creating cash flow problems to the country in question.

Related work (Radelet and Sachs, 1998) reveals that Thailand, in fact, suffered from an illiquidity, not insolvency problem. Although the country had the capacity to service its foreign debts in the long-term, it was unable to borrow fresh funds to service debt obligations in the short run. Together with speculation attacks on the baht, panicked creditors and their sudden refusal to rollover short-term foreign loans motivated the currency crisis in Thailand.

On July 2, 1997, the Thai government floated its baht which immediately depreciated by 17%. Domestic residents followed by foreign investors began moving money offshore in search of higher returns. The baht devaluation led to speculation against other regional currencies. Shortly, the currency crisis spread to Indonesia, Malaysia and the Philippines. This resulted in sharp devaluation of these countries’ currencies, fall in equity prices as well as rising interest rates which further damaged their economies (Standard Chartered, 1997).

The currency pressures also led to the depreciation of Singapore dollar (albeit lesser, -10%) which illustrates the strong linkage of the Singapore economy with the rest of the region.

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1 Aschinger (1998) explains destabilising speculation possibly develops as a result of incomplete information and irrational behavior by market participant. This kind of speculation increases price volatility and its determinants to market's efficiency.
The speculation then moved to Taiwan where its government decided to raise its interest rates to defend the New Taiwan dollar (NTD) in October 1997. Finally, its currency was depreciated as the high interest rate strategy was not practical. Actually, the NTD devaluation was to enhance the country’s export competitiveness, but such advantage was eroded by the larger devaluation of Korean Won and other Asian currencies.

After the NTD devaluation, the Hong Kong dollar came under speculative pressure. The rising interest rates in Hong Kong on October 23, 1997 to defend its currency led to a sharp decline in the stock market and further triggered the stock market falls around the world, (Standard Chartered, 1997).

In November 1997, the speculation shifted to South Korea. The country encountered a foreign currency liquidity crisis because foreign creditors recalled their loans from the financial institutions (O’shea Laura, 1998). The Korean Won depreciation also urged concerns about the exchange rate of the Japanese Yen vis-a-vis the New Taiwan dollar as exports from Japan and Taiwan competed directly and significantly with those from South Korea.

Exports to Southeast Asian economies declined as demand for consumer goods declined in line with the regional slowdown. The crisis in Asian financial markets was further under pressure due to the weakening Japanese currency against the US dollar. The lower yen could affect regional export industries and discourage foreign direct investment from Japan to many Asian countries.

Attention then shifted to focus on the fate of China’s yuan, because the weak yen had a severe impact on Beijing’s foreign trade and the Chinese government would have no other choice, but to devalue the yaun (Roberts and Barnathan, 1998). If it does so, this would inevitably trigger a new round of competitive devaluation throughout the region.
The wave of competitive devaluation and the troubled financial picture shook investors' confidence and was followed by capital flight. The crisis did not remain only in the region, instead it continuously spread outside the region, to locations such as Russia, Latin America, Brazil. At this point, it remains unclear how far the contagion will spread. Even though the U.S. dollar, at the time of writing this research, has adversely weakened against the Japanese yen and led to an appreciation of other Asian currencies, the weak US dollar may not benefit Asian recovery.

The contagion effect possibly reveals real linkages between the affected countries through trade links and competitive devaluation, common domestic and external shocks, and financial links (Corsetti et al., 1998). Thailand might have acted as a "wake-up call" for creditors to reassess the creditworthiness of Asian borrowers (Goldstein, 1998a). When they did, they found that other economies within the region had similar fundamental weaknesses and suspected that these countries would eventually devalue their currencies.

Speculative attacks on their currencies possibly hastened the process of competitive devaluation. When countries experienced a devaluation of their currencies, other countries who had not devalued, like China, faced a deterioration in competitiveness and increased vulnerability. A rising number of countries affected by the crisis and other multilateral channels of trade and capital flow interdependence generated spillovers to other locations.

It is possible that many international lenders considered the Asian countries as a single entity and therefore expected other countries in the region to experience soon similar difficulties as Thailand (Radelet and Sachs, 1998). Therefore, the actual contagion could be driven by the irrational behaviour\(^1\) of international

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\(^1\) Speculation was subsequently developed by irrational behaviour because of increased credit risk, risk of inflation and fear that restrictive monetary policies may not be able to stabilise the currencies quickly enough to make up for the loss of confidence in them.
lenders. However, it required weak fundamentals in the affected countries in the first place for international financial investors to react irrationally.

The Asian governments eventually undertook a more comprehensive solution to improve their domestic economic fundamentals, enhance the soundness of the banking system and address the structural weaknesses in their economies. International organisations, such as International Monetary Funds (IMF), World Bank, also responded to the crisis in Asia by offering very large amounts of financial assistance. For example, IMF granted financial aid in an amount of $17.2 billion for Thailand, $43 billion for Indonesia and $57 billion for South Korea. Part of the conditionalities demanded by IMF was a cleanup of the borrowers' financial systems. Although Malaysia did not require credit facilities from IMF, it had adopted similar contractionary policies.

However, it is widely criticised that the financial aid from IMF has exacerbated the moral hazard problems, and conditionalities demanded by IMF have done more harm to its borrowers' economies than it is claimed as a rescue package. The unemployment rate and interest rates have increased, the value of their currencies has sharply decreased, and prosperity has turned into social dislocation and riots. Worst of all, the crisis has spread out of the region and would possibly cause an unravelling of the global financial system (Mandel, 1998).