

Lecture Notes for Chapter 9

International Financial Markets and Institutions

Chapter 9

Currency Crises I

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Road Map

- 1 Outline: Course aims, summary of finance, international issues
- 2 Preliminaries: Conventions, notation, and basic concepts

Part A Currency markets

- 3 The spot market for foreign exchange
- 4 The forward market for foreign exchange

Part B The behaviour of exchange rates

- 5 Balance of payments
- 6 Aspects of the international monetary system
- 7 The behaviour of spot and forward exchange rates
- 8 Portfolio theories of exchange rate behaviour
- 9 Currency crises

Part C Markets for exchange-rate derivatives and the hedging decision

- 10 The market for currency futures
- 11 The market for currency options

Part D Summary and Revision

12 Summary of international finance

13 Revision classes

9.1 Overview

- Look at currency crises from the 1990's
- Try and understand why they took place

9.2 Various currency crises

- Dec 1994, devaluation of Mexican Peso
- July 1997, Asian Crisis
- August 1998, Collapse of Russian Rouble
- 2002, Fall of the Argentine Peso

9.3 Asian Crisis

Weaker Economies	1996 B_C , B USD	Liabilities to Foreign Banks B USD	July HC/USD	Nov HC/USD	% Δ
Indonesia (rupiah)	9.0	29.7	2400	3600	-33.3%
S. Korea (won)	-23.1	36.5	900	1100	-18.2%
Malaysia (ringit)	-8.0	27.0	2.5	3.5	-28.6%
Phillippines (peso)	-3.0	2.8	27	34	-20.6%
Thailand (baht)	-14.7	48.0	25	40	-37.5%
Stronger Economies					
China (renminbi)	47.2	56.0	8.4	8.4	+0.0%
Hong Kong (dollar)	0.0	28.8	7.75	7.73	+0.0%
Singapore (dollar)	14.3	55.3	1.43	1.60	-10.6%
Taiwan (dollar)	11.0	17.6	27.8	32.7	-15.0%

- Many Asian countries changed from being net exporters to net importers, leading to current account deficits
- $B_C < 0$ —buy FC and sell HC—value of HC declines
- To keep a stable exchange rate, need net inflow of capital, so there is demand for HC from foreigners—capital account surplus, $B_K > 0$
- What happens if capital inflows stop?
- Value of HC will fall!
- We have just used our Balance of Payments Model of Exchange Rates

