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Bank Lending and Contagion

Evidence from the Asian Crisis

Graciela L. Kaminsky and Carmen M. Reinhart

3.1 Introduction

There have been several major episodes of “contagious currency crises” during the 1990s. The first of these was the Exchange Rate Mechanism (ERM) crisis of 1992–93. Explanations of why currency instability spread through Europe frequently stressed the interdependence of ERM countries via extensive trade in goods and services (see, e.g., Eichengreen, Rose, and Wyplosz 1996). Yet, the ERM crisis was later followed by the Mexican peso crisis in late 1994, with its “tequila effect” on Argentina and other Latin American countries, and the Russian crisis of 1998, which paralyzed capital flows to emerging markets. There is ample evidence that trade links are not capable of explaining why Argentina was so hard hit by the devaluation of the Mexican peso, as there is minimal bilateral trade between Argentina and Mexico and little scope for competition in a common third market (see Kaminsky and Reinhart 2000 on this issue). Similarly, Russia’s importance in world trade is hardly capable of explaining why emerging markets came under such duress following its devaluation and default in August 1998. The absence of obvious trade links in these episodes and the growing importance of financial markets have led academics, policy mak-

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ers, and the financial press to search for other possible explanations of contagion. Some of these explanations have relied on herding behavior on the part of investors (see Calvo and Mendoza 2000). Other stories have suggested that contagion can arise through exposure to common lenders, be it via hedge funds (as in Calvo 1998) or banks (as in Kaminsky and Reinhart 2000).

The focus of this paper is to analyze how the crisis in Asia spread during the second half of 1997. We cast our net wide and investigate several possible trade and financial linkages among the Asian economies which may help explain why a devaluation in a relatively small country in the region (i.e., Thailand) had such widespread regional consequences. We proceed to construct a series of contagion vulnerability indexes, which capture the various manifestations of exposure through trade and finance to the initial crisis country. We contrast the predictions of this vulnerability index to the actual outcomes during the Asian crisis and compare these results to other recent crisis episodes in emerging markets. We also pay particular attention to the role played by Japanese and European banks, which were lending heavily to emerging Asia on the eve of the crisis.¹ Daily interest rates for Indonesia, Malaysia, the Philippines, South Korea, and Thailand, and exchange rate data are used to assess whether the patterns of causality and interdependence changed as the crisis spread as well as to answer the broader question of whether interdependence among selected Asian economies has changed as the result of the crisis. Our main findings can be summarized as follows.

First, as regards the propagation of shocks across national borders during the Asian crisis, the behavior of foreign banks, particularly Japanese banks that began drastically to curtail their lending to the affected Asian countries following the Thai devaluation, appears to have played a role in spreading the crisis, particularly to Indonesia, Malaysia, and South Korea.² The large exposure of European banks to South Korea and their subsequent retrenchment further deepens the regional liquidity crunch.

Second, only Malaysia and South Korea (in that order) appear to have any significant trade links to Thailand. However, these trade links are indirect, through exports to a common third party. Indeed, there is relatively little bilateral trade among these emerging Asian economies. Thus, the spread of crisis to Indonesia and the Philippines cannot be explained through interdependence arising from a substantial volume of trade in goods and services.

Third, the contagion vulnerability indexes do reasonably well in anticipating which countries were most vulnerable to contagion in three recent

1. Besides Thailand, the affected countries are taken to include Indonesia, Malaysia, the Philippines, and South Korea.

2. The Philippines had a much lower exposure to Japanese banks.

crises episodes (the Mexican 1994 devaluation, Brazil's crisis in early 1999, and the Asian episode). The indexes, however, are silent as to the severity of these contagion effects. For example, Indonesia, Malaysia, and South Korea are all identified as potential candidates of spillovers from Thailand; yet Indonesia is shown, *ex ante*, as the one with the least intensive links to Thailand; *ex post*, it experienced the most severe crisis of the three.³

Fourth, the evidence from the daily data suggests that the patterns of causality and interdependence do change during the course of the crisis, as turbulence in affected countries such as Indonesia begins to have additional feedback effects on the other countries, including the initial crisis country, Thailand. Furthermore, there is a marked difference in pre- and post-crisis interest rates and exchange rate linkages among the countries in our sample. Prior to the crisis, there is little evidence of systematic causality or interdependence among these five countries; the post-crisis patterns are markedly different, particularly for Indonesia, the Philippines, and Thailand, all of which show a much greater degree of dependence on external shocks.

Lastly, Malaysia's interest rates remain uninfluenced by shocks to other interest rates in the region in the post-crisis sample. This result may be due to the presence of extensive capital controls—an issue which merits further scrutiny.

The paper is organized as follows. Section 3.2 discusses the patterns in Japanese, European, and U.S. bank lending to emerging Asia and analyzes the behavior of foreign bank lending as the crisis unfolds. Section 3.3 discusses trade linkages and other financial channels of contagion. In this section, contagion vulnerability indexes are developed and used to analyze and compare recent crisis episodes. In section 3.4, we study the issue of cross-country interdependence between daily interest rate and exchange rate shocks and how international linkages may have changed during the post-crisis period. The last section presents some brief concluding remarks.

3.2 Bank Lending and Contagion in Asia: Stylized Evidence

Much of the recent literature on contagion has suggested that trade links are a vehicle for the transmission of currency crises across national borders (see, e.g., Gerlach and Smets 1994 and Glick and Rose 1998). Other recent papers on the subject have focused on the role that capital markets play in spreading turbulence internationally (see, e.g., Frankel and Schmukler 1998 and Calvo 1998). Yet nearly all of this literature has ignored the role that banks can play in transmitting disturbances across countries. This

3. Obviously, differences across countries in how the crisis is managed by policy makers can go a long way toward differences in the severity and duration of the crisis.

channel of transmission is straightforward. Through its loan portfolio, a bank may be exposed to a country that has a financial crisis. If the crisis occurs, it impacts the bank's balance sheet and the bank is faced with the need to rebalance its portfolio. To make up for the deterioration in the quality of its loans, the bank may shift away from lending and increase its holdings of government bonds. Other countries which were borrowing from the affected bank will be vulnerable to cutbacks in their lines of credit. Furthermore, if these countries' loan contracts were of short maturity and the bank's rebalancing needs are significant, the initial crisis could trigger large capital outflows from the other borrowers. That is, not only may the bank be unwilling to extend new credits to the other borrowers, it may also refuse to roll over their existing loans—hence, the capital outflow. If the capital flow reversal is sufficiently large and abrupt, it could spark a financial crisis in one or more of the other borrowers. This type of problem is particularly acute if the borrowers were heavily dependent on that bank and do not have immediate recourse to alternative sources of financing. The bank's inability or unwillingness to lend may be compounded by the requirement that banks must provision for bad loans.

In an earlier paper, we examined the potential for contagion through exposure to a common lender (see Kaminsky and Reinhart 2000). We found evidence that common bank lenders have played a significant role in the spread of currency crises—indeed, the bank-lending channel outperforms trade channels in explaining the vulnerability of a country to contagion.

Contagion during the ERM crises of 1992 and 1993 in Europe and in Argentina and Brazil following the devaluation of the Mexican peso in 1994 appear to have little to do with the withdrawal of a common bank creditor. High and rising international interest rates and poor economic fundamentals have been blamed for the wave of currency and banking crises that swept developing countries (particularly in Latin America) in the early 1980s. Yet, badly burned by Mexico's default in August of 1982, U.S. banks were rapidly retrenching from the emerging world. The drive to reduce loan exposure was most acute for Latin America, which depended almost exclusively on U.S. banks. A more recent example of the role of banks in propagating disturbances internationally can be found in the Asian crisis of 1997; the remainder of this section is devoted to this issue.

3.2.1 Banks and Contagion in Asia

International capital had been pouring into much of Asia, most notably Indonesia, Malaysia, and Thailand, throughout most of the 1990s. Other emerging markets, particularly the largest countries in Latin America, experienced a similar surge in capital inflows (see Calvo, Leiderman, and Reinhart 1996). A key difference between the two regions, however, was that an important share of capital inflows to Latin America came through

Table 3.1 Bank Lending to Emerging Asia, June 1997–June 1998

	June 1997	December 1997	June 1998
European banks			
US\$ billions	85,338	87,846	76,820
Percent change since June 1997	n.a.	2.9	-10.0
Japanese banks			
US\$ billions	97,232	86,651	74,297
Percent change since 1997	n.a.	-10.9	-23.6
U.S. banks			
US\$ billions	23,738	21,974	16,566
Percent change since June 1997	n.a.	-7.4	-30.2

Notes: Emerging Asia comprises Indonesia, Malaysia, the Philippines, South Korea, and Thailand. n.a. = not applicable.

portfolio bond and equity flows, while in Asia, bank lending loomed large, particularly in the two years preceding the crisis. As shown in Table 3.1, lending to emerging Asia expanded markedly.⁴ There were two factors behind this sharp growth in bank credit. Part of the rise in lending was owing to the European banks' goal to achieve a higher profile in emerging markets, particularly in South Korea. Much of the lending boom, however, especially in the case of Thailand, Indonesia, and South Korea, was owing to a rapid expansion in credit from Japanese banks. Faced with a slumping economy and little domestic loan demand, Japanese banks increasingly looked overseas to the rapidly growing economies of Southeast Asia as potential borrowers.

Table 3.2 presents the distribution of lending of U.S., Japanese, and European banks to emerging Asia. Three features are worth noting. First, U.S. bank exposure to Asia was modest on the eve of the crisis; emerging Asia amounted to about US\$24 billion (table 3.1) and accounted for only 20 percent of all U.S. bank lending to developing countries (table 3.2). Second, and by way of contrast, Japanese banks were lending four times as much as U.S. banks (i.e., US\$97 billion) to emerging Asia; the five crisis countries listed in table 3.2 accounted for two-thirds of all loans to emerging markets.⁵ Third, Japanese banks were most exposed to Thailand—which is the first country to experience a crisis. Indeed, the extent of their exposure is similar to that of U.S. banks to Mexico in 1982.⁶ Fourth, European bank lending to emerging Asia was also significant and accounted for about a half of all their lending to emerging markets; South Korea alone accounted for 40 percent of their lending to the developing world.

4. Emerging Asia comprises Indonesia, Malaysia, the Philippines, South Korea, and Thailand.

5. Most of the remaining one-third was going to China.

6. See Kaminsky and Reinhart (2000) for a comparison of these episodes.

Table 3.2 Banks: Liabilities as a Percent of Borrower's Total Liabilities, 1994-98

	December 1994	June 1995	December 1995	June 1996	December 1996	June 1997	December 1997	June 1998
Indonesia	7.020	5.680	6.240	7.200	9.510	7.820	8.390	6.420
Malaysia	10.176	7.288	9.076	9.433	10.511	8.264	6.487	4.990
The Philippines	37.408	35.830	35.379	31.042	29.363	19.450	16.336	16.992
South Korea	9.695	9.971	9.790	10.885	9.359	9.564	10.119	10.227
Thailand	6.131	5.791	6.522	6.387	7.198	5.761	4.304	3.754
			Liabilities to the United States					
Indonesia	52.476	50.758	47.103	43.853	39.686	39.421	37.712	37.857
Malaysia	43.215	41.373	43.627	40.453	36.925	36.420	31.057	34.343
The Philippines	13.939	15.591	11.817	12.987	11.724	14.603	13.296	12.964
South Korea	30.792	29.223	27.673	25.574	24.335	22.787	21.525	26.136
Thailand	60.284	60.869	58.654	54.102	53.495	54.413	56.377	55.811
			Liabilities to Europe					
Indonesia	31.253	33.476	33.777	36.661	37.842	38.277	39.862	43.704
Malaysia	40.495	44.057	36.947	39.164	41.446	44.000	50.863	47.429
The Philippines	41.376	40.275	42.020	43.520	47.618	49.363	53.088	60.203
South Korea	33.729	34.306	30.455	30.512	33.835	35.568	35.747	38.813
Thailand	24.187	24.853	23.730	26.066	27.283	28.546	29.182	32.809

Source: Bank for International Settlements (BIS), various issues.

Notes: Each entry is the amount owed by that country to the lender, divided by that country's total debt (grand total). Europe total includes Spain, the United Kingdom, Sweden, Norway, the Netherlands, Luxembourg, Italy, Ireland, Germany, France, Finland, Denmark, Belgium, and Austria.

