VII

Emerging Market Currency Crises of July 1997

Following turbulence in emerging foreign exchange markets during May and June, pressures on emerging market currencies intensified in July. In Asia, several currencies depreciated sharply, while some of the European emerging market currencies and the South African rand were adversely affected by a variety of country-specific, possibly temporary factors. In the first signs of a potential spillover to Latin America, concerns that the turmoil in foreign exchange markets could lead to widespread foreign investment outflows from emerging markets had a negative impact on equity markets in the region.

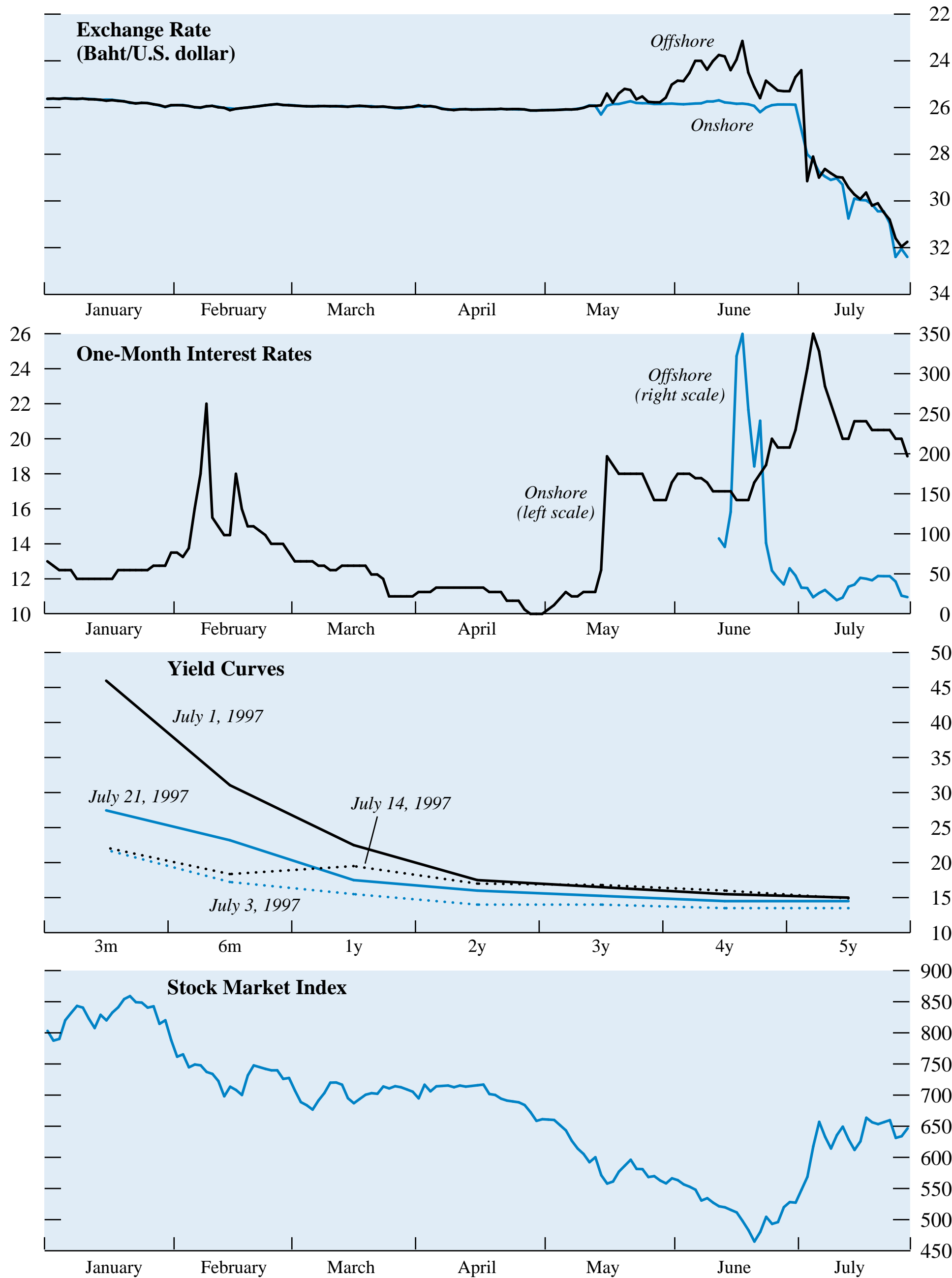
On July 2, the Bank of Thailand abandoned the baht's peg to its traditional basket, and the baht immediately depreciated sharply against the U.S. dollar (Figure 17). Pressures then quickly intensified against the Philippine peso and the Malaysian ringgit, each of which received only limited support from its central bank (Figure 18). Bank Indonesia widened the trading band for the rupiah on July 11, which appeared to forestall a substantial buildup in pressures, although the rupiah depreciated to near the bottom of the new band by July 21. In Eastern Europe, the Czech koruna depreciated further during the period and the Polish zloty also fell. Local developments, including floods in the region, played an important role in affecting market sentiment in both cases. The South African rand also came under pressure, though again developments specific to South Africa, including a negative credit risk report and declines in the price of gold, appear to have played the major role. In Latin America, which had been relatively unaffected by the pressures in May and June, concerns about the deterioration in the Brazilian current account balance coincided with downward movements in equity prices, with the Bovespa index falling by 15 percent between July 11 and 18. Concerns then spread to other Latin American equity markets, particularly those with strong trade links to Brazil—Argentina and Mexico—though they soon recovered (Figure 19).