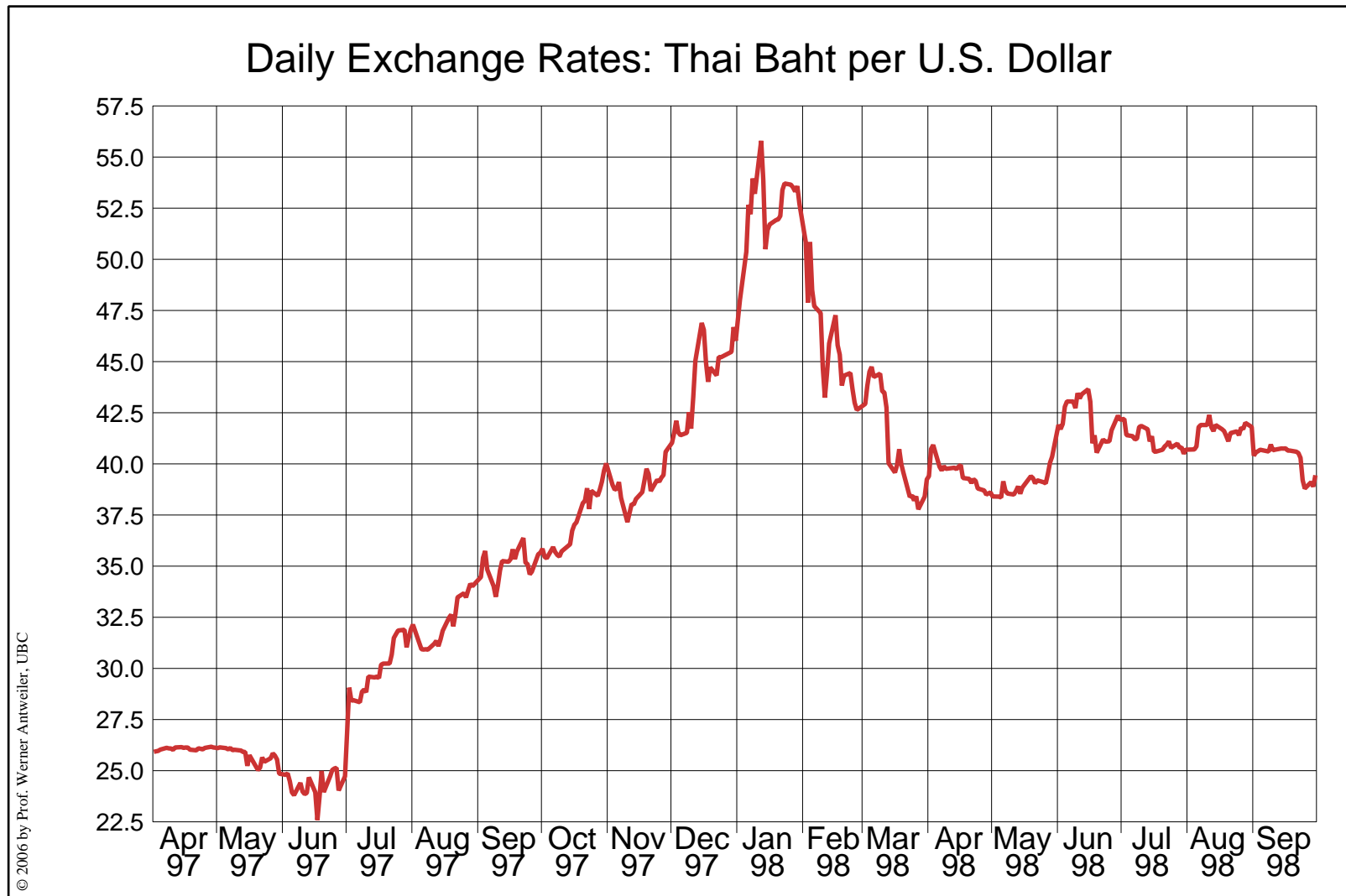
9.3.1 Summary of events

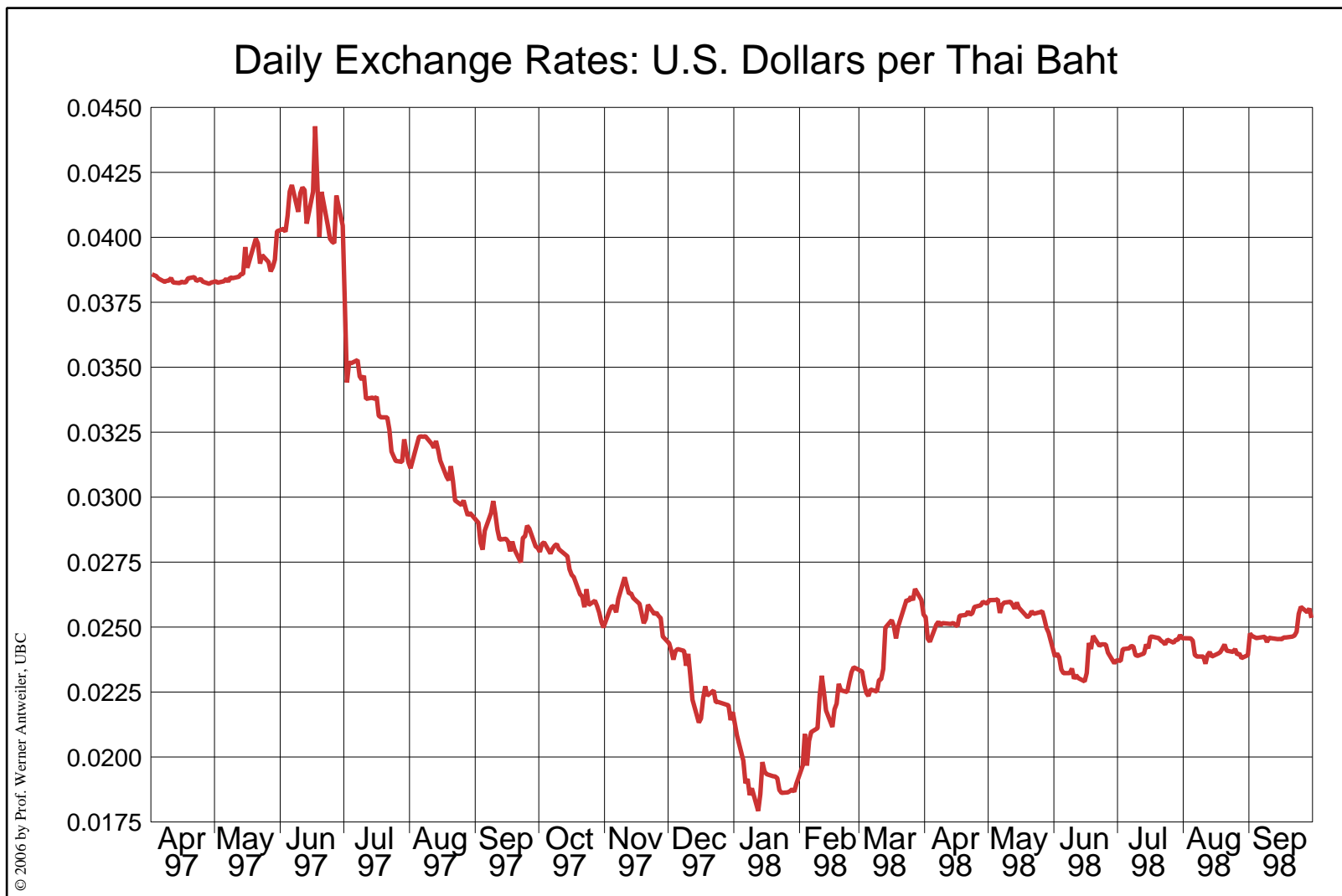
- Large inflows of capital into Thailand and other south-east asian countries
- This was a mixture of FDI and portfolio investment
- Thai banks and firms had very easy access to capital
- Thai banks lent freely to firms
- The economy expanded
- Stock markets rose
- The currency remained strong

- Investors started wondering whether Thai banks could actually repay the funds they had borrowed
- Investors started selling the Thai baht (THB)
- Capital inflows declined
- The capital account balance falls

- The Thai central bank sells FC and raises interest rates to stop the baht from falling—the exchange rate was fixed at the time
- High interest rates increase the cost of capital—investment falls and it's more difficult to repay loans
- Banks fail and the central bank has to use more FC reserves to keep the baht up
- 2 July 1997, Thai central bank allows the baht to float (too expensive to keep it fixed) and it promptly sinks

