UNIVERSITY EXAMINATIONS: 2013/2014

EXAMINATION FOR THE MASTERS OF SCIENCE (MSC) IN COMMERCE

MSF 504 MONEY AND BANKING (WEEKEND)

DATE: APRIL, 2014 **TIME: 3 HOURS**

INSTRUCTIONS: Answer Question One and Any Other Three Questions

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QUESTION ONE (31 MARKS)

THE ASIAN FINANCIAL CRISIS

The Background to the Financial Turbulence of 1997-98

The period following the devaluation of the Thai baht on July 2nd 1997 witnessed a sudden and unprecedented collapse in asset prices, corporate and financial fragility, and a drastic economic slowdown in East Asian markets. In just over 12 months, the region's stock markets-once among the largest in the world saw their market capitalization shrink by as much as 85% in US dollar terms. Similarly, East Asian currencies depreciated sharply beyond the levels needed to maintain export competitiveness, with some currencies falling by 50-80% against the US dollar by end-July 1998. East European and Latin American currencies also experienced some speculative pressure in the latter half of 1997, but generally fared much better.

This, led to a fall in real purchasing power as inflationary pressures took root. Concurrently, there was a marked slowdown in economic growth: Asia's real GDP growth declined to 5.8% in 1997 from 6.6% in 1996, with a further decline to 4.1% expected in 1998. Emerging markets took on an increasingly high-risk low-return profile as rising volatility and the deterioration in economic fundamentals led to the outflow of capital from these markets

Attention had been drawn to the region some 18 months before the crisis broke as rising inflation,

labour market rigidities and substantial current account deficits suggested the possibility of growing complications associated with maintaining a rapid pace of economic expansion. By early 1997, both the Thai stock market and the Thai baht experienced increasing downward pressure, apparently over concerns of a continued accumulation in short-term foreign debt and the onset of property deflation. The country's large current account deficit was said to have raised urgent concerns that the baht would not be able to maintain its US-dollar peg in the face of speculative pressure, while the nascent problems in the local financial and property sectors were thought by some to have exacerbated the slide in its stock market. Although during the initial stages of the crisis the problem was largely regarded as being confined to Thailand alone, the Malaysian and Philippine stock markets also began experiencing selling pressure as the conditions in Thailand deteriorated. At the same time, the South Korean stock market began to falter with apparent concern over external imbalances, and a sluggish and increasingly financially-strained domestic economy.

The crisis was viewed by some as a serious threat to the stability of the region's financial system. In May 1997, both foreign and local players were thought to have amassed short baht positions in anticipation of a breaking of the Baht's implicit peg against the US dollar. On May 14th, the Bank of Thailand (BOT) was reported to have jointly intervened with the Monetary Authority of Singapore to defend the baht in the spot and forward markets. The BOT reportedly spent US$6.8b of its foreign exchange reserves in its defense of the local currency over the period January-June 1997, and another US$23b in forward sales transactions.

Soon after, the BOT introduced measures to discourage speculation on the baht. From May 16th domestic financial institutions were not allowed to lend the baht to non-residents nor buy back baht-denominated debentures before maturity. This effectively segregated the baht market into on-shore and off-shore tiers. On June 10th, the BOT went a step further and requested custodian banks and finance companies to remit foreign-currency proceeds from sales of securities belonging to foreign investors, and to transfer securities out of foreign investors' portfolios only for the settlement of sales transactions and not for securities lending purposes. However, speculative pressure on the baht did not abate but rather intensified. After a massive depletion of its foreign reserves, on July 2nd the BOT abandoned its efforts to defend the baht and allowed the currency to be traded under a managed float.

Contagion quickly spread to the other three of the so-called ASEAN-4 countries, namely, Indonesia, Malaysia and the Philippines. The *de facto* devaluation of the baht drew attention to the viability of exchange-rate arrangements in other ASEAN-4 countries. The Malaysian ringgit and the Philippine peso in particular, which had been subject to only minor speculative pressure prior to the float, began

to weaken significantly against the US dollar under intensified selling activity. This phase saw the first signs of global contagion, in the downward pressure on Czech and Slovakian currencies. However, within the East Asian region, the Philippine peso, then the ringgit and finally the rupiah succumbed to speculative pressure in quick succession as their respective authorities eased their currency defence. Concerns over highly-leveraged corporate balance sheets was thought to have exacerbated the decline of these currencies against the US dollar. Currency and stock market volatility surged amidst uncertainty over these economies' exchange-rate policies.

On July 28th, Thailand requested technical assistance from the International Monetary Fund (IMF) and other parties; on August 20th, an agreement on a US$17.2b rescue plan was announced. By then, the turmoil had begun spreading to other parts of the region, although spill-over effects beyond the region still remained limited. Currencies and stock markets in Taiwan, Hong Kong and Singapore began to experience downward pressure while yield spreads on international bonds of Asian issuers widened considerably.

Outside the region, pressure on some currencies in Eastern Europe increased and Latin American Brady bond yield spreads grew wider. Heightened risk pushed emerging market borrowing costs sharply higher which impaired the ability of issuers to service their debt. However, other stock markets, especially those in the United States and Britain, continued to rise strongly despite a short-lived rise in global bond yields due to fears of a rise in European interest-rates.

