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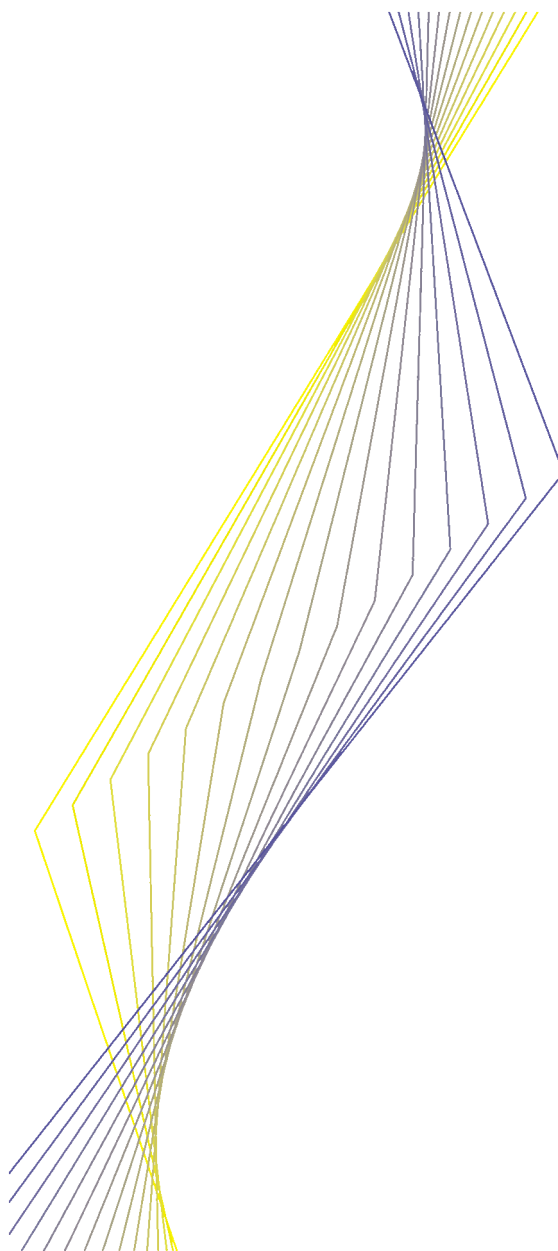
WORKING PAPER NO. 139

**ON CURRENCY CRISES
AND CONTAGION**

BY MARCEL FRATZSCHER

April 2002

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Abstract

This paper analyzes the role of contagion in the currency crises in emerging markets during the 1990s. It employs a non-linear Markov-switching model to conduct a systematic comparison and evaluation of three distinct causes of currency crises: contagion, weak economic fundamentals, and sunspots, i.e. unobservable shifts in agents' beliefs. Testing this model empirically through Markov-switching and panel data models reveals that contagion, i.e. a high degree of real integration and financial interdependence among countries, is a core explanation for recent emerging market crises. The model has a remarkably good predictive power for the 1997-98 Asian crisis. The findings suggest that in particular the degree of financial interdependence and also real integration among emerging markets are crucial not only in explaining past crises but also in predicting the transmission of future financial crises.

JEL no. F30, E60, E65, E44.

Keywords: currency crises, contagion, Markov-switching, panel data, prediction.

Non-Technical Summary

Why did the financial crises of the 1990s hit various economies almost simultaneously; why were they mostly regional; and why were they so much more severe than economic conditions warranted? – These questions have drawn tremendous attention in recent years, but no broad consensus has formed yet as to the true underlying causes of these crises. Some economists have started to concede that contagion and self-fulfilling beliefs of investors played a crucial role in the emerging market financial crises of the 1990s. However, economists still lack the answer as to *how* and *why* crises occurring in different economies are linked and interdependent.

The aim of this paper is to help contribute to an answer to this question. The paper uses a novel empirical methodology for the field of financial crises, a non-linear Markov-switching model based on Hamilton (1989, 1990), to allow for a systematic comparison of three competing explanations for financial crises: weak economic fundamentals, sunspots, i.e. exogenous shifts in agents' beliefs, and contagion, i.e. the transmission of crises due to countries' close real and financial "proximity" to each other.

In the first part, the paper starts by outlining the empirical methodology of the Markov-switching model and develops a methodology to measure three types of "proximity", or channels of contagion. The first one measures the real interdependence among economies through trade competition. A second one analyzes to what extent countries are competing for bank lending in third markets. And the third channel measures the degree of stock market integration across countries. The rationale for using these measures is that the more two countries are linked through such real or financial channels, the higher is the probability that a crisis spreads across countries.

In the second part, the paper then conducts three complementary tests on the relative importance of fundamentals, contagion and sunspots. First, it is found that country-specific fundamentals generally fail to explain the timing as well as the severity of financial crises in individual countries. Including contagion in the model, however, improves the explanatory power of the model significantly and in particular explains the large jumps in exchange rates during currency crises.

Second, a panel data analysis confirms the robustness of these results for a sample of 24 open emerging markets. The results suggest that the Latin American crisis in 1994/95 and the Asian crisis of 1997 spread across emerging markets not primarily due to the weakness of those countries' fundamentals but rather to a high degree of financial interdependence among affected economies. Third, out-of-sample tests for the Asian crisis show that including contagion into the model would have permitted a quite accurate prediction to which countries the crisis spread.

As to the policy implications, the results underline that only if we take into account the growing integration and economic interdependence of financial markets will we be able to improve our understanding and better predict the occurrence of future crises. The powerful role of contagion in particular suggests that measures for more effective crisis prevention and resolution may require a global, coordinated policy approach.