Fifth, Japanese banks were quick to pull out of emerging Asia. Between June and December of 1997, lending by Japanese banks fell by 10 percent, while lending by European banks actually rose slightly. This is not surprising in light of the previous discussion. Japanese banks were most exposed to Thailand; European and U.S. banks were most exposed to South Korea. The Thai devaluation occurred in early July, while South Korea abandoned its defense of the won in mid-November. By June 1998, however, the reduction in lending to emerging Asia was across the board. United States bank lending fell by a cumulative 30 percent, representing a decline of about US\$5 billion. The 24 percent decline in Japanese bank lending in June 1997–98, however, translates into a reduction of about US\$26 billion.

The previous observations suggest that, even if the banks were not the immediate trigger of financial contagion, their actions certainly made the spillovers, first from Thailand and later from South Korea, far more severe than they would be otherwise. In the following section, we construct a composite contagion vulnerability index; exposure to a common bank creditor figures prominently in this index.

3.3 A Contagion Vulnerability Index

In this section, we provide a brief review of the “signals” approach that we will use to assess the probability of a “contagious” currency crisis. This methodology was first used to analyze the performance of a variety of macroeconomic and financial indicators around “twin crises” (i.e., the joint occurrences of currency and banking crises) in Kaminsky and Reinhart (1999).⁷

In the analysis that follows, we focus on a sample of twenty countries over the period 1970 to 1998. The countries in our sample are Argentina, Bolivia, Brazil, Chile, Colombia, Denmark, Finland, Indonesia, Israel, Malaysia, Mexico, Norway, Peru, the Philippines, Spain, Sweden, Thailand, Turkey, Uruguay, and Venezuela. As an out-of-sample exercise, we apply this approach to analyze South Korea’s vulnerability to contagion during recent episodes of global financial turmoil.

While the preceding section stressed the key role played by foreign banks in spreading the crises throughout Asia during 1997, this section will develop a contagion vulnerability index that also allows for other types of links across countries. Specifically, we consider both bilateral and third-party trade links as well as contagion arising from other financial channels.

In order to implement the signals approach to analyze contagion, however, we need to clarify a minimum number of concepts which will be used throughout the analysis.

7. This methodology is described in some detail in Kaminsky, Lizondo, and Reinhart (1998), Kaminsky (1998), and Goldstein, Kaminsky, and Reinhart (2000).

3.3.1 Defining Currency Crises

A currency crisis is defined as a situation in which an attack on the currency leads to substantial reserve losses or a sharp depreciation of the currency—if the speculative attack is ultimately successful. This definition of currency crisis has the advantage that it is comprehensive enough to capture not only speculative attacks on fixed exchange rates (e.g., Thailand's experience prior to 2 July 1997) but also attacks that force a large devaluation beyond the established rules of a crawling-peg regime or an exchange rate band (e.g., Indonesia's widening of the band prior to its flotation of the rupiah on 14 August 1997.) Since reserve losses also count, the index also captures unsuccessful speculative attacks.

We constructed an index of currency-market turbulence as a weighted average of exchange rate changes and reserve changes. Interest rates were excluded as many emerging markets in our sample had interest rate controls through much of the sample.

The index, I , is a weighted average of the rate of change of the exchange rate, $\Delta e/e$, and of reserves, $\Delta R/R$, with weights such that the two components of the index have equal sample volatilities

$$(1) \quad I = \left(\frac{\Delta e}{e} \right) - \left(\frac{\sigma_e}{\sigma_R} \right) \cdot \left(\frac{\Delta R}{R} \right),$$

where σ_e is the standard deviation of the rate of change of the exchange rate and σ_R is the standard deviation of the rate of change of reserves. Since changes in the exchange rate enter with a positive weight and changes in reserves have a negative weight attached, readings of this index that were three standard deviations or more above the mean were cataloged as crises. For countries in the sample that had hyperinflation, the construction of the index was modified.⁸ As noted in earlier studies which use the signals approach, the dates of the crises map well onto the dates obtained if one were to rely exclusively on events, such as the closing of the exchange markets or a change in the exchange rate regime, to define crises.

3.3.2 Defining Contagion

As noted earlier, the term “contagion” has been used to mean different things across studies. In this paper, contagion refers to the case in which knowing that there is a currency crisis elsewhere increases the probability

8. While a 100 percent devaluation may be traumatic for a country with low to moderate inflation, a devaluation of that magnitude is commonplace during hyperinflation. A single index for the countries that had hyperinflation episodes would miss sizable devaluations and reserve losses in the moderate inflation periods, since the historic mean is distorted by the high-inflation episode. To avoid this, we divided the sample according to whether inflation in the previous six months was higher than 150 percent, then constructed an index for each subsample.

of a crisis at home.⁹ We are interested in understanding the channels of transmission of what we call “fundamentals-based contagion,” which arises when countries are linked via trade or finance.

Since what we are interested in explaining is how turbulence is transmitted across countries which are connected by trade or finance and in assessing which of these links are most important, it matters greatly how we define “elsewhere.” As in Kaminsky and Reinhart (2000), we define “elsewhere” by grouping the countries in our sample into various clusters. As noted in section 3.2, an important source of fundamentals-based contagion in the Asian crisis was countries’ exposure to a common bank lender. We identify two distinct bank clusters in our sample; one of these clusters is made up of countries that borrow primarily from U.S. banks, while a second bank cluster consists of countries where an important share of their borrowing is concentrated among Japanese banks.

The growing practice of cross-market hedging in recent years also suggests that countries which have (for whatever reason) exhibited a moderately positive correlation of asset returns (with the crisis country) and have relatively liquid markets may be vulnerable to contagion via cross-market hedges. We identify two high-correlation clusters in our sample in Asia and Latin America.

A competitive devaluation story, as in Gerlach and Smets (1994), suggests that a currency crisis in one country may lead to a devaluation in a second country if the two countries engage in a significant amount of bilateral trade. In a similar vein, Corsetti et al. (1998) stress that competitive devaluation pressures may arise even if two countries do not trade directly with one another. Such pressures may be present if the two countries are competing in a common third market.

The countries in each of these clusters are listed in table 3.4.¹⁰ On the basis of the information in tables 3.3 and 3.4, we can construct a rough index of vulnerability to fundamentals-based contagion for each country in the sample at each point in time. Consider the case of the Asian crisis, which began on 2 July 1997 with the devaluation of the Thai baht. To assess how the Thai devaluation could affect other countries, one could simply count the number of common clusters through which a country is exposed to Thailand. For example, Malaysia is in the same bank cluster as Thailand, as well as in the same high-correlation and third-party trade clusters—a total of three. The Philippines are also part of the same third-party trade and Asian high-correlation cluster, but not a part of the Japanese bank cluster—a total of two. Indonesia shares the same high-correlation and Japanese bank clusters with Thailand—a total of two.

9. This is the definition used in Eichengreen, Rose, and Wyplosz (1996) and Kaminsky and Reinhart (2000).

10. Details on the criteria used to define the clusters are given in Kaminsky and Reinhart (2000).

Table 3.3 Banks: Liabilities as a Percent of Lender's Total Liabilities, 1994-98

	December 1994	June 1995	December 1995	June 1996	December 1996	June 1997	December 1997	June 1998
Indonesia	2.82	2.63	2.94	3.45	5.59	4.04	4.32	2.95
Malaysia	1.58	1.23	1.61	1.84	2.47	2.09	1.58	1.05
The Philippines	2.95	3.02	3.12	3.26	4.13	2.47	2.84	2.77
South Korea	6.33	8.15	8.03	9.32	9.90	8.75	8.41	6.78
Thailand	3.10	3.55	4.34	4.31	5.34	3.51	2.23	1.61
			Liabilities to the United States					
Indonesia	15.23	15.09	15.14	15.43	15.91	15.58	15.75	15.49
Malaysia	4.84	4.48	5.29	5.80	5.93	7.06	6.12	6.44
The Philippines	0.79	0.84	0.71	1.00	1.13	1.42	1.88	1.88
South Korea	14.47	15.36	15.49	16.06	17.56	15.97	14.51	15.42
Thailand	21.96	24.01	26.60	26.79	27.09	25.40	23.74	21.27
			Liabilities to Europe					
Indonesia	3.22	3.67	4.21	4.79	5.89	5.15	4.65	4.28
Malaysia	1.61	1.75	1.74	2.09	2.58	2.90	2.80	2.13
The Philippines	0.83	0.80	0.98	1.24	1.77	1.63	2.09	2.09
South Korea	25.39	28.14	30.12	31.71	43.15	38.77	30.86	22.98
Thailand	3.12	3.60	4.18	4.79	5.36	4.53	3.43	2.99

Source: Bank for International Settlements (BIS), various issues.

Notes: Each entry is the amount owed by that country to the lender, divided by the lender's total outstanding claims to developing countries, as reported to BIS. The total claims of the lenders on developing countries is calculated as their total outstanding claims less the total claims to developed countries. European data include Spain, the United Kingdom, Sweden, Norway, the Netherlands, Luxembourg, Italy, Ireland, Germany, France, Finland, Denmark, Belgium, and Austria.

Table 3.4 Trade and Financial Clusters

	Bank Cluster		High-Correlation Cluster		Third-Party Trade Cluster		Bilateral Trade Cluster
	Japan	United States	Asia	Latin America	Asia	Latin America	Latin America
Argentina		1		1			1
Bolivia							
Brazil		1		1		1	1
Chile		1					1
Colombia		1				1	
Denmark							
Finland							
Indonesia	1		1				
Israel							
Malaysia	1		1		1		
Mexico		1		1		1	
Norway							
Peru				1			
The Philippines		1	1		1		
South Korea ^a	1				1		
Spain							
Sweden							
Thailand	1		1		1		
Turkey							
Uruguay		1					1
Venezuela		1				1	

Note: See text for detailed explanation.

^aNot part of our sample.

South Korea borrows from Japanese banks; it is part of the Asian third-party trade cluster, but asset returns correlation with Thailand is low—also a total of two. Argentina (for example) is not exposed to Thailand via any of the financial or trade links analyzed here.¹¹ On the basis of this simple tally, one would conclude that Malaysia is the most vulnerable to fundamentals-based contagion from Thailand and Argentina the least; but this simple tally does not allow us to rank the relative vulnerabilities of Indonesia, the Philippines, and South Korea, as they all share two (although different) clusters with Thailand. In the remainder of this section, we describe an approach that allows us to assign different weights in a contagion vulnerability index to the different trade and financial links; the

11. It is important to note that this is not an exhaustive analysis of all possible financial sector links. For instance, Brazil and Russia were directly impacted by the Korean crisis, as Korean financial intermediaries sold their holdings of Brazilian and Russian debt (see Calvo and Reinhart, 1996 for examples and discussion of other potential links).

weights will depend on the accuracy of these links in predicting the incidence of contagious crises.

3.3.3 Signals, Noise, and Crises Probabilities

A crisis elsewhere may or may not be a reliable signal of a future crisis at home. A summary of the possible outcomes is presented in the following 2×2 matrix.

	Crisis Occurs in the Following 24 Months	No Crisis Occurs in the Following 24 Months
Signal = 1, if there is a crisis elsewhere	A	B
No signal = 0, if no crisis elsewhere	C	D

A perfect indicator would have entries only in cells *A* and *D*. Hence, with this matrix we can define several useful concepts which we will use to evaluate the predictive ability of each of the clusters.

We begin by calculating, for a given sample, the unconditional probability of crisis,

$$(2) \quad P(C) = \frac{A + C}{A + B + C + D}.$$

If knowing that there is a crisis elsewhere helps predict a crisis at home, then it can be expected that the probability of a crisis, conditional on a signal, $P(C|S)$, is greater than the unconditional probability. Where

$$(3) \quad P(C|S) = \frac{A}{A + B}.$$

Formally,

$$(4) \quad P(C|S) - P(C) > 0.$$

If crisis elsewhere is not a “noisy” indicator (prone to sending false alarms), then there are relatively few entries in cell *B* and $P(C|S) \approx 1$. However, since “elsewhere” is defined differently for each of the clusters, their forecasting track records will differ.

We can also define the noise-to-signal ratio, N/S as,

$$(5) \quad \frac{N}{S} = \frac{B/(B + D)}{\frac{A}{A + C}}.$$

In the remainder of this section, we employ these concepts to provide evidence on the relative merits in anticipating crises of the trade and finance clusters.

