Were bid–ask spreads in the FX market excessive during the Asian crisis?

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Abstract

Bid–ask spreads for Asian emerging market currencies increased sharply during the Asian crisis. The question is whether the spreads were excessive or in line with standard models of bid–ask spreads. Pre-crisis estimates of the models show that spreads during the crisis were in most cases tighter than predicted and there were only a few cases of excessive spreads. The result is largely explained by substantial increases in exchange rate volatility during the crisis and to some extent by depreciating exchange rates. The empirical models have greater explanatory power for emerging market than for mature market currencies.

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1. Introduction

Bid–ask spreads in foreign exchange markets are important since they determine transaction and hedging costs which in turn affect trade, the effectiveness of policy and ultimately carry significant real costs to the economy.¹ The study of bid–ask spreads and the microstructure of foreign exchange markets can also improve the analysis of short-run exchange rate behavior, which is an area where conventional macro-models have had limited success.² Market

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¹ The European Commission (1990) estimated that the elimination of spreads following the adoption of a single European currency would result in savings of 0.4% of Community GDP per annum. Furthermore, the estimated total transaction costs incurred by non-financial firms were on average 15% of their profits on turnover in other EC countries.

microstructure issues are particularly important in times of balance of payments crises when the
adjustment process of the economy critically depends on exchange rate movements. Furthermore,
if transaction costs increase significantly with a move from a relatively fixed exchange rate to a
floating exchange rate, it takes longer before the added flexibility of the exchange rate has a
positive effect on the real economy.

During the Asian crisis, bid–ask spreads on most Asian currencies skyrocketed to levels
never seen before. Bid–ask spreads widened by factors of between 5 and 14 in dollar terms,
drastically increasing transaction costs for converting emerging market currencies into dollars.
Table 1 provides an overview of the costs associated with a US$10 million roundtrip transaction
before and during the crisis period for the different Asian currencies that are analyzed in this
paper. For example, for the Indonesian rupiah, the cost increased from a moderate US$8000
pre-crisis to a cross-section high of US$215,900 during the crisis whereas for the Hong Kong
dollar (which remained under its currency board arrangement) the cost increased by only US
$200. Such levels and changes in the cost of currency transactions can obviously have
significant impacts on both micro- and macroeconomic variables.

Bid–ask spreads also affect the revenue of various institutions active in the foreign
exchange market, including commercial banks where the abrupt rise in bid–ask spreads
during the Asian crisis resulted in record trading profits. The Institute of International Finance
(1999) remarked that “...a diversity of business lines enabled most banks to offset losses in
Asia with record foreign exchange trading revenues. This enabled most financial firms to
emerge from the East Asian market turmoil without experiencing debilitating losses.” One
justification for these record profits is that the gains represented compensation for the high
levels of risk that foreign exchange market participants were exposed to during such turbulent
times.

The purpose of this paper is to examine if bid–ask spreads on Asian currencies were
excessive during the 1997 crisis. In answering this question, the paper first documents features
of bid–ask spreads for Asian emerging market currencies and then estimates standard models of
bid–ask spreads that have previously been used mainly for mature markets. The predicted
spreads from the models are then compared to actual spreads to assess if spreads were
excessive. The currencies studied are the Thai baht (THB), the Indonesian rupiah (IDR), the
Korean won (KRW), the Malaysian ringgit (MYR), the Philippine peso (PHP), the Singapore
dollar (SGD), the Hong Kong dollar (HKD), and as a mature market benchmark, the Japanese
yen (JPY).

Table 1
The cost of a US$10 million round trip transaction (in US dollars)

<table>
<thead>
<tr>
<th>Currency</th>
<th>1996–1997</th>
<th>Crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thai baht</td>
<td>13,100</td>
<td>68,300</td>
</tr>
<tr>
<td>Indonesian rupiah</td>
<td>8800</td>
<td>215,900</td>
</tr>
<tr>
<td>Korean won</td>
<td>34,500</td>
<td>42,200</td>
</tr>
<tr>
<td>Malaysian ringgit</td>
<td>4000</td>
<td>28,300</td>
</tr>
<tr>
<td>Philippine peso</td>
<td>23,700</td>
<td>163,500</td>
</tr>
<tr>
<td>Singapore dollar</td>
<td>6900</td>
<td>14,000</td>
</tr>
<tr>
<td>Hong Kong dollar</td>
<td>1200</td>
<td>1400</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>6000</td>
<td>5700</td>
</tr>
</tbody>
</table>

Source: Reuters and authors’ calculations.
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