After the severe pressures in May, when intervention resulted in reserve losses of some $4 billion, followed by a period of relative calm in June, which was nonetheless accompanied by relatively high interest rates, the Thai baht was allowed to float on July 2. In the immediate aftermath of the baht's announced float, expectations of depreciation led the heavily indebted domestic corporate sector to purchase foreign exchange in the spot market rapidly in an attempt to hedge their foreign exchange exposures. This move helped drive down the baht by 14 percent in onshore, and 19 percent in offshore, trading by the end of the day. Initial reactions to the float were favorable. The stock market index rose by 8 percent on July 3, and foreign investors were reported to be paying substantial premiums on the equity available to foreign residents. However, market sentiment subsequently deteriorated because of concerns about the impact of the devaluation on the financial sector. The baht was highly volatile, and interest rates remained high, suggesting a period of continued uncertainty for the exchange rate.

The Thai financial sector was particularly vulnerable to the interest rate increases traditionally employed in the defense of an exchange rate. After the bout of severe pressures on the baht in early May, the Thai authorities imposed controls on capital transactions in an effort to shield the domestic sector from interest rate increases, while at the same time making speculation costly to foreign entities.[40] Despite the floating of the baht, these controls remained in place. The combination of capital and exchange controls effectively drove a wedge between the onshore and offshore markets that was reflected in large interest rate and exchange rate differentials between the two markets. The segmentation, however, proved imperfect and attempts at circumventing restrictions led to escalating capital controls that became increasingly difficult to enforce. For example, foreign investors desiring baht to close out short positions or to arbitrage differentials between the two markets liquidated their equity positions for baht, putting downward pressure on equity prices. The authorities then moved to require foreign investors to liquidate their equity positions for dollars. They did not, however, impose similar restrictions on the fixed-income market, given the corporate and financial sectors' needs to roll over domestic debt and

[40]As noted in Chapter IV, these measures included restricting local banks (from May 15) from extending baht credit to offshore banks, restricting local banks (from May 16) from conducting foreign exchange swaps (baht for dollars), and restricting local banks (from May 16) from selling baht for dollars in the spot market to speculators in the offshore market.