Table 3.5 Conditional Probabilities and Noise-to-Signal Ratios for Trade and Financial Clusters

Noise-to-Signal Ratio	Bank Cluster	High-Correlation Cluster	Third-Party Trade Cluster	Bilateral Trade Cluster
25 to 50	0.90	0.58	1.54	2.34
50 and above	0.07	0.39	0.57	0.08
Weight in Vulnerability Index				
25 to 50	1.10	1.73	0.64	0.42
50 and above	14.08	2.57	1.75	12.5
$P(C CE) - P(C)$				
25 to 50	-3.1	20.8	-6.3	-21.8
50 and above	52.0	47.1	30.7	47.3

Source: Based on Kaminsky and Reinhart (2000).

Table 3.5 presents the results from this exercise for each of the clusters. As noted in Kaminsky and Reinhart (2000), contagion appears to be a highly nonlinear process, irrespective of which country grouping scheme is used. If one-quarter to one-half of the countries in a given cluster have a crisis, the probability of a crisis at home does not increase by much; this is shown under the rows labeled 25 to 50 percent. Yet, if more than one-half of the countries in the cluster have a crisis, the probability of a crisis at home increases dramatically. This nonlinearity is evident in the marked declines in the noise-to-signal ratios as the proportion of countries affected by crises increases. The decline in the noise-to-signal ratio is most dramatic for the Latin American bilateral trade cluster, which falls from 2.34 to 0.08. This sharp improvement in forecasting accuracy is also evident in its marginal predictive ability, $P(C|S) - P(C)$. The common bank lender cluster has the lowest noise-to-signal ratio while the third-party trade cluster has the highest. While assessing the predictive ability of the individual clusters is a useful exercise to discriminate among competing explanations of contagion, countries which are linked in trade are also often linked in finance. This implies that multiple channels of contagion may be operating at once. To examine exposure to contagion via a variety of channels, we now turn to the construction of a composite vulnerability index.

3.3.4 Trade and Financial Clusters, and a Composite Contagion Index

Kaminsky (1998) and Goldstein, Kaminsky, and Reinhart (2000) show how to construct a composite index to gauge the probability of a crisis conditioned on multiple signals from various indicators (i.e., economic fundamentals); the more reliable indicators receive a higher weight in this composite index. This methodology can be readily applied to construct a composite contagion vulnerability index.

In weighing individual indicators, a good argument can be made for

eliminating from our list of potential leading indicators those variables which had a noise-to-signal ratio above unity; this is tantamount to stating that their marginal forecasting ability $P(C|S)$ is zero or less. Applying this criterion to our results, we would focus on the case where more than 50 percent of the countries in the cluster are experiencing a crisis. As shown in table 3.5, the highest noise-to-signal ratio is 0.57, well below unity—but the track record of the signals in each of the clusters is far from uniform. Thus, we weigh the signals by the inverse of the noise-to-signal ratios reported in table 3.5.

Formally, we construct the following composite indicator,

$$(6) \quad I_t = \sum_{j=1}^n \frac{S_t^j}{\omega^j}.$$

In equation (6) it is assumed that there are n different indicators (i.e., clusters). Each cluster has a differentiated ability to forecast crises and, as before, this ability can be summarized by the noise-to-signal ratio, here denoted by ω^j , S_t^j is a dummy variable that is equal to 1 if the univariate indicator, S_t^j , crosses its critical threshold and is thus signaling a crisis and zero otherwise. As before, the noise-to-signal ratio is calculated under the assumption that an indicator issues a correct signal if a crisis occurs within the following twenty-four months. All other signals are considered false alarms.

The maximum value that this composite vulnerability index could score is 30.9 if a country belonged to the same four clusters as the crisis country. This score is a simple sum of the inverse of the noise-to-signal ratio.

3.3.5 Evidence from Three Recent Crisis Episodes

We now consider, on the basis of the trade and financial sector linkages discussed here, which countries would have been classified as vulnerable to contagion during three recent episodes of currency crises in emerging markets. The first of these episodes begins with the devaluation of the Mexican peso in December 1994.

On the heels of the Mexican devaluation, Argentina and Brazil were the countries to come under the greatest speculative pressure. In a matter of a few weeks in early 1995, the central bank of Argentina lost about 20 percent of its foreign exchange reserves, and bank deposits fell by about 18 percent as capital fled the country. Such a severe outcome could hardly be attributed to trade linkages and competitive devaluation pressures, as Argentina does not trade with Mexico on a bilateral basis and does not compete with Mexican exports in a common third market.¹² In the case of Brazil, the speculative attack was more brief, although the equity mar-

12. See Kaminsky and Reinhart (2000) for details on the pattern of trade.

ket sustained sharp losses. Both of these countries record high readings in their vulnerability indexes following the Mexican devaluation. While the effects on Asia of the Mexican crisis were relatively mild, the country which encountered the most turbulence in the region was the Philippines, which also registers a relatively high vulnerability score.

In the case of the Thai crisis, Malaysia shares both trade and finance links with Thailand. For the other Asian countries the potential channels of transmission are fewer. As noted earlier, the Philippines are part of the same third-party trade cluster as Thailand, which receives a weight of 1.75 (i.e., $1/0.57$) in the composite index; it is also part of the Asian high-correlation cluster, which receives a weight of 2.57 (i.e., $1/0.39$) in the index. Indonesia shares the same high-correlation cluster with Thailand and is a part of the Japanese bank cluster, which receives a weight of 14.08 (i.e., $1/0.07$). Hence, as shown in table 3.6, Indonesia's and the Philippines' contagion vulnerability indexes score 16.65 and 4.32, respectively. South Korea, as noted in section 3.2, also borrowed heavily from Japanese banks. Accordingly, its exposure to Thailand came more from having a common lender than from conventional competitive trade pressures.

Table 3.6 A Contagion Vulnerability Index

	Contagion Vulnerability Index		
	December 1994: Mexican Crisis	July 1997: Thai Crisis	January 1999: Brazilian Crisis
Argentina	16.65	0	29.15
Bolivia	0	0	0
Brazil	18.4	0	n.a.
Chile	0	0	26.58
Colombia	12.5	0	15.83
Denmark	0	0	0
Finland	0	0	0
Indonesia	0	16.65	0
Israel	0	0	0
Malaysia	0	28.33	0
Mexico	n.a.	0	18.4
Norway	0	0	0
Peru	2.57	0	2.57
The Philippines	14.08	4.32	14.08
South Korea	0	26.58	0
Spain	0	0	0
Sweden	0	0	0
Thailand	0	n.a.	0
Turkey	0	0	0
Uruguay	0	0	26.58
Venezuela	12.5	0	15.83

Note: n.a. = not applicable.

The most recent of these emerging market crises was Brazil's devaluation of the real in early 1999. Not surprisingly, Argentina, which has both trade (Mercosur) and financial linkages with Brazil, shows the highest vulnerability; other Mercosur countries come close in suit.

3.4 Contagion and Interdependence: Interest Rates and Exchange Rates

The preceding discussion has suggested that, even in the absence of any shifts in market sentiment or herding behavior on the part of investors, there are multiple reasons that a crisis in one country may have important repercussions on other countries which are exposed to the crisis through financial or trade arrangements. Yet these fundamental channels of crisis transmission are not likely to emerge or disappear quickly. Developing mutually satisfactory trade arrangements or building close ties with possible creditors may take time and is not likely to change dramatically from one moment to the next. For example, as shown in table 3.2, countries which were in the Japanese-bank cluster before the crisis remain so after the crisis; a similar statement can be made about the U.S. borrower group.

A proximate way to explore whether vulnerability to "true contagion"—that is, interdependence that cannot be accounted for by the kinds of conventional trade or finance links that we have focused on thus far—may be to examine causal patterns (or interdependence) among the affected countries in market-determined variables such as interest rates, exchange rates, and stock returns. One possible explanation of contagion has to do with the "wake-up call hypothesis" (see Goldstein, Kaminsky, and Reinhart 2000), which suggests that the initial crisis serves as a wake-up call, leading investors to reassess the risks of other countries which share some of the vulnerabilities with the crisis country—irrespective of whether they have a common bank lender or are linked in trade. Alternatively, herding may arise even when investors are rational if verifying rumors (or information in general) is costly (see Calvo and Mendoza 2000). If rumors become more frequent in the aftermath of a crisis, this may impart greater interdependence or increased comovement among financial indicators across countries.

3.4.1 Methodology Issues

To examine whether there is greater interdependence or unidirectional causal links among five of the affected Asian countries following the financial crisis that began with the 2 July 1997 devaluation of the Thai baht, we assembled daily data on domestic interest rates and exchange rates for Indonesia, Malaysia, the Philippines, South Korea, and Thailand. The data begin on 1 January 1996 and run through July 1999. Hence, there is a roughly comparable number of observations prior to the crisis (392 observations) and following the crisis (334 observations.) We employ a simple vector autoregression (VAR) framework, which treats all variables as po-

tentially endogenous, and include ten lags of each of the variables in the system. Omitting time subscripts, a representative equation for domestic interest rates (r) in Indonesia (denoted by the subscript i) in this five-equation system is given by

$$(7) \quad r_i = \alpha_i + A_1(L)r_i + A_2(L)r_m + A_3(L)r_p + A_4(L)r_{sk} + A_5(L)r_t + \varepsilon_i.$$

The subscripts m , p , sk , and t refer to Malaysia, the Philippines, South Korea, and Thailand, respectively. The lag operators are the A 's and ε 's denote the random shocks. A comparable system was estimated for daily changes in the exchange rate (in percent). For each block of regressors we conducted F - and log-likelihood ratio tests that tested the null hypothesis of no causal relationship.

3.4.2 Interest Rate and Exchange Rate Links: Evidence from Asia

Table 3.7 reports the results for interest rates; the detailed test statistics and their associated probability values are presented in appendix tables 3A.1–3A.4. The columns “cause” the rows; an N denotes that the null hypothesis of no causality was not rejected while a Y indicates rejection of the null hypothesis at a 5 percent level of significance or higher. For example, the top row, which summarizes the results for Indonesia for the 1 January 1996–1 July 1997 period, shows four N entries, indicating that interest rates in the four remaining countries in the system had no systematic influence on Indonesian interest rates. The last column of table 3.7 tallies the number of significant entries. Table 3.8 summarizes in comparable manner the results for the daily exchange rate changes.

Several features of the pre- and post-crisis results for interest rate patterns are worth noting. First, for the precrisis sample, none of the regressors (other than lags of the dependent variable) are statistically significant at standard confidence levels. Second, the post-crisis period is quite different in that regard with a greater degree of interdependence among the countries. Fluctuation in Thai and Philippine interest rates significantly influences interest rates in Indonesia. Likewise, interest rates in Indonesia influence the Philippines and Thailand. Third, interdependence was most intense during the period immediately following the Thai devaluation and the subsequent devaluation of the Korean won on 17 November 1997.

Fourth, Malaysian interest rates are not significantly affected by interest rate developments in the other four countries in the full post-crisis period. One could speculate that this insulation may be due to the introduction of exchange controls in September 1998. Indeed, prior to the imposition of exchange restrictions, Malaysian interest rates were influenced by other countries' interest rates during the height of the crisis in July 1997–April 1998.

Fifth, no clean unidirectional causality pattern from Thailand to the

Table 3.7 Daily Interest Rates: Causality Tests

	Indonesia	Malaysia	The Philippines	South Korea	Thailand	Numbers That Are Significant
<i>Indonesia</i>						
1 January 1996–1 July 1997		N	N	N	N	0
2 July 1997–1 July 1999		N	Y	N	Y	2
2 July 1997–16 November 1997		Y	N	N	Y	2
17 November 1997–30 April 1998		N	Y	Y	Y	3
<i>Malaysia</i>						
1 January 1996–1 July 1997	N		N	N	N	0
2 July 1997–1 July 1999	N		N	N	N	0
2 July 1997–16 November 1997	Y		Y	Y	N	3
17 November 1997–30 April 1998	N		N	Y	Y	2
<i>The Philippines</i>						
1 January 1996–1 July 1997	N			N	N	0
2 July 1997–1 July 1999	N			N	Y	1
2 July 1997–16 November 1997	N	Y		N	N	1
17 November 1997–30 April 1998	Y	Y		N	N	2
<i>South Korea</i>						
1 January 1996–1 July 1997	N	N	N		N	0
2 July 1997–1 July 1999	N	N	N		N	0
2 July 1997–16 November 1997	N	Y	Y		Y	4
17 November 1997–30 April 1998	Y	Y	N		Y	3
<i>Thailand</i>						
1 January 1996–1 July 1997	N	N	N	N		0
2 July 1997–1 July 1999	Y	N	Y	N		2
2 July 1997–16 November 1997	N	N	Y	Y		2
17 November 1997–30 April 1998	Y	N	Y	N		2

Note: N = null hypothesis (no causality) was not rejected. Y = rejection of null hypothesis at the 5 percent level of significance.

