THE COLLAPSE OF THE THAI BAHT AND A SIMPLE "NEW SECOND GENERATION" CURRENCY CRISIS MODEL

by

Ramkishen S. Rajan* and Iman Sugema**

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* School of Economics, University of Adelaide, Australia. E-mail: ramkishen.rajan@adelaide.edu.au (corresponding author).

** Department of Economics, Research School of Pacific and Asian Studies, Australia National University, Australia and Department of Economics, Bogor Agricultural University, Indonesia. E-mail: iman.sugema@economics.anu.edu.au.

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ABSTRACT

An important element of the Thai crisis was the sterilization of reserve outflows by the monetary authorities in an attempt to bailout fragile banks. This paper develops a "New Second Generation" currency crisis model to explore the effects of such a policy

Key words: *banks, currency crisis, East Asia, lender of last resort, Thailand*

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1. Introduction

An important characteristic of the Thai crisis of 1997, was the large-scale sterilization of reserve outflows by the monetary authorities, so as to ensure smooth growth of money supply during the crisis period (World Bank, 1999 and Table 1)[1]. The rationale for this monetary creation was due to the Bank of Thailand (BOT) acting as a lender of last resort in the face of domestic banking fragilities and the threat of an outright collapse of the banking sector (Table 2). Indeed, the provision of credit to the domestic banks and the concomitant focus on banking sector fragilities, provides a reason why activist (i.e. tight) monetary policy to defend the currency may not be a viable/preferred option. This is so, given its adverse repercussions on the banking sector and the real economy through the Keynesian aggregate demand, and the – potentially more potent - Fischerian debt deflation channels (Calvo and Reinhart, 1999)[2].

The above discussion, which hints at strategic choice of policy actions and the discretionary role of the monetary authority, implies the need to appeal to "new second-generation" (NSG) models a la Obstfeld (1996). These models have, as a common element, conscious maximization by the monetary authority of a welfare function which incorporates the tradeoffs between the costs and benefits of defending a peg under attack. Unlike the "old second-generation" models (see Obstfeld, 1986 and Dellas and Stockman, 1993), which are based on the Krugman (1979) monetary framework, there is no such canonical framework in the case of the NSG models. However, all of them do exhibit certain basic traits, which include the following:

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[1] Calvo (1996), Flood et al. (1996), Sachs et al. (1996) and others have emphasized this to have been a characteristic of the Mexican crisis of 1994-95 too.

[2] The costs of hiking interest rates is a non-negligible point, because, technically speaking, governments could defend a currency peg (by reducing the monetary base sufficiently) if they were willing to subordinate all other goals to it (Obstfeld and Rogoff, 1995).

(a) there is a reason why the government is tempted to abandon the prevailing peg[3]; (b) there is a reason why the government would like to hang on to the fixed exchange rate Thus, there is a tension between motives (a) and (b). The decision regarding the abandonment of the peg is a policy decision, as an optimizing policy-maker balances the various tradeoffs[4]; and (c) there exist two or more equilibra corresponding to various magnitudes of the post-crisis depreciation.

A popular NSG model is that used by Sachs et al (1996) and Velasco (1996), in which the government, burdened with public debt, attempts to offset adverse shocks to government revenue and inflation. Motivated by this framework, this paper aims to develop a NSG model to explore the effects of government bailout of the domestic banking system through monetary infusion. As with Chinn et al. (1999), Dooley (1998) and Flood et al. (1996) and others, it is assumed that the central bank acts as a lender of last resort in the face of an imminent domestic banking collapse.

2. The Model

The government is assumed to minimize the following single period quadratic loss function:

$$L_t = \tfrac{1}{2}(\beta\Pi_t^2 + f_t^2) + cZ, \qquad \beta > 0 \qquad (1)$$

where: Π_t is the inflation rate (which is assumed equal to the rate of devaluation by

[3] For the purposes of this paper, we make no distinction between fiscal and monetary (central banking) authorities, assuming that the 'policy maker' or 'government' is a monolithic body.

