Chapter 2

Causes of Currency Crisis: Fundamentals, Globalisation or Speculators

2.1 Introduction

Prior to mid-1997, the World Bank described eighth Asian economies namely, Japan, Korea, Taiwan, Hong Kong, Malaysia, Thailand, Singapore and Indonesia (known as high performing Asian economies-HPAEs) as miracle economies, due to high achievement in economic development since 1965 (The World Bank, 1993). These countries have achieved high economic growth largely due to superior accumulation of physical and human capital (Jomo, 1997).

Generally, the East and Southeast Asia economies adopted an outward looking policies for economic development. Since the adoption of the policy, the countries have enjoyed high economy growth. Taiwan has achieved an average of 5.6 per cent growth during 1960-1990 (Bhanoji Rao, 1998) and 5.7 per cent in 1996 (Table 2.1). Meanwhile, Hong Kong, Korea, Singapore and Thailand also experienced high economic growth, with an average of 6.6 per cent, 7.0 per cent, 6.9 per cent and 4.6 per cent respectively during 1960-1990 (Bhanoji Rao, 1998). This performance increased in 1990s as indicated in Table 2.1. Indonesia and Malaysia also enjoyed good economic performance during 1960-1990 (Bhanoji Rao,1998), and in 1990s (Table 2.1).

Table 2.1:Eight Asian Economies: GDP Growth Rate, 1992-1996

(percentages)

	1992	1993	1994	1995	1996
Hong Kong	6.3	6.1	5.4	4.7	4.9
Indonesia	7.2	7.3	7.5	8.2	8.0
Korea	5.1	5.8	8.6	8.9	7.1
Malaysia	7.8	8.1	9.2	9.5	8.6
Philippines	0.3	2.1	4.4	4.8	5.5
Singapore	6.2	10.4	10.2	8.9	7.0
Taiwan	6.8	6.3	6.5	6.0	5.7
Thailand	8.1	8.3	8.7	8.6	6.7

Source: International Monetary Fund, International Financial Statistics, various issue.

The above policy also has created significant international competitiveness in a wide range of manufactured products in East Asia economies. Furthermore, the policy has resulted in high saving rates, quality human resources, capable entrepreneurs and did not create fiscal imbalances or high inflation. These economic performances certainly did not signal any indication for those economies to expect any major economic problem or crisis.

However, since the outset of the currency crisis, the structural weaknesses of those economies was revealed, that is in terms of export growth and current account deficits since 1996 (Table 2.2). The decline of export growth in 1996 is very much noticeable in Korea, Malaysia, Singapore and Taiwan while in Thailand, there has been a decline in the dollar value of exports. The current account position of Indonesia and Korea deteriorated in 1996. Meanwhile, Singapore and Taiwan maintained current account surpluses despite the adverse trend in export growth.

Table 2.2: Current Account Deficits and Export Growth Rates in Seven East Asian Economies in the 1990s

	Current account (% of GDP)			Annual Growth (%) (Exports in dollar terms		
Countries	1990-1993	1993-1995	1996	1993-1995	1996	1997
Indonesia	-2.9	-2.2	-3.5	10.2	9.7	8.9
Korea	-1.6	-0.8	-5.0	18.1	4.2	0.3
Malaysia	-4.8	-6.5	-4.9	21.9	6.2	3.2
Philippine	-3.7	-4.2	-4.7	21.7	16.7	24.0
Singapore	10.1	13.6	14.1	23.2	5.7	0.4
Taiwan	5.9	2.7	3.0	11.3	3.8	3.7
Thailand	-7.2	-6.3	-8.0	20.1	-1.2	2.3

Source: V.Bhanoji Rao, 'East Asian Economies:The Crisis of 1997-1998', Economic and Political Weekly, June 6,1998.pp: 1400.

Many observers have praised the HPAEs as models that should be followed by other countries. However, since the East and Southeast Asian crisis erupted, many have blamed domestic policies of these countries as the causes of the current crisis. As Martin Khor (1998) commented, the ill judgement of the banks and financial institutions, the over-speculation in the real estate and the share market, the collusion between governments and businesses, the bad policy of having fixed exchange rates and high current account deficits lead to outburst of the financial crisis.