Table 3.8 Daily Exchange Rate Changes: Causality Tests

	Indonesia	Malaysia	The Philippines	South Korea	Thailand	Numbers That Are Significant
<i>Indonesia</i>						
1 January 1996–1 July 1997		N	N	N	N	0
2 July 1997–1 July 1999		Y	N	Y	N	2
2 July 1997–16 November 1997		Y	N	Y	N	2
17 November 1997–30 April 1998		N	Y	Y	N	2
<i>Malaysia</i>						
1 January 1996–1 July 1997	N		N	N	N	0
2 July 1997–1 July 1999	N		N	Y	N	1
2 July 1997–16 November 1997	N		N	N	N	0
17 November 1997–30 April 1998	N		N	N	Y	1
<i>The Philippines</i>						
1 January 1996–1 July 1997	N			N	N	0
2 July 1997–1 July 1999	Y	Y		Y	Y	4
2 July 1997–16 November 1997	Y	Y		N	Y	3
17 November 1997–30 April 1998	Y	Y		Y	Y	4
<i>South Korea</i>						
1 January 1996–1 July 1997	N	N	N		N	0
2 July 1997–1 July 1999	Y	N	N		Y	2
2 July 1997–16 November 1997	Y	Y	N		N	2
17 November 1997–30 April 1998	Y	Y	Y		Y	4
<i>Thailand</i>						
1 January 1996–1 July 1997	N	N	N	N		0
2 July 1997–1 July 1999	Y	Y	N	Y		3
2 July 1997–16 November 1997	Y	Y	Y	Y		4
17 November 1997–30 April 1998	Y	N	N	Y		2

Note: See table 3.7 note for explanation of N and Y.

other countries emerges from this exercise—not even in the earlier stages of the crisis. For the period 2 July 1997–16 November 1997, there is causality from Thailand to Indonesia and South Korea but not to the Philippines or Malaysia. Indeed, as the crisis progresses causal relationships among the countries most often go both ways.

Turning to the patterns that emerge from performing the same exercise on daily exchange rate changes, there are important similarities with the results for interest rates. First, for the precrisis sample none of the regressors (other than lags of the dependent variable) are statistically significant at standard confidence levels—as was the case for interest rates. Second, during the post-crisis period there is a much greater degree of interdependence among the exchange rates of the five countries—even greater than that exhibited by interest rates.

Third, exchange rates in the two smaller countries in the group, the Philippines and Thailand, are the most influenced by exchange rate developments elsewhere in the region. In the case of the Philippines, all four exchange rates (baht, ringgit, rupiah, and won) are statistically significant in the regressions; for Thailand, nearly all. This may be consistent with evidence of “large neighbor effects” on capital flow movements.¹³ Fourth, changes in the Korean won (South Korea is the largest country of this group) significantly influence the remaining four currencies in the post-crisis period.

Taken together, these results suggest that interdependence among currencies and interest rates among these five Asian economies has increased in the wake of the financial crisis. Given that trade and financial linkages have not changed markedly during this recent period, one interpretation for this greater interdependence is that, in the aftermath of the crisis, financial market participants are more likely to lump these economies into one group than they were previously.

3.5 Thoughts on Further Research

This paper has suggested that financial sector links have played an increasingly important role in the 1990s in transmitting disturbances across national boundaries. Many of the channels of transmission (i.e., cross-market hedges) and many of the agents (i.e., hedge funds and mutual funds) are still relatively novel, particularly in the context of emerging market finance. As such, these potential channels of interdependence merit much closer scrutiny at both the theoretical and empirical dimensions. Microeconomic data at the institutional level are certainly bound to increase our understanding of the role played by capital markets and their new instruments in an increasingly globalized environment.

13. See Calvo and Reinhart (1998) for applications to Latin America.

In addition, while banks in financial centers have a long history of lending to the developing world and booms and busts in such lending are not a new phenomenon, banks' lending strategies and decisions are still not well understood. Foreign banks' lending practices may be a source of instability to emerging markets when the shock originates at the center, as it did with the sharp rise in U.S. interest rates in October 1979, or when the shock originates in the difficulties faced by a relatively small borrower (i.e., Thailand) to whom the banks have substantial exposure. To gain insights into this phenomenon, it is necessary to go beyond the aggregate macroeconomic data and analyze the response of individual bank balance sheets and lending decisions to the kinds of shocks discussed in this paper. This analysis is not only useful for better understanding past booms and busts in foreign lending—it is of increasing relevance in anticipating future ones. Indeed, given the trend in many emerging markets toward greater openness in their financial sectors and a rising presence of foreign or “truly international” banks, the issue of what role these banks play in transmitting disturbances across borders is of increasing relevance.

Appendix

Causality Tests

Table 3A.1 Daily Interest Rates, 1 January 1996–1 July 1997

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		0.82 (0.61)	0.15 (0.99)	0.51 (0.88)	0.09 (0.99)
Log-likelihood		9.33 (0.50)	1.77 (0.99)	5.79 (0.83)	1.03 (0.99)
Malaysia					
<i>f</i> -statistic	1.02 (0.43)		0.45 (0.92)	1.25 (0.26)	0.78 (0.64)
Log-likelihood	11.54 (0.32)		5.13 (0.88)	14.10 (0.17)	8.92 (0.54)
The Philippines					
<i>f</i> -statistic	1.31 (0.22)	0.45 (0.92)		0.70 (0.73)	0.55 (0.85)
Log-likelihood	14.73 (0.14)	5.18 (0.88)		7.96 (0.63)	6.30 (0.79)
South Korea					
<i>f</i> -statistic	0.69 (0.73)	1.15 (0.32)	1.23 (0.26)		0.43 (0.93)
Log-likelihood	7.87 (0.64)	13.04 (0.22)	13.90 (0.18)		4.90 (0.90)

(continued)

Table 3A.1 (continued)

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Thailand					
<i>f</i> -statistic	0.18 (0.99)	0.57 (0.84)	0.46 (0.92)	1.09 (0.37)	
Log-likelihood	2.02 (0.99)	6.49 (0.77)	5.20 (0.88)	12.31 (0.26)	

Notes: Number of observations = 392. Probability numbers in parentheses.

Table 3A.2 Daily Interest Rates, 2 July 1997–1 July 1999

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		0.37 (0.95)	2.44 (0.01)**	0.38 (0.95)	2.34 (0.01)**
Log-likelihood		4.36 (0.93)	27.64 (0.00)**	4.47 (0.92)	26.49 (0.00)**
Malaysia					
<i>f</i> -statistic	0.48 (0.90)		0.68 (0.74)	0.23 (0.99)	0.82 (0.61)
Log-likelihood	5.65 (0.84)		7.97 (0.63)	2.74 (0.99)	9.52 (0.48)
The Philippines					
<i>f</i> -statistic	1.49 (0.14)	1.24 (0.26)		0.71 (0.71)	1.61 (0.10)**
Log-likelihood	17.09 (0.07)*	14.36 (0.16)		8.29 (0.60)	18.46 (0.05)**
South Korea					
<i>f</i> -statistic	0.38 (0.95)	0.30 (0.98)	0.22 (0.99)		0.30 (0.98)
Log-likelihood	4.49 (0.92)	3.57 (0.96)	2.63 (0.98)		3.51 (0.97)
Thailand					
<i>f</i> -statistic	3.12 (0.00)**	0.58 (0.83)	2.19 (0.02)**	0.43 (0.93)	
Log-likelihood	34.93 (0.00)**	6.80 (0.74)	24.91 (0.01)**	5.09 (0.88)	

Notes: Number of observations = 334. Probability numbers in parentheses.

**Significant at 5 percent confidence level.

*Significant at 10 percent confidence level.

Table 3A.3 Daily Interest Rates, 2 July 1997–16 November 1997

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		1.06 (0.41)	0.72 (0.70)	0.48 (0.90)	1.66 (0.12)
Log-likelihood		19.71 (0.03)**	13.90 (0.18)	9.39 (0.50)	29.42 (0.00)**
Malaysia					
<i>f</i> -statistic	1.11 (0.37)		1.37 (0.22)	1.17 (0.33)	0.41 (0.93)
Log-likelihood	20.68 (0.02)**		24.78 (0.01)**	21.28 (0.02)**	8.19 (0.48)
The Philippines					
<i>f</i> -statistic	0.61 (0.80)	1.52 (0.16)		0.46 (0.91)	0.77 (0.66)
Log-likelihood	11.79 (0.30)	27.27 (0.00)**		9.11 (0.52)	14.66 (0.15)
South Korea					
<i>f</i> -statistic	1.49 (0.17)	1.59 (0.14)	1.40 (0.21)		1.10 (0.38)
Log-likelihood	29.69 (0.00)**	28.30 (0.00)**	25.37 (0.01)**		20.36 (0.03)**
Thailand					
<i>f</i> -statistic	0.79 (0.64)	0.64 (0.77)	1.68 (0.11)	1.73 (0.10)*	
Log-likelihood	15.02 (0.13)	12.35 (0.26)	29.78 (0.00)**	30.44 (0.00)**	

Notes: Number of observations = 99. Probability numbers in parentheses.

**Significant at 5 percent confidence level.

*Significant at 10 percent confidence level.

Table 3A.4 Daily Interest Rates, 17 November 1997–30 April 1998

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		0.47 (0.90)	1.71 (0.10)*	1.31 (0.24)	1.84 (0.07)*
Log-likelihood		8.01 (0.63)	26.65 (0.00)**	20.95 (0.02)**	28.55 (0.00)**
Malaysia					
<i>f</i> -statistic	0.47 (0.90)		0.19 (0.99)	1.19 (0.32)	1.18 (0.32)
Log-likelihood	7.93 (0.64)		3.23 (0.97)	19.12 (0.04)**	18.99 (0.04)**

(continued)

Table 3A.4 (continued)

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
The Philippines					
<i>f</i> -statistic	1.17 (0.33)	1.34 (0.22)		1.08 (0.39)	1.04 (0.42)
Log-likelihood	18.92 (0.04)**	21.34 (0.02)**		17.62 (0.06)*	17.00 (0.07)*
South Korea					
<i>f</i> -statistic	3.72 (0.00)**	1.17 (0.33)	1.06 (0.41)		1.58 (0.13)
Log-likelihood	51.99 (0.00)**	18.89 (0.04)**	17.20 (0.07)*		24.84 (0.01)**
Thailand					
<i>f</i> -statistic	2.49 (0.01)**	0.57 (0.83)	1.52 (0.15)	1.13 (0.35)	
Log-likelihood	37.11 (0.00)**	9.65 (0.47)	23.94 (0.01)**	18.281 (0.05)**	

Notes: Number of observations = 119. Probability numbers in parentheses.

**Significant at 5 percent confidence level.

*Significant at 10 percent confidence level.

Table 3A.5 Daily Exchange Rate Changes, 1 January 1996–1 July 1997

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		0.71 (0.71)	0.50 (0.89)	0.51 (0.88)	0.71 (0.71)
Log-likelihood		8.03 (0.63)	5.71 (0.84)	5.83 (0.83)	8.13 (0.62)
Malaysia					
<i>f</i> -statistic	1.38 (0.19)		0.58 (0.83)	0.83 (0.60)	0.68 (0.74)
Log-likelihood	15.54 (0.11)		6.65 (0.76)	9.38 (0.50)	7.74 (0.65)
The Philippines					
<i>f</i> -statistic	1.11 (0.35)	0.93 (0.50)		0.89 (0.54)	1.54 (0.12)
Log-likelihood	12.58 (0.25)	10.55 (0.39)		10.11 (0.43)	17.36 (0.07)*
South Korea					
<i>f</i> -statistic	0.48 (0.90)	0.78 (0.64)	0.97 (0.46)		0.45 (0.92)
Log-likelihood	5.52 (0.85)	8.90 (0.54)	11.01 (0.36)		5.16 (0.88)
Thailand					
<i>f</i> -statistic	0.17 (0.99)	0.73 (0.70)	1.41 (0.17)	0.93 (0.51)	
Log-likelihood	1.91 (0.99)	8.29 (0.60)	15.86 (0.10)*	10.47 (0.40)	

Notes: Number of observations = 392. Probability numbers in parentheses.