[4] More precisely, this class of models has in common, "escape clauses" a la Obstfeld (1991), in which the policy makers use discretion in the event of exceptional circumstances, otherwise they

assuming PPP); ƒ is the size of the fiscal deficit (which is policy-determined, flow variable)[5]; β is a parameter; c generically refers to the costs incurred by the government by devaluing (in terms of loss of reputation and credibility, political costs etc); and Z = 1 if Δe_t (devaluation) > 0, otherwise Z = 0. Two assumptions have been made. First, that the government only faces a cost if it devalues, but not if it revalues (the latter generally being perceived as a sign of strength by private agents). Second, that the costs of devaluation are fixed, being independent of the size of the devaluation, itself.

The resource constraint faced by the government may be written as follows:

$$bo_t + g(\Delta i^e_t) - \psi(\Pi_t - \Pi^e_t) = f_t, \qquad \psi > 0 \qquad (2)$$

where: (Δi^e_t) refers to an unexpected rise in real interest rates; Π^e_t is the rate of devaluation/inflation expected by private agents; bo_t is the size of bank bailout by government; and ψ is a parameter. Thus, the overall fiscal cost of the bank bailout in this case is equal to the sum of the existing bailout plus the increase due to an unanticipated hike in interest rates (to try and stave off the currency attack). Eq. (2) assumes that the exogenous shock takes the form of an unanticipated rise in interest rates rather than an exogenous negative shock to net tax revenue as in Sachs et al. (1996) and Velasco (1996).

The public is assumed to make the first move, setting expectations on the basis of the existing magnitude of the bank bailout. The shock is then realized and observed by

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follow a policy rule.

[5] The fiscal burden of bank bailouts was most clearly articulated by Diaz-Alejandro's (1985) when he described the 1982 Chilean banking crisis. Writing about East Asia, Burnside et al. (1998) and Corsetti et al. (1998) have argued that forward-looking agents may have become aware of the high fiscal costs involved in financial sector restructuring. Thus, even though actual fiscal balances were in surplus, these contingent liabilities implied high "prospective" fiscal deficits.

the authorities, who set policy based on eq. (1). Thus, as typical in these models, the government is assumed to possess informational advantage over the public.

The aim is to maximize eq. (1) subject to eq. (2). The first order conditions are:

$$f_t^* = (\beta/\psi)\Pi^*_{t,} \quad (3)$$

$$\Pi^*_t = (1 - \lambda)[bo_t - g(\Delta i^e_t) + \psi\Pi^e_t], \quad (4)$$

where: $\lambda = \beta/(\psi^2 + \beta)$.

The analysis and solution proceeds along similar lines to any escape clause-based model**.** Agents are assumed to form expectations of devaluation/inflation on the basis of outstanding bailout obligations of the government (which is known with certainty) and the expected net revenue shock. The shock is realized and observed by the government, which then makes its decision.

If the government maintains the prevailing peg, $\Pi_t = 0$. Thus, from eqs. (1) and (2), the government loss function from a fixed exchange rate (L^F_t) is:

$$L^F_t = \tfrac{1}{2}[bo_t - g(\Delta i^e_t) + \psi\Pi^e_t]^2. \quad (5)$$

To derive the government loss function if it devalues (L^D_t), substitute eqs. (4) and (5) into eq. (1). This yields:

$$L^D_t = \tfrac{1}{2}\lambda[bo_t - g(\Delta i^e_t) + \psi\Pi^e_t]^2 + c. \quad (6)$$

The government will forsake the policy rule (of fixed parity) and invoke the escape clause (i.e. devalue) if $L^F_t > L^D_t$ i.e., if:

$$bo_t - g(\Delta i^e_t) + \psi \Pi^e_t > k. \quad (7)$$

where: $k = [2c/(1 - \lambda)\psi]^{1/2}$.