Figure 17. Thailand: Selected Financial Indicators, 1997

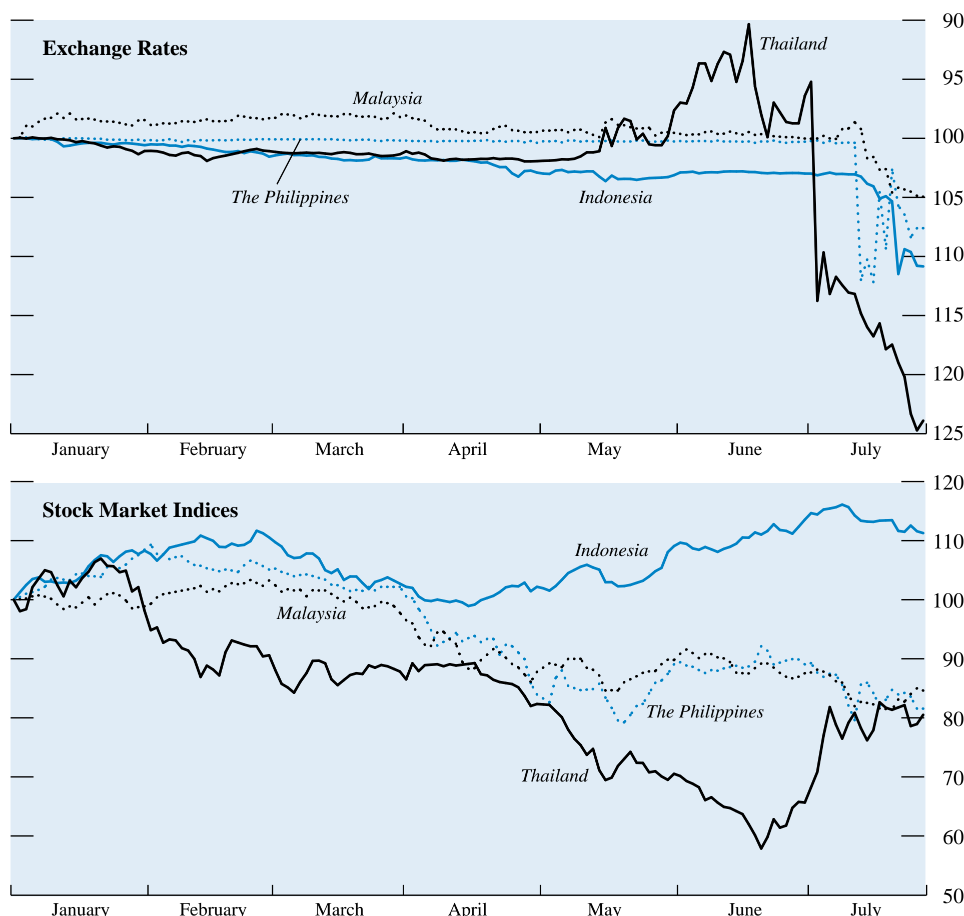


Sources: Bloomberg Financial Markets L.P.; Reuters; and IMF staff estimates.

maintain access to new financing. In spite of the segmentation of baht credit markets, onshore interest rates remained high. In addition, attempts to arbitrage the differential between onshore and offshore rates, for example through the purchase of bills of exchange at steep discounts, continued. The convergence of exchange rates and the reduction of interest rate differentials between the two markets suggest that the controls became progressively less effective (Figure 17).

The Philippine peso came under severe pressure in the immediate aftermath of the baht's depreciation on July 2. These pressures were largely confined to the

Figure 18. Financial Market Developments in Selected Asian Countries, 1997
(January 2, 1997 = 100)