*Significant at 10 percent confidence level.

Table 3A.6 Daily Exchange Rate Changes, 2 July 1997–1 July 1999

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		1.95 (0.04)**	1.07 (0.39)	3.19 (0.00)**	0.85 (0.59)
Log-likelihood		21.22 (0.02)**	11.67 (0.31)	34.17 (0.00)**	9.29 (0.51)
Malaysia					
<i>f</i> -statistic	1.09 (0.37)		1.08 (0.38)	1.89 (0.04)**	1.27 (0.25)
Log-likelihood	11.98 (0.29)		11.83 (0.30)	20.57 (0.02)**	13.85 (0.18)
The Philippines					
<i>f</i> -statistic	1.74 (0.07)*	2.79 (0.00)**		4.07 (0.00)**	3.18 (0.00)**
Log-likelihood	18.94 (0.04)**	30.00 (0.00)**		43.22 (0.00)**	34.08 (0.00)**
South Korea					
<i>f</i> -statistic	1.87 (0.05)**	1.36 (0.19)	0.97 (0.47)		0.45 (0.92)
Log-likelihood	20.28 (0.03)**	14.85 (0.14)	11.01 (0.36)		5.16 (0.88)
Thailand					
<i>f</i> -statistic	3.58 (0.00)**	3.03 (0.00)**	1.41 (0.17)	3.62 (0.00)**	
Log-likelihood	38.24 (0.00)**	32.57 (0.00)**	15.42 (0.12)	38.68 (0.00)**	

Notes: Number of observations = 334. Probability numbers in parentheses.

**Significant at 5 percent confidence level.

*Significant at 10 percent confidence level.

Table 3A.7 Daily Exchange Rate Changes, 2 July 1997–16 November 1997

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		1.11 (0.38)	0.76 (0.66)	1.67 (0.12)	0.83 (0.61)
Log-likelihood		20.53 (0.02)**	14.61 (0.15)	29.56 (0.01)**	15.71 (0.11)
Malaysia					
<i>f</i> -statistic	0.49 (0.89)		0.25 (0.99)	0.57 (0.83)	0.53 (0.86)
Log-likelihood	9.64 (0.47)		5.00 (0.89)	11.06 (0.35)	10.34 (0.41)
The Philippines					
<i>f</i> -statistic	1.13 (0.35)	1.66 (0.12)		0.66 (0.75)	4.06 (0.00)**
Log-likelihood	20.99 (0.02)**	29.47 (0.00)**		12.80 (0.23)	60.63 (0.00)**

(continued)

Table 3A.7 (continued)

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
South Korea					
<i>f</i> -statistic	2.15 (0.04)**	1.93 (0.06)	0.97 (0.49)		0.62 (0.79)
Log-likelihood	36.67 (0.00)**	33.51 (0.00)**	18.14 (0.05)**		12.00 (0.29)
Thailand					
<i>f</i> -statistic	1.87 (0.07)*	1.59 (0.14)	1.29 (0.26)	2.17 (0.04)**	
Log-likelihood	32.5 (0.00)**	28.31 (0.02)**	23.63 (0.01)**	36.96 (0.00)**	

Notes: Number of observations = 99. Probability numbers in parentheses.

**Significant at 5 percent confidence level.

*Significant at 10 percent confidence level.

Table 3A.8 Daily Exchange Rate Changes, 17 November 1997–30 April 1998

	Indonesia	Malaysia	The Philippines	South Korea	Thailand
Indonesia					
<i>f</i> -statistic		0.77 (0.66)	1.28 (0.26)	1.44 (0.18)	0.53 (0.87)
Log-likelihood		12.71 (0.24)	20.51 (0.02)**	22.84 (0.01)**	8.88 (0.54)
Malaysia					
<i>f</i> -statistic	0.75 (0.68)		0.38 (0.95)	0.57 (0.83)	1.24 (0.28)
Log-likelihood	12.45 (0.26)		6.54 (0.77)	9.62 (0.47)	19.88 (0.03)**
The Philippines					
<i>f</i> -statistic	2.58 (0.01)**	2.62 (0.01)**		2.19 (0.03)**	1.24 (0.28)
Log-likelihood	38.22 (0.00)**	38.82 (0.00)**		33.16 (0.00)**	19.90 (0.03)**
South Korea					
<i>f</i> -statistic	1.99 (0.05)**	1.43 (0.19)	1.94 (0.05)**		2.93 (0.00)**
Log-likelihood	30.48 (0.00)**	22.65 (0.01)**	29.90 (0.00)**		42.67 (0.00)**
Thailand					
<i>f</i> -statistic	1.40 (0.20)	0.82 (0.61)	0.75 (0.68)	1.36 (0.22)	
Log-likelihood	22.25 (0.01)**	13.57 (0.19)	12.42 (0.26)	21.68 (0.02)**	

Notes: Number of observations = 119. Probability numbers in parentheses.

**Significant at 5 percent confidence level.

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Comment Eiji Ogawa

Kaminsky and Reinhart's paper empirically analyzes whether financial sector links via common bank lenders form a powerful channel for funda-

mentals-based contagion. They achieve an interesting result, that the performance of bank links better explained the contagion effects than did third-party trade links, bilateral links, high-correlation cluster, or a global crisis elsewhere. They conclude that foreign banks' behavior exacerbated the original crisis by calling in loans in countries where the banks had exposure. They also point out that Japanese banks played an important role in the Asian crisis of 1997.

I have three comments on their paper, placing a focus on the use of bank links to explain the contagion effects.

First, if we focus on foreign banks' presence in Asian loan markets, we should also watch European banks' behavior in those countries. Figure 3C.1 shows stocks of bank loans to the Asian countries. European banks have a relatively larger share in the loan markets of those countries (except for Thailand), although Japanese banks have a relatively larger share in Thailand's loan market.

Second, banks do not always call in loans from countries where they have exposure. We should observe banks' loan-calling behavior by looking at the decrease in bank loans rather than at stocks of bank loans. It is certain that Japanese banks had a relatively large share in the stocks of bank loans to the Asian countries except for the Philippines. Figure 3C.2 shows flows of bank loans to these countries. Japanese banks have had a relatively large share in decreases in bank loans to Thailand since the second half of 1997. However, Japanese banks had a small share in decreases in bank loans to Korea and the Philippines, and not a very large share in decreases in bank loans to Indonesia and Malaysia. Thus, Japanese banks did not seem substantially to draw back loans from the Asian countries (except for Thailand) after the currency crisis.

Third, we should watch the capital inflows to these countries *before* the currency crises because it has been pointed out that excess capital inflows to countries with fragile banking systems brought about the severe currency and banking crises. In the Asian countries, the asset price bubbles ended by early 1994; consequently, Asian banks seemed to have built up nonperforming loans since 1994. Part of the cause of the crises was that foreign banks gave excess loans to Asian banks that had too many nonperforming loans during the 1994–97 period. Figure 3C.2 shows that European banks made relatively larger contributions to increases in bank loans to these countries (except for Thailand) during the precrisis period.

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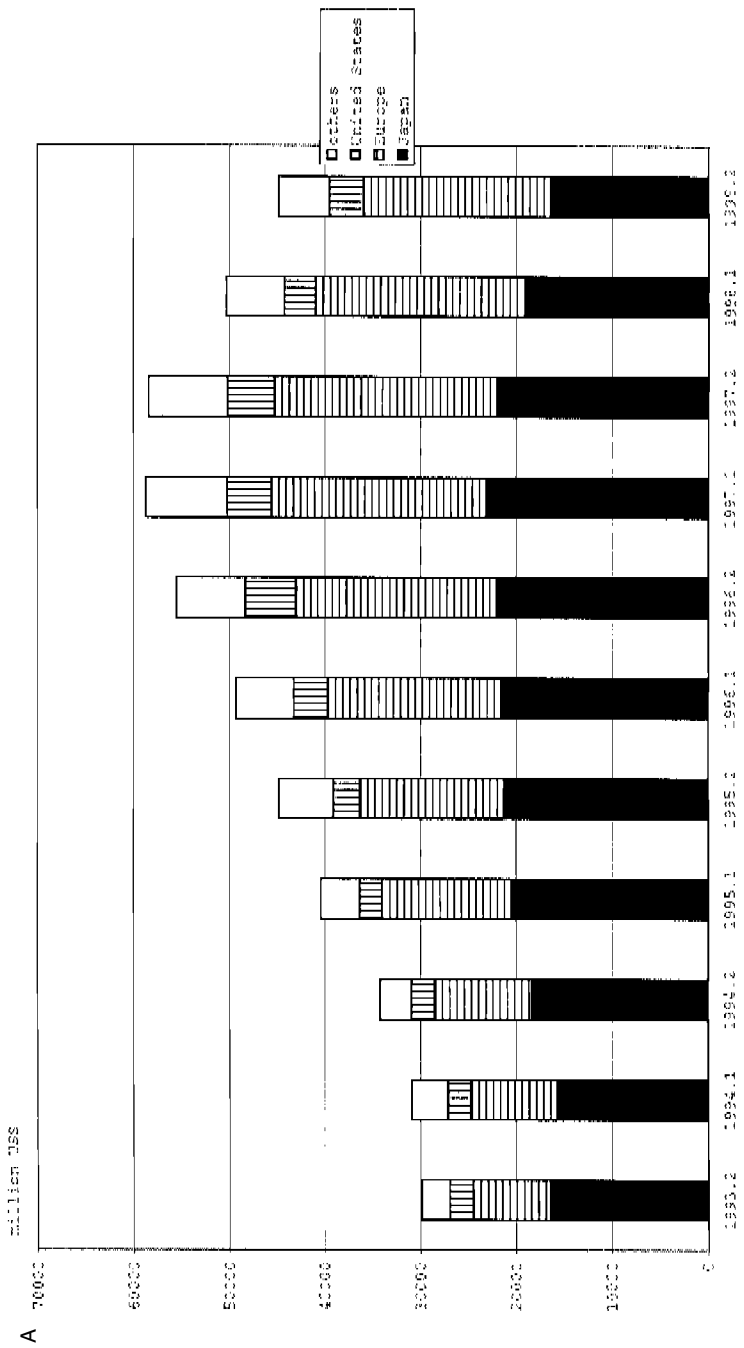


Fig. 3C.1 Stocks of bank loans: *A*, Indonesia; *B*, South Korea; *C*, Malaysia; *D*, the Philippines; *E*, Thailand
Source: Bank for International Settlements (BIS), various issues.