Generally, there are various factors contributed to the outburst of East Asian financial crisis. Domestic and international factors interacted and led to worst crisis in the history of financial crisis. However, most commentators have agreed that one of the main factors that contributed to the crisis is short of liquidity resulting from the rapid outflow of foreign short-term capital. In the early 1990s, there was large amount of short-term capital flowed into Asian emerging markets (Radalet and Sachs, 1998). This inflows was attracted by promising high returns, liberalized markets and stable values of the host currencies under the dollar peg. However, when weaknesses in the financial system detected in terms of increase in accumulation of external debts, the capital rapidly flowed out from the market. The governments tried to stop the outflows by using their foreign reserves, however, this was not adequate to hold the exchange rate at the appropriate level. Hence, the currencies of the East Asian economies all depreciate one after another with Thai baht experienced the first hit.

Although there is no clear cut reason for the current crisis, however, it is noted that all factors played an interacted role in triggering the currency turmoil in mid-1997. In the following section the three major likely causes, that is, weak fundamentals, globalization and speculation are evaluated by looking the various views given by economist as well as policymakers.

2.2 Weak Economic Fundamentals

Prior to the mid-1997 crisis, some economic fundamentals of Asian countries have supported rapid economic growth since the last decades. However, since the onset of crisis, the Asian countries has been blamed of their weak fundamentals as the reason for the collapse of exchange rates in the region. There are contradictory views among international economists and policymakers regarding this issue.

Paul Krugman consistently argued that the region's growth rates would slow down eventually as diminishing returns set in (according to the laws of economic). He claimed that the economic growth that is based on the expansion of inputs (expansion of employment, increase in educational skill and massive investment in physical capital), rather than growth in output per unit of input, is subject to diminishing returns (Ranjit Gill, March 1998). Furthermore, he asserted that the current economic problems ailing Asia is mainly about bad banking practices, poorly regulated financial institutions and massive asset inflation (New Straits Times, 27 September 1998). Some economists have used the traditional 'text book' theory to blame the present problem on the poor fundamentals of the economics. This is because, according to them, the investors will pull out of a currency only if they believe it is likely to fall due to weak fundamentals, resulting in a self-fulfilling crisis. However, Krugman rejected this argument, reasoning that the economic fundamentals of the nations involved were sound in which governments were in fiscal balance and had responsible credit creation and monetary policies, while inflation and unemployment rates were low. Instead he argued that the crisis were "brought on by financial excess and then financial collapse". The root of the problem is the implicit government guarantees to financial institutions and the absence of adequate supervision. He pointed out that this is true in the case of Thailand and South Korea. It is believed that with such guarantees, Asian financial institutions were encouraged to undertake excessively risky investment. This in turn gives incentive to banks to "play a game of heads I win, tails the taxpayer loses" (New Straits Times, 26 September 1998).

The above argument also supported by Lance Taylor (1998), who argued that the boom and bust were not caused by excessive fiscal expansion or the creation of 'wholesale moral hazards' by market-distorting state interventions. Rather, they arise from the government withdrawal from regulating the real side of the economy, the financial sectors and the international capital market. In addition, prior to the crisis, there was increased vulnerability of the real economy in Asia. This was reflected in the deterioration in the current account and falling export growth especially in 1995 and 1996 (Robert Wade, 1998). Moreover, it is argued that, domestic factors as well as the developments in the international financial markets have contributed to the buildup of the imbalances that eventually led to the crisis.

A study by Francis Colaco (1997) on the current crisis argues that, first, financial crises in some countries, such as Thailand, are consequence of poor macroeconomic policies and weak institutional---legal, regulatory and supervisory structures. According to Colaco, countries that ignore the salutary historical lessons of the need to base financial liberalisation on strengthened macroeconomic policies and institutional structures are bound to suffer financial and currency crisis in a global economy. Secondly, contagion effects has been evident, to a greater or lesser extent, in the transmission of the financial and currency crisis of Thailand to other

East Asian economies. Third, speculation has legitimate role to play in signaling distortions in a country's economic and financial framework that are not suitable.

