Prevent Contagion Essay, Research Paper

Globalization has been the theme directing the future. Yet, as Mr. Henry M. Paulson, chairman and CEO of Goldman Sachs Group Inc. recently acknowledged, national and regional markets are linked only in ?precarious ways? leading to weak spots within the economy and fueling the possibility for regional or even worldwide financial crises (Peck Ming, 12/8, p.1). In just the past 12 years, three major crises have caused tremors felt around the world. All three examples represent incidences of contagion, or ?the interaction between financial sector crises and balance-of-payments crises in which a loss of investor confidence may set off vicious cycle of capital flow reversals, a liquidity squeeze and a depressing currency? (Internet 2, p. 2). And all three help illustrate the need for a remaking of the international financial architecture in order to prevent future occurrences of contagion (Garten, 1/29, p. 1).

Contagion no doubt remains a fuzzy topic for which no single definition exists. Most scholars and economists agree that contagion is the ?transmission of a crisis that is not caused by the affected country?s fundamentals but by its ?proximity? to the country where a crisis occurred. By proximity, academics refer to one of two situations. First, real integration contagion occurs when a devaluation and financial crisis in one economy worsens the competitiveness of others and lowers the trade balance thus devaluing those currencies. The strength and speed to which such a crisis spreads is directly related to the strength of the trade and investment link. The second, deemed financial integration contagion, occurs when a crisis in one market convinces investors to pull out from other markets either to ?raise cash for redemptions or balance their portfolios? or to follow investors to reduce losses in closely integrated financial markets therefore raising the probability that those markets will also suffer a crisis (Internet2, Fratzscher, 12/16, p.3). The second form suggests that investors often invest without complete information and often apply the problems of one country onto the problems of related countries with similar national indicators or economic fundamentals. Therefore, investors often fleet healthy economies, and thereby help the spread of the crisis (Internet2, Fratzscher, 12/16, p.3).

The most recent crisis, the Asian crisis and the problems in Thailand that help set it off, provides a wealth of information and insight into methods to predict, correct, and prevent incidences of contagion in the future.

Perhaps the most perplexing feature of the Asian crisis was not its size, but that it hit some of the best performing economies in the world. The three countries hit hardest (Thailand, South Korea, and Indonesia) had sound economic fundamentals leading into the crisis. All had high savings, education and skill development programs, currencies pegged to the U.S. dollar, little inflation, and nearly balanced government budgets. In 1996, the year before the crisis hit, they all posted GDP growth rates of 7 to 8 percent (McCall, 4/27, p. 4-5). Capital, both in the form of bank loans and equity investments, poured into the area as investors were attracted by these conditions and the possibility to achieve higher rates of return. And because the baht was pegged to the U.S. dollar, foreign exchange risk was virtually zero and companies rushed to borrow in U.S. dollars for baht liabilities since interest rates for the U.S. dollar were about half those of the baht rates (Peck Ming, 12/8, p.1-3). Domestic asset prices soared as investors from primarily the U.S., Western Europe, and Japan poured in (McCall, 4/27, p. 4-5). So what went wrong?

For starters, companies could only borrow short term money though they used it to fund long term projects. Because of the large inflow of capital, foreign banks were allowing the short term loans to be rolled over upon maturity. Investors deciding to pull out for any reason could not because their money was tied up. The accumulation of large amounts of short term debt proved to be a critical weakness as problems of ?overinvestment, inflated domestic asset prices, and deteriorating loan quality? arose (Camdessus, 1/16, p. 3). With inadequate risk assessment by foreign investors, weak bank supervision and regulation, and access to short term capital that was not adequately monitored, the economy became vulnerable to shifts in investor sentiment. These countries were all export-dependent and ended up in a dead-end when China expanded its productive capacity and devalued the yuan by 35% in 1994. Further, between 1995 and 1997, the dollar rose 60 percent relative to the Japanese yen, leaving East Asian nations with overvalued currencies. This hurt domestic growth. As external competitiveness dropped, there was strong downward pressure on the Thai baht that made maintaining the fixed exchange rate difficult. As investors around the globe began taking short positions on the baht, downward pressure intensified and on July 2, 1997, the Thai baht was depegged from the U.S. dollar. Devaluation caused many business in Thailand to sink and pushed many into serious debt and investors withdrew as much capital from the area as they could recover (McCall, 4/27, p. 4-5).

The first ?domino? of the Asian crisis had fallen. Not too long after, the Philippines and Indonesia followed suit. In just over three months, the value of the baht and the rupiah fell 30 percent relative to the dollar and the contagion spread (McCall, 4/27, p. 4-5).

With trade patterns clearly defined and well-known, a case of economic contagion can often be predicted once the first country falters. Strong trade and investment links with the country in crisis and heavy trade competition with the country in question act as good indicators. However, since trade partners and economic links are not easily or quickly modified, little can be done to prevent the spread of this type of contagion other than making rapid policy changes such as contracting the money supply or tightening restrictions on bank lending. Therefore, real integration contagion is not difficult to predict but is often difficult to stop (Internet 1, Anon).

On the other hand, financial integration contagion?crises spread by incomplete information?are more difficult to predict but can often be avoided by better reporting of analysis and data. Measuring how similar economic fundamentals are to the country in crisis, seeing if any potential political or financial scandals are near, and looking at the whether complete information and data are available to investors can sometimes help indicate the direction of this type of contagion. Further capital inflows that are highly leveraged making investors especially sensitive to low returns feeds into this type of environment, though it is still difficult to measure or predict. The only defense against ?herd behavior,? as it is often called, might be capital controls to prevent large and undesirable capital movements (Internet 1, Anon).

Even with the complications of predicting, correcting, and preventing outbreaks of contagion, the Asian crisis ?prompted a great raft of policy initiatives from the international community? aimed at reducing the severity of financial crisis in emerging markets (Plender, 1/25, p. 1). In order to solve the liquidity crisis, a series of structural and macroeconomic programs were drafted and implemented mostly in order to affect the solvency, liquidity, and confidence issues that existed in the area.

Insolvency, when ?fiscal imbalances are large enough to generate doubts about the public sector?s actual or prospective capacity to repay the debts implied by current and anticipated future imbalances? (). Three actions can be taken to promote solvency. 1) Run small deficits or precautionary fiscal surpluses during normal times. This lowers the public debt over time and builds confidence. Further, a precautionary fiscal surplus provides allows the budget to absorb an adverse economic shock without generating a huge deficit. 2) Develop appropriate rules for the conduct of fiscal policy. 3) Develop well-defined fiscal stabilization funds. Such a fund would promote solvency and would also be used to address liquidity problems. On the whole, solvency improves confidence and boosts investment. Liquidity and solvency go hand-in-hand. ?To decrease an economy?s vulnerability to financial shocks, governments should concern themselves with liquidity, as well as solvency? (). Liquidity can be increased by avoiding short-term debt and issuing debt in advance of cash-flow needs.

As important as fiscal reform, the banking sector needs to be addressed and re-examined. When the banking system is out of order, a financial shock can lead to a disruptive flight from the system.

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