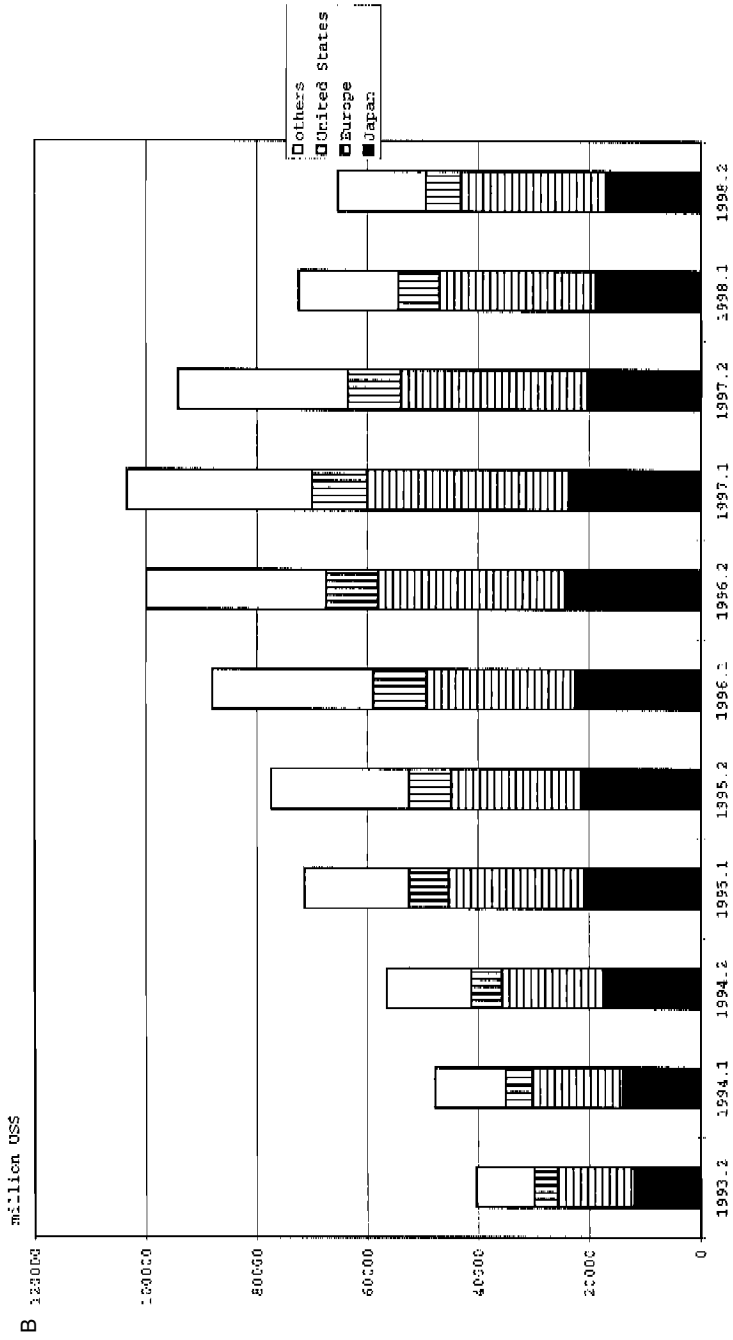


Fig. 3C.1 (cont.)

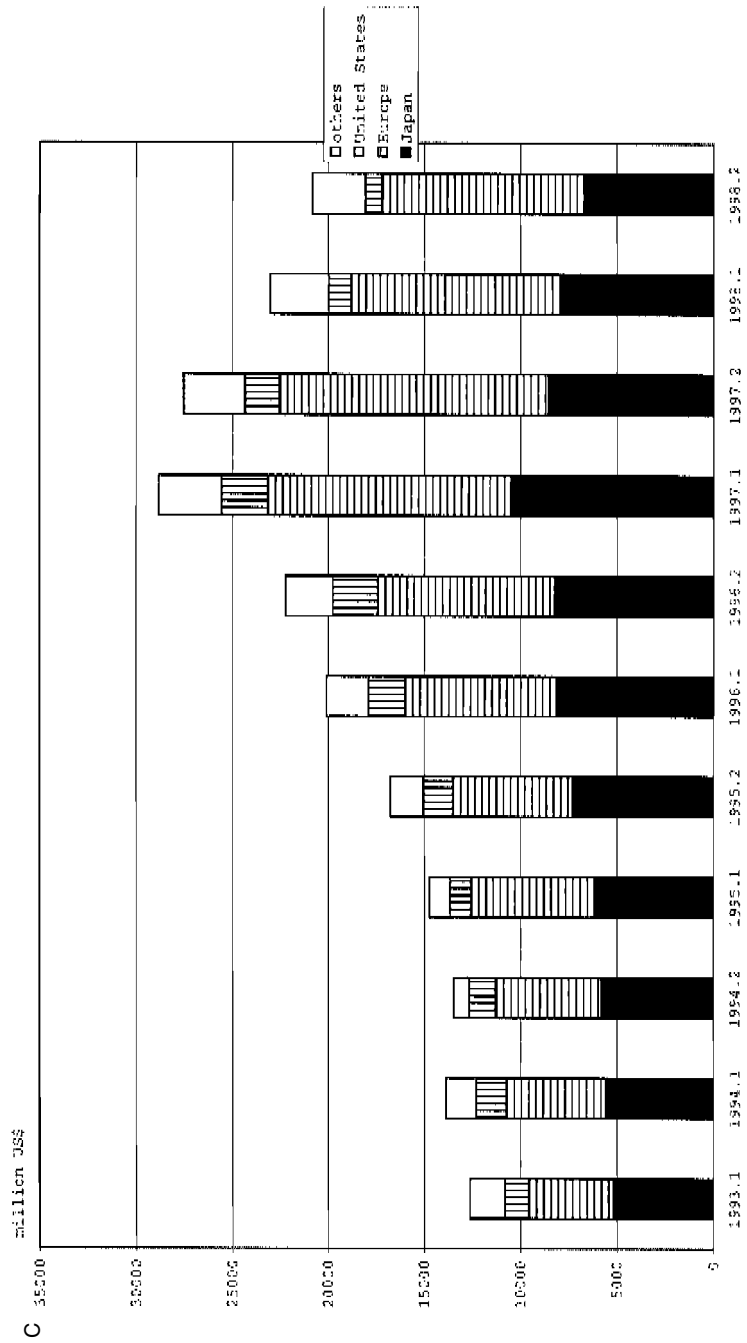


Fig. 3C.1 (cont.)

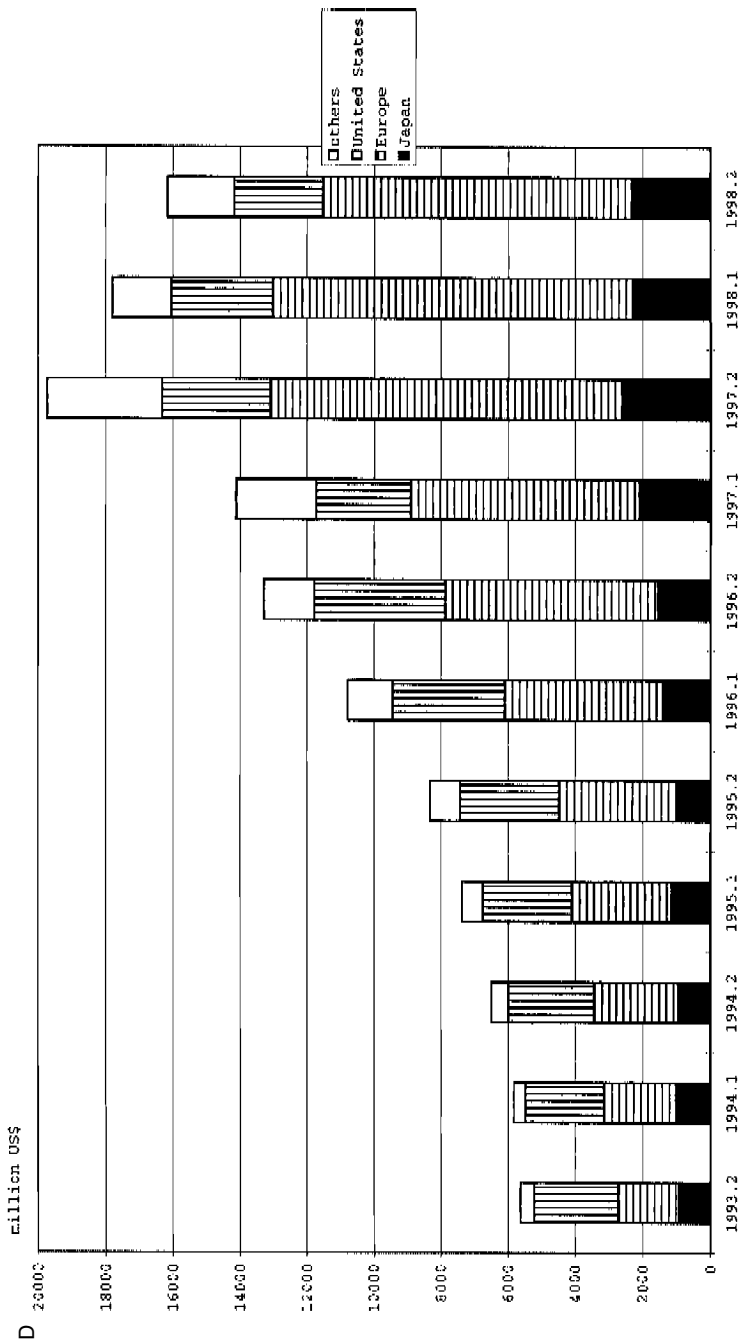


Fig. 3C.1 (cont.)

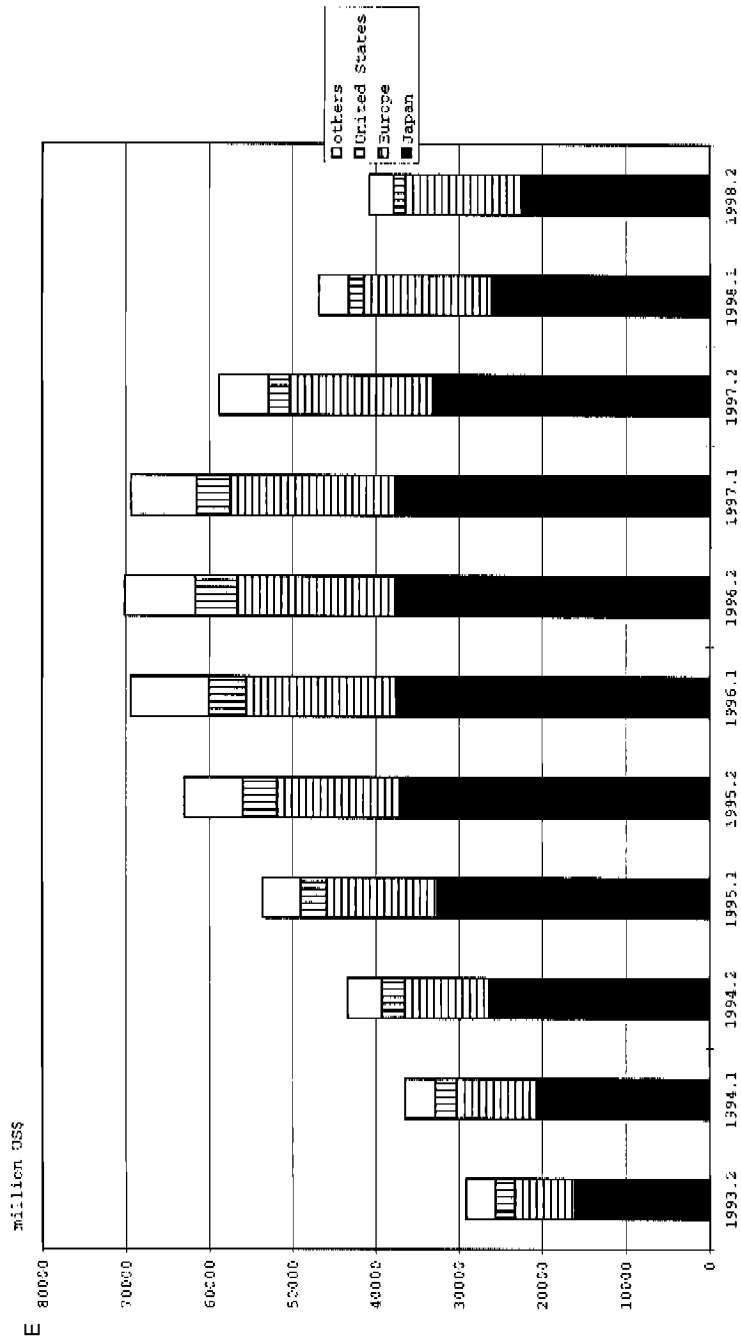


Fig. 3C.1 (cont.)