2.2.1 Key Indicators of Economic Performance

In order to prevent financial crisis, some key macroeconomic indicators of an economy's performance have been identified in the literature. In a recent paper, Graciela L. Kaminsky and Carmen M.Reinhart (1995) examine the experience of 19 countries in East Asian, Europe, Latin America and West Asia, in the period 1970-1995 that had experienced banking and currency crises. They found that the most promising indicators of currency crisis are: large real exchange rate appreciation, declining exports and foreign exchange reserves, large declines in the industrial production and sharp increases in the ratio of M2 to reserves (or rapid increases in monetary growth). Moreover they contended that the most of banking crisis were preceded by financial liberalisation which had not been accompanied by bold regulatory and supervisory framework.

In a more recent paper, Graciela, Saul Lizondo and Carmen (1997) examine the leading indicators of currency crisis. They used 'signals' approach, which involves monitoring the evolution of a number of economic indicators that tend to systematically behave differently before a crisis. When an indicators exceeds a certain threshold value this is interpreted as a warning signal that a currency crisis may take place within the following 24 months. They conclude that the variables that have the best track record in anticipating crisis in the context of the 'signals' approach include: exports, output, deviations of the real exchange rate from trend, equity prices and the ratio of broad money to gross international reserves.

Some key variables have been identified in the literature as indicators of economic fundamentals: the real exchange rate, exports, imports, the ratio of net foreign reserves to M2 and the spread between domestic and international lending rates. This indicators was examined for Indonesia, Thailand, Singapore, Malaysia and Philippines for the period of 1994 to 1997 by Colaco (1997). It is observed that in Thailand, the real exchange rate depreciated slightly while the net foreign reserves to M2 increased and the spread between domestic and international rates increased and remained high. According to Colaco, this trend support the view that the fundamentals were deteriorating and that the vulnerability to financial and currency crisis was increasing. On the other hand, Lauridsen (1998) argued that the financial crisis started in Thailand because of political instability, indecisiveness and mismanagement at the political and administrative level. He claimed that, macroeconomic problem such as fiscal imbalances and excessive money supply is only a minor importance in triggering the crisis.

In the case of Indonesia, two of the three indicators: real exchange rate depreciation and a declining net foreign reserves to M2 ratio, showed reduced crises vulnerability starting around mid-1995. International financial markets remained bullish on Indonesia as the growth rate of export remained robust and reserves expanded. However, interest rate spreads which remained high was taken as a indicator of continuing weaknesses in domestic financial markets. Actually government raised interest rate to reduce the rapid outflow of capital. However speculators perception are different from policymakers. Speculators exploited this vulnerability, including over-expansion in the property market to attack the currencies in the East and Southeast Asian region. As a result the Indonesian rupiah and the stock market tumbled.

Meanwhile Malaysia, starting in mid-1995 experienced depreciation in the real exchange rate and a decline in the export growth rate. The ratio of net foreign reserves to M2 declined as the reserve position improved. Interest rate spreads remained high. These indicators, therefore, did not reveal Malaysia's vulnerability to crisis that seems to have been based more on ambitious public expenditure on mega projects and an incipient property bubble. As a result, the Malaysian ringgit and the Kuala Lumpur stock market have both seen significant declines since the outburst of currency crisis.

The Philippines also experienced depreciation in the real exchange rate, declines in the M2 to reserves ratio and the narrowing of the interest rates spread. Export growth rates have fluctuated but have been at relatively high levels and reserves have been increasing. Hence, these indicators did not explain that the fundamentals were weak. On the other hand, Singapore's real exchange rates had depreciated, export growth rates declined, the M2 to reserves ratio has been stable and the interest rate spreads have been negative. In Singapore case, its economy growth was affected mainly because of contagion effect. Colaco (1997) concluded that weak economic fundamentals is the main cause of the currency and financial crisis in Thailand, whereas, contagion effects which is unrelated to fundamentals to greater or lesser degree explained the spread of the crisis to other East Asian countries trough trade linkages.

2.3 Financial Liberalization

Asian governments liberalized their financial system through the 1990s including the external capital accounts (Robert Wade, 1998). Liberalization permitted domestic agents to raise finance on foreign markets and gave foreign agents to access to the domestic financial market. With liberalization, governments gave up the capacity to coordinate foreign private borrowing. Many have warned that, liberalizing the financial sector and opening the capital account is dangerous especially when banks have little experience in international financial markets, when non-banks also borrows abroad, bank–based financial system, high debt/equity ratios and pegged exchange rates (Gabriel Palma, 1998).