Given the above, it is straightforward to derive the following results:

Case 1. Certain devaluation, i.e. $g(\Delta i^e_t) = \Pi^e_t = 0$:

$$bo_t > k \quad (8)$$

Case 2. Uncertain/self-fulfilling devaluation, i.e. $g(\Delta i^e_t) = 0$, $\Pi^e_t > 0$:

$$bo_t > \lambda k \text{ and } bo_t < k \quad (9)$$

Case 3a. *Partially* credible peg:

$$bo_t \leq \lambda k \quad (10)$$

Case 3b. *Fully* credible peg:

$$bo_t + g(\Delta i^e_t) \leq \lambda k \quad (10^l)$$

We have the case of a devaluation with certainty if the size of the bailout is “large” (eq. 8). This occurs as the government undertakes a surprise devaluation, voluntarily pursuing an expansionary monetary policy to bailout out the troubled banks, i.e. $g(\Delta i^e_t) =$

0[6]. Eq. (9) implies multiple equilibra, as an interest rate hike is infeasible (despite Π^e_t > 0). Cases 3a and 3b are of particular interest. Case 3a (eq. 10) refers to a *partially* credible peg, where an interest rate hike is feasible, but if the defense of the currency is "too costly" (i.e. speculation is "too intense"), the authorities will devalue the currency. In other words, the model suggests that the peg will not enjoy *full* credibility as long as the central bank functions as a lender of the last resort and the banking sector is not "rock solid". In order for an interest rate hike to be effective and seen as credible in staving off speculative attacks, it should not have "too significant" an adverse impact on the domestic banking sector. This is shown by eq. (10[I]), which reveals that *full* credibility of a peg is determined by both the costs/magnitude of the existing bank bail out as well as the costs of a hike in interest rates.

3. Concluding Observations

Monetary disequilibrium and banking fragilities seem to be common threads that connect the Mexican and Thai crises. Both crises have been characterized by the respective governments attempting to minimize the adverse impacts of capital reversals on their domestic banking systems. This backstopping function of the central bank is modeled within an escape clause-based currency crisis framework - a la Sachs et al. (1996) and Velasco (1996) - which emphasizes the non-mechanical behavior of governments that tradeoff various economic policy objectives.

As in all NSG models, the model developed in this paper stresses that while speculative attacks are not inevitable (based on underlying bad fundamentals), neither are they random or arbitrary (i.e. unanchored by fundamentals). Rather, there must exist some weaknesses in the economic fundamentals of the country for an attack to occur,

[6] One could additionally assume that the authority sets a ceiling fiscal allocation ($f \leq f_{max}$) to the bailout of troubled banks. If this is the case, eq. (8) must be modified as: $bo_t > \min \{k, f_{max}\}$.

as the credibility of the fixed exchange rate regime is less than perfect. Thus, in the case of the model developed in this paper, a currency crisis may never (always) occur if the existing stock of the government's *contingent liabilities* is "very low" ("very high") and the domestic economy is "sufficiently immune" from an interest rate hike. However, only when these fiscal costs of bank bailouts are within a certain range (as formalized above), is the currency vulnerable to such a crisis. Within this "crisis zone", there are a multiplicity of equilibra such that an economy remains on what seems to be a sustainable path ('superior equilibrium'), until some trigger or evidently minor event coalesces market expectations to an "inferior" one, that is realised.

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Table 1
Monetary Base (millions of baht and $), Dec. 1995 - December 1997[a]

Period	Amount (baht)	Amount ($)
Q1: 96	411057.5	16292.4
Q2: 96	396161.3	15621.5
Q3: 96	403762.7	15883.7
Q4: 96	452924.2	17685.4
Mar-97	462165.8	17796.1
Jun-97	514285.9	19941.3
Sep-97	433848.5	11879.8

Notes: a) end of period
Source: Bank of Thailand and IMF

Table 2
Claims by Monetary Authorities on Domestic Financial Institutions, Q1: 1996 - Q3:1997[a]

	Q1-96	Q2-96	Q3-96	Q4-96	Q1-97	Q2-97	Q3-97	Q4-97
Indonesia[b]	15295	15930	16531	15182	16084	19154	21245	67313
Malaysia[c]	6585	6867	5679	5249	5325	5284	5411	5032
Philippines[d]	13.1	13.2	13.6	14.2	14.3	16.1	20.0	34.5
Thailand[e]	38.4	66.0	72.0	90.1	194.0	353.9	597.9	723.4

Notes: a) end of period; b) billions of rupiah; c) millions of ringgit; d) billions of peso; e) billions of baht
Source: Computed from IMF data