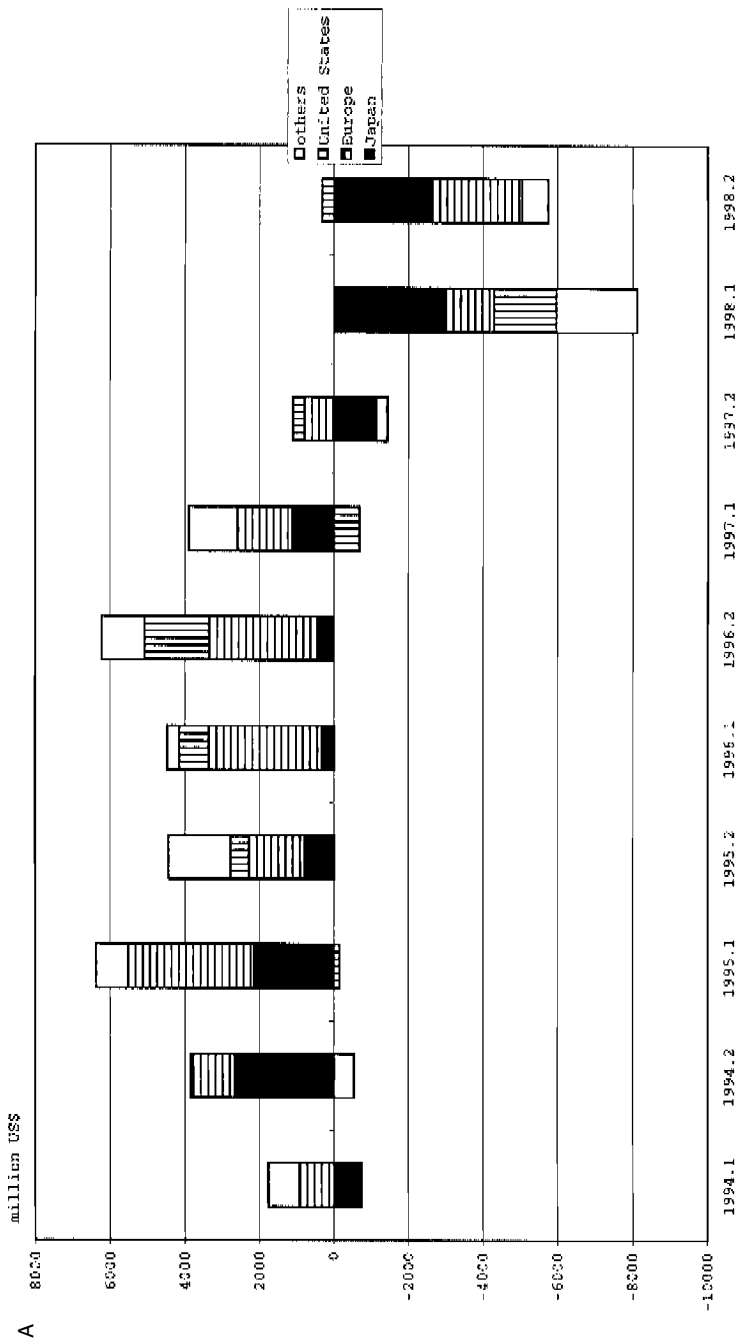


Fig. 3C.2 Flows of bank loans: *A*, Indonesia; *B*, South Korea; *C*, Malaysia; *D*, the Philippines; *E*, Thailand
Source: BIS, various issues.

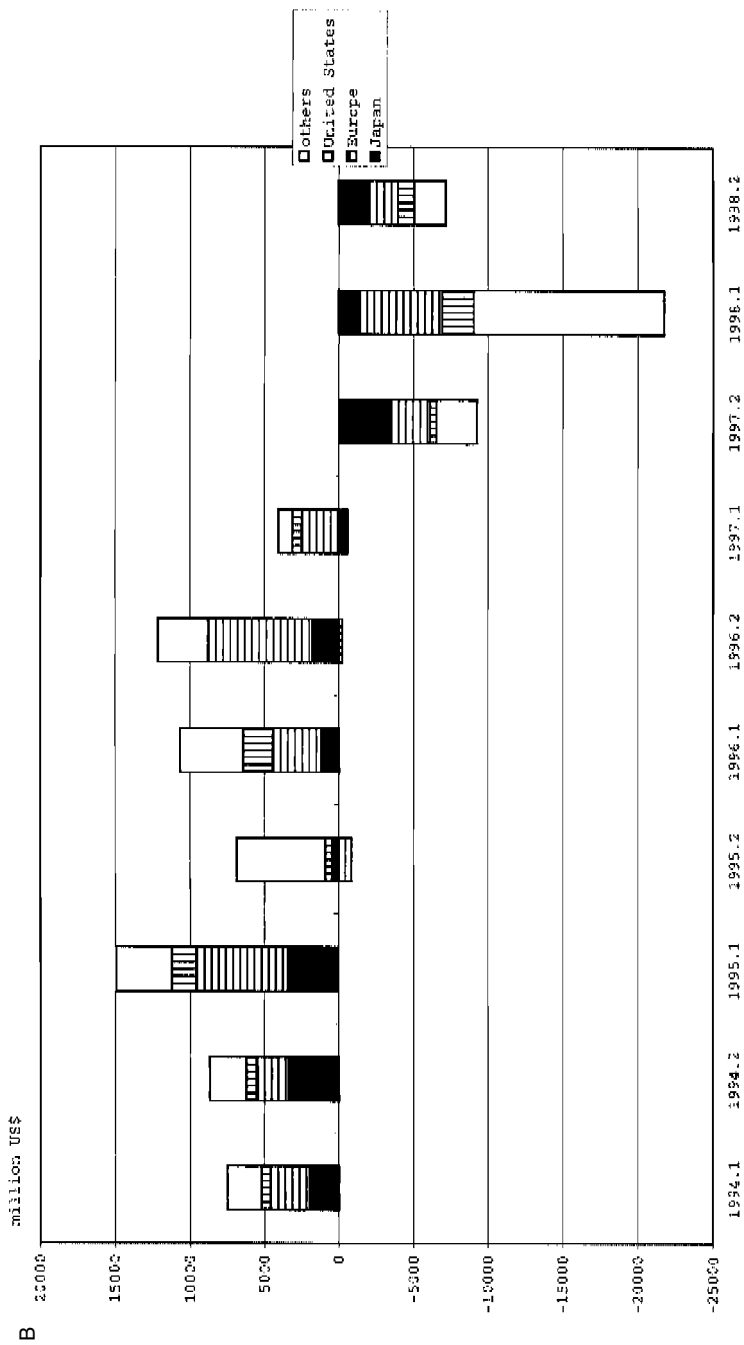


Fig. 3C.2 (cont.)

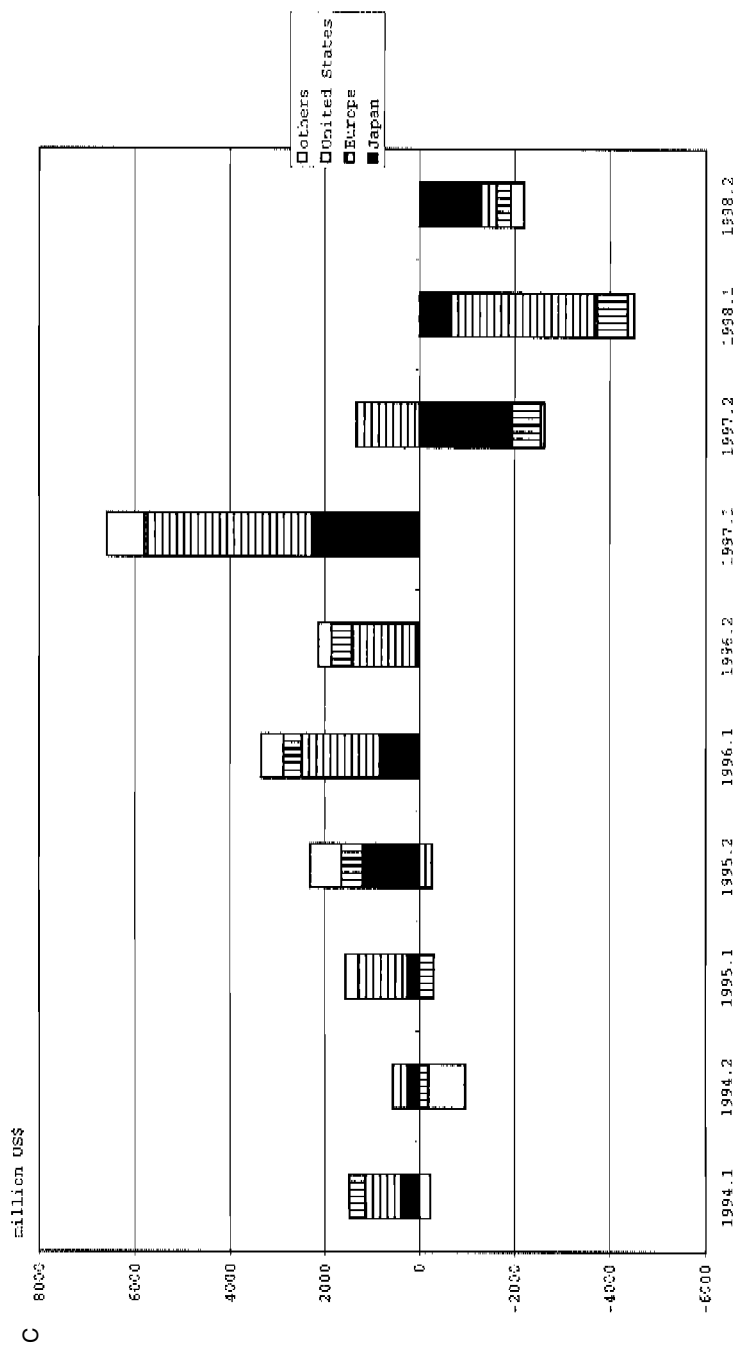


Fig. 3C.2 (cont.)

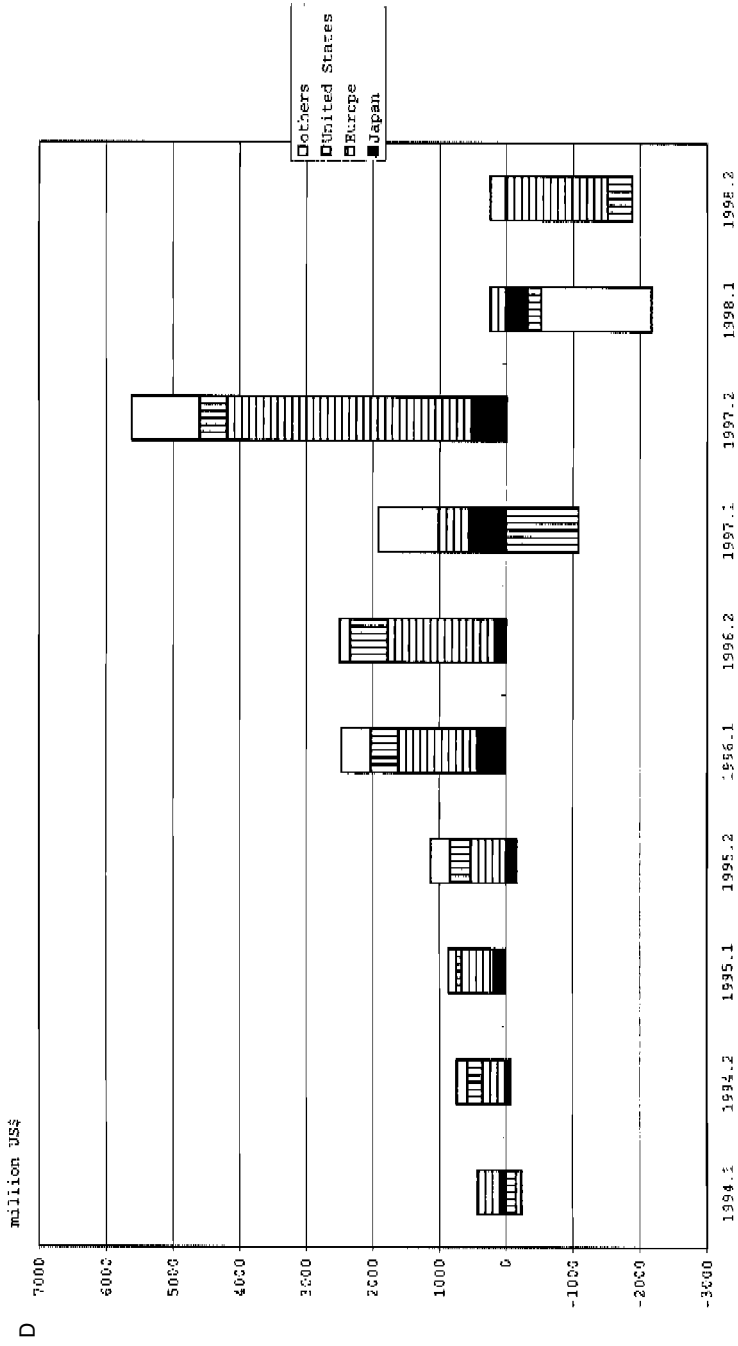


Fig. 3C.2 (cont.)