As an alternative to mainly blaming the countries, another view was developed to explain the causes of current crisis. Global financial market, which is, very much inter-related, was also identified as the major contributor to the East Asian currency turmoil. This is with combination of (The Star, 27 July,1998):

- Financial deregulation and liberalization across the world
- The increasing interconnection of global markets

- Speed of transaction through computer technology and the development of large financial players (such as the speculative hedge funds, the investment banks and the huge mutual and pension funds)

The combination of above nature of global financial system had lead to the rapid shifting of large blocks of short-term capital flowing across borders in search of quick and high returns. Only 1 to 2 per cent is accounted for by foreign exchange transactions relating to trade and foreign direct investment (STAR, 26 September 1998). The remainder is for speculation or short-term investment that can move quickly when the speculators or investors perceptions change.

When developing countries carried out financial liberalization before its institutions has knowledge base to prepare to deal with the consequences, the country opens itself to the possibility of tremendous shocks and instability associated with inflows and outflows of funds. In 1996, developing countries received net private capital flows about US$94 billion and US$70 billion in the first half 1997. However, with the onset of the currency crisis, the inflow suddenly shifted into reverse gear, in which, US$ 102 billion went out in the second half of 1997 (Martin Khor, 1998). According to Martin Khor (1998), situation that happened in the East Asia is not peculiar but has already happened in the 1980s, to Mexico in 1994 and to Sweden and Norway in the early 1990s. Those countries also faced sudden currency depreciation due to speculative attacks or large outflows of funds.

Furthermore, with the reformation of financial market liberalization, the East Asian economies become vulnerable to the external shocks because it attempted to reform its financial markets in the 1990s. This reform led to dramatic increase in the number of banks and their linkages to the international economy, and increases exposure of these economies to international financial shocks. The developments of 1997 were not inevitable results of an "Asian Capitalist Model" but rather the accidents of partial financial reform that exposed the Asian economies more directly to international financial market instability (Radalet and Sachs, 1998).

In another perspective, financial liberalization have led to massive inflow of short-term foreign capital. The inflow of short-term capital is also induced by the agreement based on derivative contracts (J.A Kregel, 1998). It is generally agreed that the East and Southeast Asia economic crisis was for most part triggered by a liquidity crisis which resulted in from a large and rapid outflow of foreign short-term capital (Yamazawa, 1998). On the other hand, excessive inflow of short-term capital also caused bubble in the property market. Developing economies needed funds for further development. They required foreign fund to fill the excess of domestic investment over domestic savings and also to finance deficits in the current accounts. The rapid inflow of short-term capital caused excess liquidity in East and Southeast Asia markets, which flowed into risky investment in real estate and other incompetitive business. This resulted in increase in non-performing loans at local banks and aggravated financial weakness in the East and Southeast Asia economies.

In East and Southeast Asia countries in terms of financial liberalization, the foreign exchange was made convertible with the local currency not only for trade and direct investment purposes but also for autonomous capital inflows and outflows (for capital account transactions). This was largely deregulated and permitted. This has facilitated the large inflows of funds in the form of international bank loans to local banks and companies, purchase of bonds and portfolio investment in the local stock markets. For example, the Bangkok International Banking Facilities was set up in March 1993 to receive foreign funds for recycling to local banks and companies and in 1996 the institution has about US$31 billion (Lauridsen, 1998).

Prior to economic crisis South Korea has liberalized its prohibition or restriction on foreign lending. Since then the country accumulated US$150 billion of foreign debts and most of the foreign debt (short-term loans) is accumulated by private sector (Chang Ha-Joon, 1998). In Indonesia, since financial sector has liberalized, local banks and private companies had borrowed heavily from abroad. The external debt was only revealed in Thailand, South Korea and Indonesia after the currency crisis burst out. The external debt which, was contracted by private sector has build-up the short-term debts and transformed to a major crisis by the depreciation of the currencies.

