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Currency bid-ask spread dynamics and the Asian crisis: Evidence across currency regimes

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Using a sample of 21 emerging and developed country currencies, we evaluate the impact of the Asian crisis on bid-ask spreads. While the crisis had widespread and uniform volatility effects, the spread effects were not uniform across emerging and developed country currencies. For Asian emerging markets, spreads widened and spread volatility increased significantly during the crisis, while developed markets spreads narrowed and spread volatility decreased significantly. We investigate the impact of more flexible and less flexible exchange rate regimes on bid-ask spreads using panel data. In general, countries with tightly-managed regimes have significantly lower spreads than countries with more freely-floating regimes, while controlling for the influence of other factors such as volatility. Asian developing market spreads are higher than spreads of the other countries, again, after controlling for the influence of other factors.

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1. Brief review of Asian currency crisis

The onset of the Asian crisis typically is designated by the devaluation of the Thai baht on July 2, 1997 when the Thai government abandoned its pegged exchange rate regime and adopted a floating regime (e.g., Kamin, 1999; Kallberg et al., 2005). In the subsequent weeks, Indonesia, Korea, Malaysia, the Philippines, and Singapore also decided to adopt more freely-floating exchange rate systems.¹

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¹ More specific dates for noteworthy events from May 1997 to January 1999 can be found in Kallberg et al. (2005).

Kamin (1999) shows that after six months into the crisis, Indonesia, Korea, Malaysia, the Philippines, and Thailand had declines in their nominal exchange rates of about 40%, which is similar to declines in the Mexican peso during the 1980s Latin America Debt crisis and the 1994–1995 Tequila crisis. He argues that the Asian crisis was the first financial crisis to have widespread consequences for emerging market economies and, in several respects, to have more greatly affected developed markets than previous crises. Bekaert and Harvey (2003) also examine currency crises and contagion. They explain that a devaluation or a shift to a float may occur for two main reasons: either the policies of the governments are at odds with a peg, or pure speculative behavior unexpectedly occurs. Based on these two reasons, a crisis may be contagious since the crisis draws attention to other countries with inconsistent policies or because speculators hunt for additional currencies to attack. Additionally, Glick and Rose (1999) find that trade is an important channel for contagion in currency crises and Caramazza et al. (2004) find that financial linkages to the crisis country increases the probability of currency contagion. Evidence on financial integration of some of the countries affected by the crisis, is provided by Phylaktis (1999).

Furman et al. (1998) describe the Asian crisis as unique in that it occurred in a region that had been experiencing tremendous growth. One of the many potential causes of the Asian crisis that they and others (e.g., Mishkin, 1999) address is the use of a pegged exchange rate system, which had been widely adopted by the governments in the region prior to the crisis. Furman et al. (1998), however, argue that a floating system, by itself, would not have circumvented the crisis.

The differential effect of the Asian crisis on rates of exchange for currencies of pegged versus floating exchange rate regimes is examined by Grier and Grier (2001). Using a sample of 25 developing countries, they report that the average depreciation of currencies they classified as following pegged (floating) regimes was 28.2% (20.7%) by the end of 1997. Furthermore, they argue that currencies associated with a pegged regime prior to the Asian crisis suffered greater depreciation than was justified by macroeconomic variables. Their investigation did not extend to the behavior of spreads, however.

Kallberg et al. (2005) look for structural shifts in the equity returns-domestic currency returns and equity volatility-domestic currency volatility relationships surrounding the Asian crisis for six Asian countries.² Generally, they find that structural shifts in the volatility structure occurred in the fall of 1997 while the structural shifts in the returns occurred in the first half of 1998.

These prior studies imply that a number of factors may have influenced the dynamics of currency bid-ask spreads during the Asian crisis period, but they do not directly investigate such a possibility. Furthermore, no comparative study has been undertaken to evaluate the impact on currency spreads of developed country currencies as well as non-Asian developing country currencies. This is an important omission to the extent that the Asian crisis had widespread consequences for both developing and developed markets. Also, it is essential for policymakers and participants in the interbank market, perhaps the only truly global market, to better understand the impact of different currency regimes on currency bid-ask spreads.

This study addresses these questions and presents significant findings that contribute to the literature. We find that while the crisis had widespread volatility effects on emerging and developed country currencies, the spread effects were not uniform. The size of spreads and the volatility of spreads for Asian emerging markets rose, while those of developed markets fell. Our further investigation reveals that tightly-controlled (loosely-controlled) exchange rate systems are associated with smaller (larger) spreads, while controlling for volatility and other factors. We provide evidence that Asian developing market currency spreads are higher than the spreads of other countries, again after controlling for the influence of other factors.

The next sections reviews the literature on spread dynamics and states in more detail the hypotheses tested. Section 3 describes the data and reports some preliminary findings. Section 4 presents the methodology and discusses our findings. Lastly, Section 5 concludes this paper.

² Their use of the term 'regime shift' is not associated with governments adjusting exchange rate regimes, but instead is associated with the structural changes in macroeconomic relationships.

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