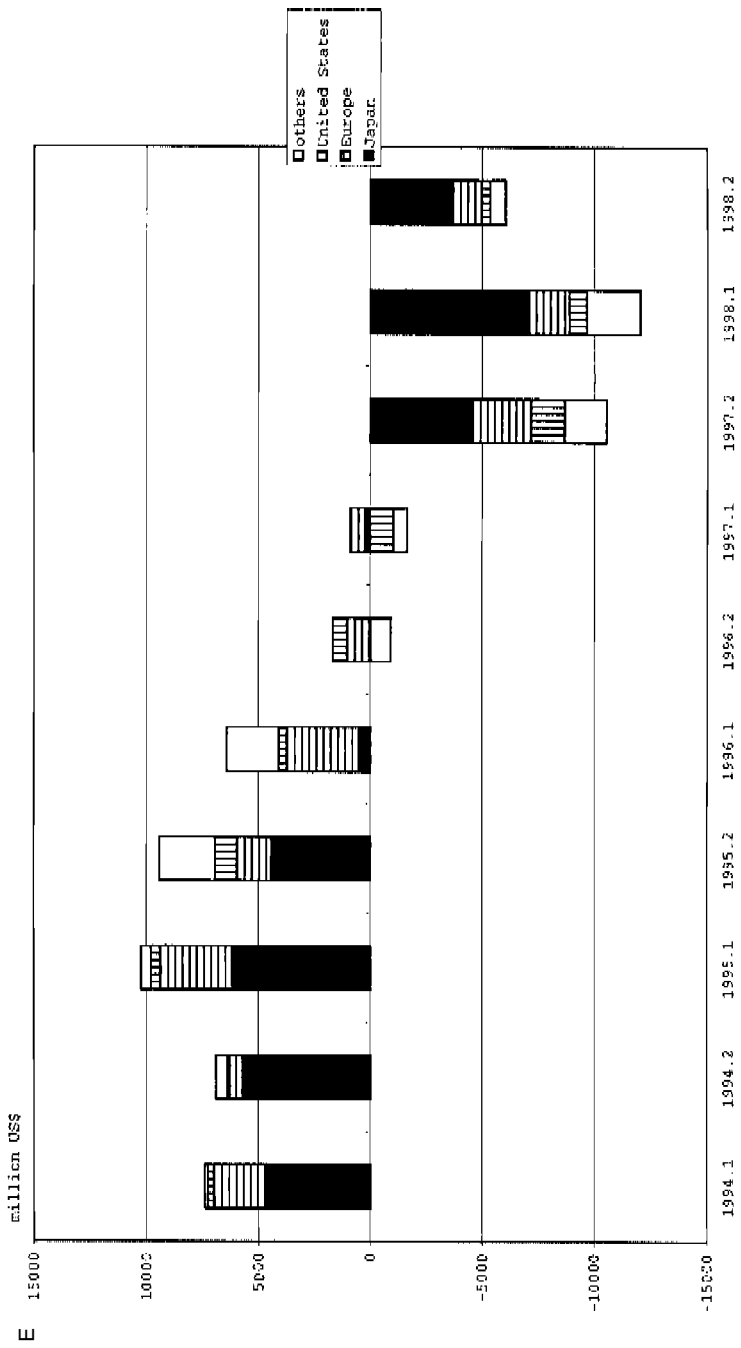


Fig. 3C.2 (cont.)

Comment Mahani Zainal-Abidin

This paper is another contribution to the growing literature on contagion from economic and financial crises. Previous studies on the East Asian crisis have examined the causes of the crisis, but this paper has opened a new horizon—namely, a vulnerability index. This identifies the links that give rise to vulnerability and thus contagion. Exposure to a common bank is one of the channels in which the disturbances arising from a crisis are transmitted; other channels of transmission are trade and financial links. The role of a common bank lender was painfully clear in the Latin American crises, where U.S. banks' presence was almost omnipotent. Subsequent stabilization hinged on rescheduling these loans. The presence of a common lender in East Asian economies is a more recent phenomenon and this paper defines how much or how little foreign banks have to do with contagion. Another aspect of contagion that the paper examines is the interdependence or pattern of causality among the affected countries. It refers to the daily pattern of interest and exchange rates among the affected East Asian countries and confirms that there was a strong interdependence among most of these countries in the full post-crisis period.

The vulnerability index developed by this paper shows that (in descending probability) Malaysia, South Korea, Indonesia, and the Philippines are exposed to Thailand, the "initiator" of the crisis. This index is an improvement on earlier indicators of linkages, which were based mainly on trade and financial relationships, because it captures the third transmission channel and ranks each country's vulnerability. However, as acknowledged by the authors, this index is unable to predict the severity of the contagion effects. Moreover, the vulnerability ranking does not follow the actual sequence in which the countries were affected last time. For example, although Malaysia's ranking is higher than Indonesia's (meaning that Malaysia is more vulnerable to a crisis in Thailand), in actuality, Malaysia experienced a deep economic contraction much later than did Indonesia, namely in the first quarter of 1998.

The efficacy of the vulnerability index in explaining the transmission outcome and the role of a common bank lender can perhaps be improved by taking into account the following.

Ratio of Foreign Borrowing to Total Loan Exposure

In identifying whether a country belongs to a common bank cluster, the paper classifies the foreign liability of Indonesia, Malaysia, the Philippines, South Korea, and Thailand according to its source—Japan, Europe, or the United States. However, the impact of recall of loans by foreign

banks depends in the first instance on the relative exposure of each country to foreign bank loans. Among the affected East Asian countries, Malaysia has the smallest percentage of foreign borrowings. For example, as at end of June 1997, Malaysia's short-term external debt was 11.2 percent of its total borrowing, while for South Korea it was 67.5 percent, for Thailand, 45.7 percent, and for Indonesia, 34.2 percent (Raghavan 1998). This was because of the Malaysian policy that only companies with foreign income capability can borrow overseas. Thus, the recall of funds by foreign banks in Malaysia had relatively little effect.

The Role of Foreign Bank Withdrawals in Transmitting the Effects of the Crisis

Bank loan recalls are arguably less damaging than the other two effects in finance and trade because banks are unlikely to trigger a massive capital outflow from borrowing countries. The crisis usually unfolds in stages. During the first stage, there is interaction among portfolio investment, local equity market, and domestic banks. An event triggers portfolio outflows and causes a sharp decline in the equity market. Then local banks become vulnerable either because they have extended financing to purchase overvalued shares or because shares have been used as collateral for loans. Interest rates are raised to support the exchange rate and banks begin to trim their loans. In the second stage, the domestic financial system faces a liquidity crunch and this massively hits all other parts of the national economy. Foreign banks reduce their exposure to such a troubled economy, which exacerbates the matter.

Foreign banks are not leaders in contagion because, as shown above, they are not in the first stage. Furthermore, they may not be able to liquidate their positions easily. To recall a loan is more difficult than to repatriate short-term capital or trade flows. Bank loans are very frequently invested in tangible assets such as buildings, machinery, and equipment. In East Asian countries, the proceeds from foreign loans during their high growth period (1990–97) were directed mainly to roads, energy plants, and property development. The only immediately available action is to revoke those few loans not yet disbursed. Thus, in view of these different sequences and speeds of transmission among the three channels, the index would be useful as a predicative tool, provided that appropriate weights were assigned to the three channels.

Exposure to European Banks as a Common Lender

The paper has shown that East Asian economies borrowed heavily from both Japanese and European banks. In Indonesia, Malaysia, the Philippines, and South Korea, the exposure to European banks in June 1998 was much larger than for Japanese banks. Thailand was the exception. The withdrawal pattern of the two bank blocs was also different—the Japanese

withdrew first, from the middle of 1997, whereas Europeans did not begin until the first half of 1998 and their percentage of withdrawal was larger. Thus, Europe should be considered a separate cluster.

Investment Component of the Index

The index consists of trade and financial links and exposure to a common lender. Perhaps the analysis on regional economic links can be extended to investment relationships as a channel for contagion. The development experience of the Southeast Asian region demonstrates the role of foreign direct investment (FDI) in linking these economies through an integrated production chain. For example Japanese multinational companies have strings of production units in different countries of the Association of Southeast Asian Nations (ASEAN), each producing one part of the production chain. Nonmultinational regional investment is also substantial; for example, Singapore has significant investments in Malaysia and Indonesia. With close investment links, a crisis in one country may quickly affect production in another, the most obvious reasons being shortage of fresh capital and lower demand. In an integrated FDI production network, an external factor, say, low demand as a result of any unrelated event outside the region, can reduce the production of the entire network. Since the early 1990s, South Korea has been a major investor in ASEAN, and when the latter's economy contracted, a number of Korean companies in the region scaled down their operations.

Interdependence Test Results

The results of the interdependence test prompt a question: Why was the interdependence, as instanced by similarities in trends in interest rates and exchange rates, seen during the crisis and not before? An explanation is that the crisis forced the affected countries to adopt similar monetary and exchange rate policies. Countries floated their exchange rates and since their economies were already closely linked, a similar impact across the border was not unexpected. A more convincing explanation is that Thailand, South Korea, and Indonesia followed closely a set of conditionalities when they received assistance from the International Monetary Fund (IMF). Another explanation is that investors viewed the affected region as a single entity. Delay in times of crisis can be costly and investors used information about one country as a surrogate for all countries in the region.

The finding from the interdependence test that causality extended from Thailand to Indonesia and South Korea but not to the Philippines or Malaysia (during the period 2 July 1997 to 16 November 1997) should be compared with earlier estimates of the vulnerability index. According to that index, Malaysia is the most vulnerable to a crisis originating from Thailand, followed by South Korea, Indonesia, and the Philippines. Thus a

relationship defined solely on financial channels (the causality result using interest and exchange rates) can give a different picture from one constructed using broader criteria (the vulnerability index estimated from trade and financial links and exposure to a common bank lender). This supports the earlier assertion that it is essential to understand the order of events in the transmission channel. As shown by these two indicators, the financial and trade channels depict the immediate impact while the banking perspective takes place at a later stage. Nevertheless, the impact of all channels can be equally strong.

Another finding of the interdependence test is that Malaysia's interest rate was not significantly affected in the full post-crisis period, and the paper speculates that this insulation came from the introduction of selective exchange control in September 1998. Malaysia, like other affected countries, adopted a restrictive monetary policy in order to support the exchange rate during the early period of the crisis (2 July–16 November 1997). However, this was reversed to a looser monetary stance in the first quarter of 1998, and the other affected countries took a similar approach (albeit a bit later). The lowering of the interest rate did not have much effect at first, as there was still a big liquidity crunch. Thus, the policy to lower the interest rate was introduced much earlier than the selective capital control initiative.

To sum up, this paper notes that many emerging economies are moving toward greater financial sector liberalization and that foreign banks have an increasing presence. This had serious implications, as seen during the East Asian crisis. Financial liberalization has woven regional economies together irrevocably. No member of the group or cluster can be fully immune from the afflictions of its neighbors. The financial sector liberalization has increased the emerging economies' capability to attract capital to finance growth. During the crisis, the two most obvious clusters were those based on equity markets (portfolio flows) and monetary policy (interest rates). Another indicator of the existence of a cluster is the interest rate spread of bonds, which are the closest surrogate for a state's sovereign risk. As shown by this paper, a country is more vulnerable to the problems of other members of the same cluster and is less exposed to crises in other clusters. Financial liberalization may well encourage the widening of a cluster as more economies become integrated. Eventually, will all clusters combine to form a single global group? If so, does financial liberalization lead to frequent crises and less immunity from contagious events?

As they recover from their respective crises, the affected East Asian countries are under pressure to open their doors to foreign banks. Among the reasons given are that domestic banks are too close to some selected customers, that they are not prudently managed, and that they need fresh injections of funds to replenish their depleted capital. These criticisms are not totally incorrect, but foreign banks are not blameless, either. They lent

aggressively during the boom, especially in overinvested sectors such as property and infrastructure. There have been calls to “bail-in” (that is, to share the burden of the crisis) foreign banks to encourage them to be more prudent in the future. Another concern about a large presence of foreign banks is that in times of a crisis, a government or central bank is likely to have more persuasive power over domestic banks than foreign banks. The evidence provided by this paper on the role of foreign banks in a crisis is a vital lesson for emerging economies to bear in mind when facing the challenges posed by financial liberalization.

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