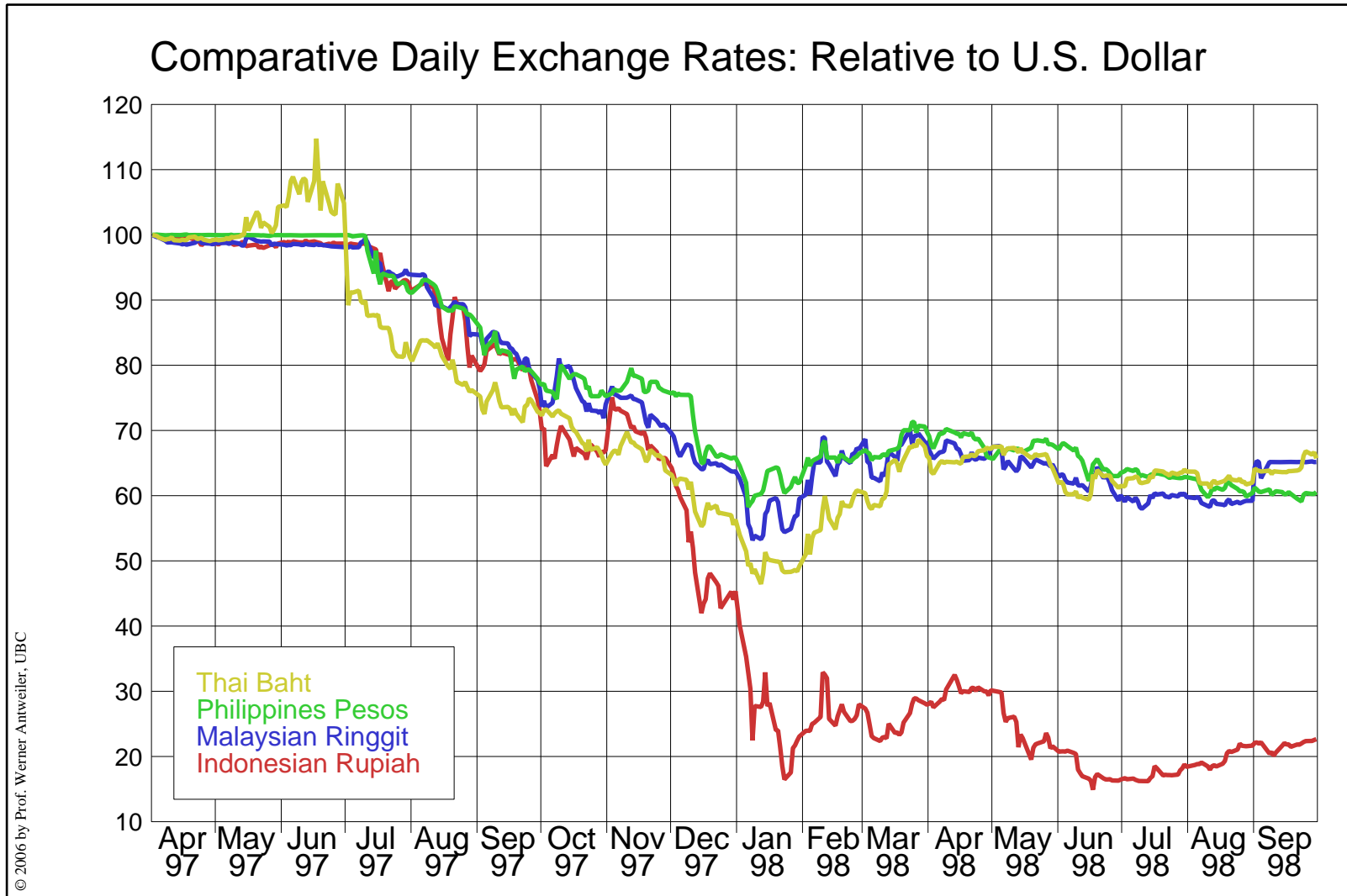
- The baht fell 17% against the USD and more than 12% against the JPY in a few hours!
- By Dec 1997, the baht had fallen from 25 THB/USD to 50 THB/USD





9.3.2 Contagion

- After the Thai devaluation, the Philippine Peso, Malaysian Ringgit and Indonesian Rupiah all fell



- Oct 1997, Taiwan surprised the markets by devaluing its currency by 15%. That seemed to make the Asian Crisis worse.
- The Hong Kong central bank used a lot of its reserves to stop the HKD from falling
- Nov 1997, the Korean won fell from 900 KRW/USD to 1100 KRW/USD
- The RMB was not devalued, but there was speculation that the Chinese government would devalue later—it never happened