Meanwhile in the case of Malaysia, financial liberalization since early 1980s also saw a heavy inflow of foreign capital in the economy. This supplemented the already high saving rates in Malaysia and lead to saving-investment gap about 5 per cent of the Gross National Product (GNP) in 1997 and increased private sector debt especially from abroad. The ratio of foreign loans to GNP has risen rapidly in recent years and foreign liabilities in commercial banks increased more than triple between 1995 and 1997 (Jomo, 1998). And these factors have contributed to the build-up of the currency crisis and exacerbated the impact of the current crisis on Malaysian economy. To avoid the instability in the financial markets, domestic financial liberalization needs to be accompanied by sound macroeconomic policies and strengthened legal, regulatory and supervisory structures. Only when these structures are in order then the risk of facing financial and currency crisis are reduced following the opening up of the capital account.

2.4 Speculators and Contagion

Since the outbreak of East Asian currency crisis, some have blamed foreign currency traders as the main culprits. Hedge traders were condemned for attacking currencies in this region that lead to downfall of East and Southeast Asian emerging economies to most devastating level. However, so far there is no prominent evidence to prove this accusation. To certain extent, it is believed that speculation and contagion have been the mechanism responsible for starting and spreading the currency crisis.

There are contrasting view on the role of currency speculators. Currency speculation has a useful role to play in ensuring the effective operation of financial markets. Speculation signals perceptions of some key market participants that are important distortions in macroeconomics, financial policies, and structures and in policy decision making. By anticipating and betting on the magnitude of change in currency markets, currency speculation can stabilize markets. Furthermore, if the markets ratify their bets, they make profit, if not, they make losses.

Another view is that, speculation can be destabilizing in which they impose high economic costs on the economies whose currencies being attacked, while producing earnings for speculators. A major attack on the currency is possible because resources available to speculation exceed those available to relatively small economies such as the emerging economies in the Southeast Asia. As a result, currency movements in emerging markets can be quite large. According to Charles Kindleberger (1996), speculation in certain circumstances can create self-fulfilling prophecies and be destabilizing. This in turn would lead to excesses and overshooting of the domestic currency.

On the other hand, Krugman (1979) explains that speculative pressures on a currency are the results of inconsistencies between macroeconomic policies and government's exchange rate target. In the face of rapid growth in domestic credit and large budget deficits, if a government sticks to a currency peg and defended the exchange rate by drawing the foreign reserves, it could lead to collapse of the peg. Observing the depletion of reserves, speculators will attack the currency and the sudden collapse of the peg will be certain. This seemed to be true in the case of

Thailand, in which, the Thai central bank used foreign reserves to defend its peg but eventually it failed and let the baht float in 2 July 1997.

It is believed that financial speculation led by some hedge funds, were responsible for the original 'trigger action' in Thailand. For example, the Thai government used up over US$20 billion of foreign reserves to ward off speculative attacks. Speculators are believed to have borrowed and sold Thai baht, receiving US dollar in exchange. When baht fell, they needed much less dollars to repay the baht loans, thus making large profits. One of the immediate actions to be taken in a case of speculation is raising the short-term interest rates to exceptionally high levels and limit utilization of foreign exchange reserves.

2.5 Conclusion

Generally, there are various explanations on the causes of the East and Southeast Asian currency crisis. However, most commentators allude the following causes: weak financial sectors, unfavorable external factors, globalization pains and bursting of property market. These factors cause a crisis of confidence and leads to withdrawal of funds and collapse of the value of currencies in the region. Devaluation the currencies has adversely affected the economic growth of those countries and led them into deep recession.

Its already more than a year since the outbreak of East and Southeast Asian currency turmoil but the debate on it causes and implications are still going on in the international economic meetings. Insofar there is no perfect solution was successful in addressing the crisis. Given the severity of the financial crisis, a more comprehensive solution was sought by policymakers. In line with this, those ailing economies in the region must focus on improving the economics fundamentals and enhancing the soundness of the banking system. At the same time they also must address the structural weakness of the banking system. For several countries in the region, this effort was supported by international financial assistance packages to restore macroeconomic and financial market stabilities and undertake reform and restructuring programs, as well as to increase their foreign reserves to enable them to fulfil their short-term obligations.