In September-October, strong pressure mounted for the devaluation of these currencies in both spot and futures markets. The central bank of Brazil, for instance, was reported to have spent US$8.3b of its foreign reserves over this period to keep the real exchange rate within its trading band under the crawling peg system. Faced with a plummeting rupiah and a corporate sector encumbered by a large short-term debt burden, the Indonesian government announced on October 8th its intention to seek financial support from the IMF and other multilateral organisations in an attempt to restore confidence in its economy.

Pressure also began to build on the Hong Kong dollar as fears grew over whether the Hong Kong Monetary Authority could maintain its currency arrangement against the US dollar. After a three-day decline in stock prices, during which the Hang Seng index lost more than 23%, these pressures eventually triggered a correction in stock prices world-wide. Concerns over the vulnerability of Hong Kong's stock market and currency, and the potential impact of the Asian crisis on corporate earnings in the United States was believed to have led to a 554.3-point or 7.2% plunge in the Dow Jones Industrial Average index on October 27th. The market's dramatic fall in the United States was echoed around the

world, with most major markets consequently registering sharp falls that day or, in the case of the Asian markets, the next trading day. Emerging bond and stock markets suffered heavy losses as monetary authorities in several countries, including Brazil, Greece, Mexico and Russia, raised domestic interest rates sharply.

Most stock and derivatives markets reported a sharp increase in volumes during this period, despite the fact that price limits, trading halts and other forms of trading restrictions were activated in many exchanges as prices and index levels fell below pre-determined trigger levels. Although existing trading systems were reported to have, in general, functioned satisfactorily during this period of heightened market stress, liquidity in some emerging markets dried when excessive selling pressure emerged.

Developments in East Asia continued to have an effect on financial markets around the world through to December. European and American stock markets recovered by early December although lower bond yields and a rapidly-appreciating US dollar seemed to imply a continuing flight to safety from stocks in general.

Asian markets remained dogged by regional worries, which were now augmented by developments in South Korea and in Japan. Concerns increased over South Korea's difficulties in resolving its corporate debt overhang and in rolling-over financial-sector foreign debt. The closures of Yamaichi-Japan's fourth-largest brokerage-in early November and of Hong Kong-based Peregrine Investment Holdings in January 1998 added to concerns over the impact of the crisis on the health of some of the region's financial institutions.

As the possibility of more corporate failures grew, East Asian currencies succumbed to intensified selling pressure and subsequently many of them-including the Malaysian ringgit, the Philippine peso, the Thai baht and the Indonesian rupiah-were driven down to historic lows by mid-January 1998.

Required: (Use the case)

a) While there have been various factors identified from the case as potentially specific causes of the crisis, the scope and the extent of the East Asian crisis cannot be adequately addressed without examining the role of financial contagion. Explain. (15 Marks)

b) The Central Banks of the region had a role to play which they seem to have not done. Identify the roles and explain. (16 Marks)

QUESTION TWO

a) The Central Bank of Kenya was established soon after the country attained Independence.

Explain the reasons why the Kenya Government may have found it necessary to establish its own Central bank (10 Marks)

b) You are provided with the following Monetary aggregates

Currency Issues 55 million,

Demand deposits 200 million,

Time deposits 50 million,

Saving deposits accounts 250 million.

Required:

(i) Calculate the country's narrow stock of money supply (4 Marks)

(ii) Calculate the country's broad stock of money supply (4 Marks)

c) Explain the two ways through which a central government can enter the financial markets. Is there a potential problem of doing this? (5 Marks)

QUESTION THREE

a) Explain how the financial intermediaries ease the problem with asymmetric information. What are the main benefits of intermediation? (12 Marks)

b) Commercial banks are not in the business of creating money, instead the process only takes place as a by-product of the banks' core functions. Explain the role bank balances in the creation of money and credit. (11 Marks)

QUESTION FOUR

a) Explain how a higher interest rate can trigger an adverse selection or moral hazard effect between a lender and a borrower. (11 Marks)

b) Direct finance is seen to be the simplest and most efficient system of financing *if the conditions are right*. Explain the conditions which must be right highlighting the known weaknesses of direct financing and the role of intermediaries in the financial system. (12 Marks)

QUESTION FIVE

a) Most cross border trade payments are handled through correspondent banking relationships , whereby a series of banks and domestic payment systems are typically linked together to move funds. Explain the factors which have contributed to the development in cross border payments

for last decade. (11 Marks)

b) A depositor with Bank “A” writes a cheque for Kshs. 100,000 to another person who bank’s with Bank “W”. The bank “W” customer then deposits the cheque with her bank for payment. If bank W goes through the Central Bank of Kenya to get the payment, how will the transaction appear? Discuss the process using T-accounts showing how the accounts of Banks “A”, “W” and CBK will be affected. (12 Marks)

QUESTION SIX

a) During financial crises in the past the impact on the monetary measure "M2" have almost looked the same, what usually happens to the "M2" and why do we see this pattern. And finally how does this affect the actions of the CB? (9 Marks)

b) International banking has been an important component of a broader process of financial globalization and integration. However international banking is also seen as having encouraged menace of money laundering which is the process by which illicit source moneys are introduced into an economy and used for legitimate purposes. Explain the three main phases of Money laundering (9 Marks)

c) “The Monetary Policy of a developing country cannot be the same as the monetary policy of a developed country”. Explain the statement with a relevant illustration. (5 Marks)