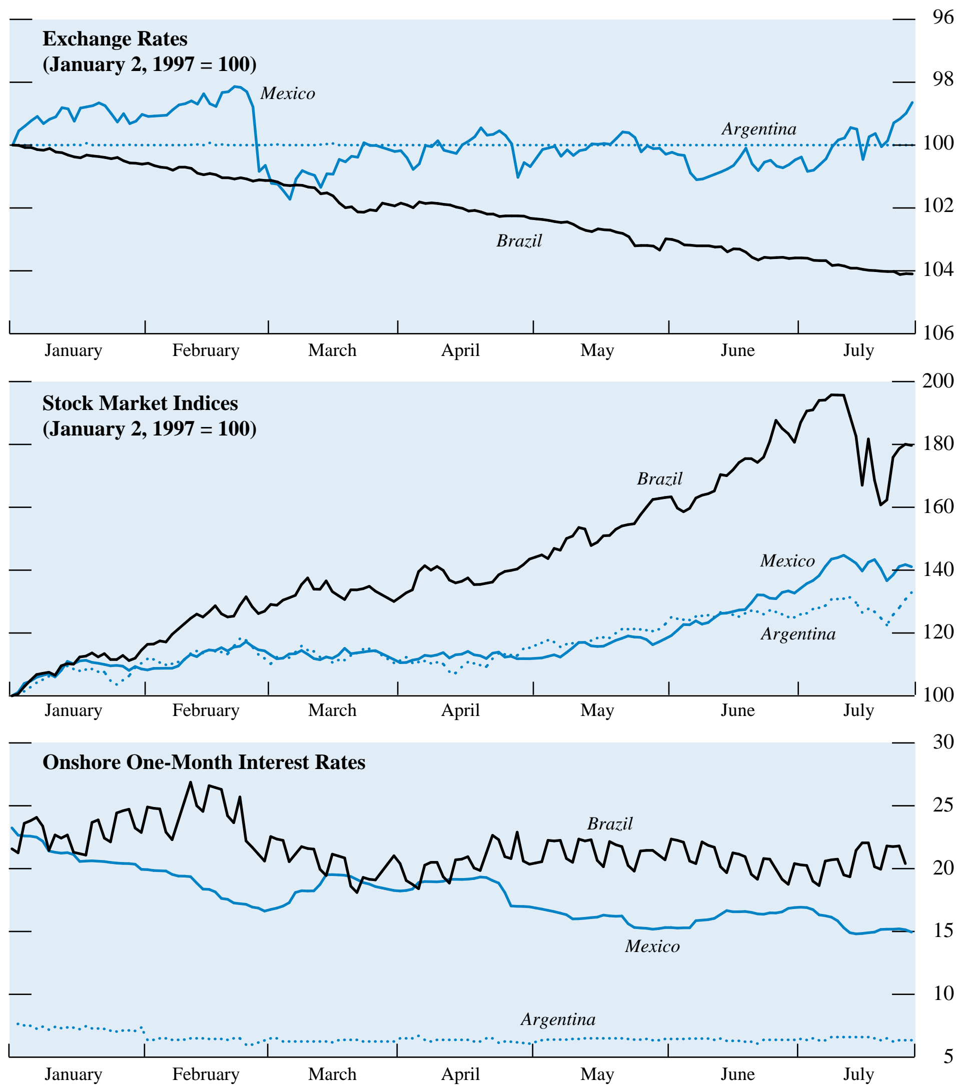


Source: Bloomberg Financial Markets L.P.

onshore spot market, given the absence of a liquid forward market in pesos. Attention has focused recently on the extent to which pressures on the peso originated in the offshore nondeliverable forward (NDF) market, and were subsequently transmitted to the spot market as participants attempted to arbitrage the differentials between the two markets. However, average volumes and liquidity in the NDF market are substantially lower than in the spot market. The small size of the NDF market suggests that it would be difficult for participants to build up substantial short positions through the market, and these pressures were largely channeled through the spot market. Nevertheless, on July 22, the central bank prohibited local banks—for a period of three months—from engaging in NDF contracts with offshore banks, reflecting the concern that the NDF market had contributed to speculation in the foreign exchange market.

The Bangko Sentral ng Pilipinas (BSP) responded to these pressures by raising interest rates and intervening in the spot market, and there were reports that local banks were also discouraged from making peso credit available for speculation (Figure 20). Overnight interest rates were raised in steps to 32 percent. It was estimated that between July 2 and July 10 the BSP lost more than $1.5 billion of reserves. It stopped intervening on July 11, allowing the peso to depreciate initially by 11.5 percent. The Bankers Association of the Philippines (BAP) unexpectedly invoked circuit breakers, imposing volatility caps on the Philippine Dealing System that shut down the spot foreign exchange market. On the following trading day the BAP eliminated this cap. Subsequently the peso mid-rate fluctuated in a wide range of some 8 percent. Liquidity in the spot market was extremely low and daily trading volume averaged $75 million between July 14

