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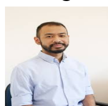
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2 INSTRUCTORS MANUAL: *FOUNDATIONS OF MULTINATIONAL FINANCIAL MANAGEMENT*, 6TH ED.

domestic economic policies are unstable, exchange rates will be volatile as traders react to new information.

SUGGESTED ANSWERS TO "ASIAN CURRENCIES SINK IN 1997"

1. What were the origins of the Asian currency crisis?

ANSWER. The case suggests several causes of the Asian currency crisis. First was the loss of export competitiveness. A number of Asian countries had tied their currencies to the dollar, so the dramatic appreciation of the dollar against the yen, Deutsche mark, and other currencies made their exports less price competitive. Their competitiveness problem was exacerbated by the fact that during this period, the Chinese yuan depreciated by about 25% against the dollar. A second contributing factor to Asia's financial problems was moral hazard – the tendency to incur risks that one is protected against. Specifically, most Asian banks and finance companies operated with implicit or explicit government guarantees. When combined with poor regulation, these guarantees distorted investment decisions, encouraging financial institutions to fund risky projects in the expectation that the banks would enjoy any profits, while sticking the government with any losses. Without market discipline or risk-based bank lending, the result was overinvestment – financed by vast quantities of debt – and inflated prices of assets in short supply, such as land. The Asian financial crisis then was touched off when local investors began dumping their own currencies for dollars and foreign lenders refused to renew their loans to Asian companies and banks.

2. What role did expectations play in the Asian currency crisis?

ANSWER. Expectations were critical in causing the financial bubble and then popping it. Specifically, the Asian financial bubble persisted as long as people believed the government could honor its implicit guarantee. However, this guarantee brought with it the seeds of its own demise as inevitable glut of real estate and excess production capacity lead to large amounts of nonperforming loans and widespread loan defaults. When reality struck and investors realized that the government didn't have the resources to bail out everyone, asset values plummeted and the bubble burst. The decline in asset values triggered further loan defaults, causing a loss of the confidence on which economic activity depended. Investors also worried that the government would try to inflate its way out of its difficulty. The result was a selfreinforcing downward spiral and capital flight. As foreign investors refused to renew loans and begin to sell off shares of overvalued local companies, capital flight accelerated and the local currency fell, increasing the cost of servicing foreign debts. Local firms and banks scrambled to buy foreign exchange before the currency fell further, putting even more downward pressure on the exchange rate. This story explained why stock prices and currency values declined together and why Asian financial institutions were especially hard hit. Moreover, this process was likely to be contagious, as investors searched for other countries with similar characteristics. When such a country is found, everyone rushes for the exit simultaneously and another bubble is burst, another currency is sunk. In the case of the Asian currency crisis, investors also realized that their loss of export competitiveness gave the Asian central banks a mutual incentive to devalue their currencies to try to regain their export competitiveness. According to one theory, recognizing these altered incentives, speculators attacked the East Asian currencies almost simultaneously and forced a round of devaluations.

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