Figure 19. Financial Market Developments in Selected Latin American Countries, 1997



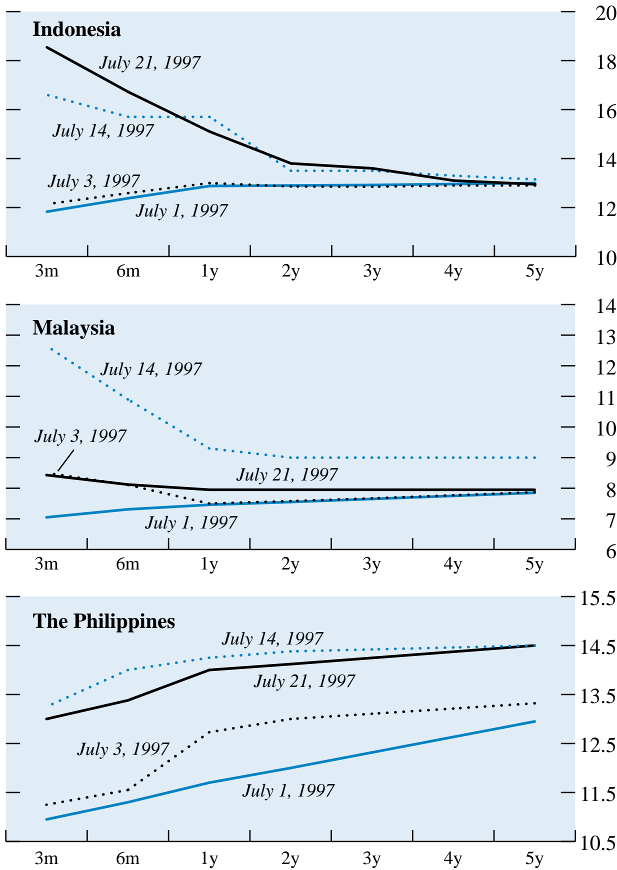
Source: Bloomberg Financial Markets L.P.

and 24 compared with an estimated $220 million over the previous six months. The low level of liquidity in the market, combined with uncertainty among market participants about the future value of the peso, resulted in reported bid-ask spreads of 5–10 percent.

Since the Malaysian ringgit was subject to pressures in the immediate aftermath of the baht's devaluation, Bank Negara Malaysia intervened heavily in support of the ringgit until July 11, when it abruptly withdrew from the foreign exchange market. The cessation of intervention allowed the ringgit to depreciate by 2.4 percent on July 11, before Bank Negara reentered the market and the exchange rate appreciated, thereby imposing a cost on speculators. Markets reacted with nervousness to Bank Negara's intervention in support of the currency, and there was a perceived increase in the downside risks from shorting the ringgit. During the subsequent week, however, the central bank did not intervene in significant amounts, which gradually reduced perceived downside risks, triggering a selloff, and the ringgit depreciated by 5 percent between July 11 and 18. Interest rates, which rose when pressures began, fell back substantially, leading to a fairly flat yield curve.

The intervention band for the Indonesian rupiah was widened from 8 to 12 percent on July 11 in a preemptive move designed to deter speculation. In the event, the rupiah depreciated by 8 percent by July 21,

Figure 20. Yield Curves in Selected Emerging Markets, July 1997



Source: Bloomberg Financial Markets L.P.

and as it fell toward the bottom of the band, some speculative pressures built up to test the floor. In response, Bank Indonesia raised interest rates from 12 percent to 13 percent on July 23, and reportedly intervened heavily in support of the currency.

In what was viewed as a spillover effect from the Asian emerging market currency depreciations, the Brazilian equity market fell by 15 percent during the week of July 11 to 18. This followed a spectacular rise in the market by over 90 percent from the beginning of the year, though, and was viewed by some market participants as representing perhaps a necessary correction. While there was no evidence of short selling of the real, concerns that speculative pressures could lead to a larger-than-expected depreciation, as they had in Asia, contributed to the sell-off in the equity market.