1 Introduction

Many economists have started to concede in recent years that contagion and self-fulfilling beliefs of investors have played a crucial role in the emerging market financial crises of the 1990s.¹ Despite the progress on the theoretical side, however, empirical models of currency crises have been shown to perform poorly (Berg and Pattillo 1998) and many economists and policy institutions have been struggling to develop adequate models to predict future financial crises (Kaminsky et al. 1997, Goldstein et al. 2000).

Much of the empirical literature on financial crises, however, still focuses on country-specific macroeconomic factors and has ignored or at least underestimated the importance of contagion, i.e. the possibility that the origin of a crisis may lie in the occurrence of a crisis elsewhere in the world rather than with weak domestic fundamentals. As a consequence, economists still lack the answer as to why many crises of the 1990s clustered within regions and affected a broad range of countries almost simultaneously. In other words, the question that remains is how and why crises occurring in different economies are linked and interdependent.

The aim of this paper is to help find an answer to this question. The use of a non-linear Markov-switching model, based on the seminal work by Hamilton (1989, 1990), is suggested in order to enable a systematic comparison of three competing explanations for financial crises: weak economic fundamentals, sunspots, i.e. exogenous shifts in agents' beliefs, and contagion. Contagion in this paper is defined as the transmission of a crisis that is not *caused* by the affected country's fundamentals (although, of course, the transmission has an impact on the country's fundamentals *ex post*) but by its "proximity" to the country where a crisis occurred.

The paper suggests and develops a new methodology to measure three types of "proximity", or channels of contagion. The first one measures the real interdependence among economies through trade competition. A second one analyzes to what extent countries are competing for bank lending in third markets. And the third channel measures the degree of stock market integration across countries.

The paper then conducts three complementary tests on the relative importance of fundamentals, contagion and sunspots. First, the use of Markov-switching models reveals that country-specific fundamentals generally fail to explain the timing as well as the severity of financial crisis in individual countries. Including contagion in the model, however, improves the explanatory power of the model significantly in most cases and even eliminates the need for regime shifts in the Markov-switching framework for some countries. Second, a panel

¹ For instance, Krugman (1999, p. 8/9) admits: "[T]he power of contagion in the last two years settles a long-running dispute about currency crises in general: the dispute between 'fundamentalists' and 'self-fulfillers'. ... I hereby capitulate. I cannot see any way to make sense of the contagion of 1997-98 without supposing the existence of multiple equilibria, with countries vulnerable to self-validating collapses in confidence, collapses that could be set off by events in faraway economies that **somehow** served as a trigger for self-fulfilling pessimism." (bold added). The collection of papers in Agenor, Miller, Vines and Weber (eds., 1999) provides a compelling overview of the controversies surrounding financial crisis.

data analysis confirms the robustness of these results for a sample of 24 open emerging markets. The results suggest that the Latin American crisis in 1994/95 and the Asian crisis of 1997 spread across emerging markets not primarily due to the weakness of those countries' fundamentals but rather to a high degree of financial interdependence among affected economies. Third, the model's ability to predict the Asian crisis is tested. It is shown that taking contagion factors into account would have permitted a quite accurate prediction of to which countries the crisis spread. Overall, these results emphasize that only if we take into account the systemic character of financial crises will we be able to improve our understanding and better predict the occurrence of future crises.

The paper starts by briefly reviewing the literature on contagion in section 2. Section 3 then develops the Markov-switching model and discusses its underlying assumptions. Data definitions and the contagion methodology are outlined in section 4. The empirical results for the Markov-switching and panel data models are presented in sections 5 and 6. Finally, the paper concludes by outlining some general policy implications in section 7.

2 Literature on currency crises and contagion

The question of how to define the term contagion is a still controversial one. Contagion in this paper is defined in the following way:²

Definition of contagion: Contagion is the transmission of a crisis to a particular country due to its real and financial interdependence with countries that are already experiencing a crisis.

On the contrary, other authors, like Forbes and Rigobon (1999), adopt a narrower definition in which such interdependencies need to intensify during crises, and the increase may not be related to similarities in fundamentals across countries in order to constitute contagion. To understand and evaluate these differences in definition, one needs to analyze the different transmission channels of currency crises. They can be grouped into three categories: financial interdependence, real interdependence, and sunspots, i.e. exogenous shifts in agents' beliefs.

Financial interdependence across countries can have at least two different causes. First, a crisis may be transmitted due to direct financial linkages, i.e. the fact that financial institutions may have large cross-border holdings. Second, indirect financial linkages, in particular the presence of a common lender and decisions by institutional investors, received a lot of attention in recent years. A crisis in one country may induce a common lender to call loans and refuse to provide new credit, not just to countries that have already experienced a crisis but also to others, thus spreading the crisis across countries (Van Rijckeghem and Weder 1999, Kaminsky and Reinhart 2000, Caramazza, Ricci and Salgado 2000).

Similarly, institutional investors may be forced to withdraw funds not only from a crisis country but also from other markets in order to raise cash for margin calls and to rebalance

² This definition follows one of the earliest papers on the issue of contagion by Calvo and Reinhart (1996), who call spillovers due to interdependence "fundamentals-based contagion" and other spillover channels, such as for instance through herd behaviour, "true contagion".

portfolios (Goldfajn and Valdes 1997, Calvo 1998, Kodres and Pritzker 1999). Analyzing data on country funds, Frankel and Schmukler (1998) for instance find evidence that herding behavior and institutional factors were partly responsible for the spread of the Mexican crisis in 1994-95 to other emerging markets.

Real interdependence can either be explained through bilateral trade or through trade competition in third markets. A crisis in one country is more likely to spread to another economy if the two have a large degree of bilateral trade (income effects) or are strong competitors in third markets (price effects) because the latter economy loses competitiveness and thus can not avoid devaluation. Gerlach and Smets (1995) provide a theoretical model analyzing these links, while Eichengreen, Rose and Wyplosz (1996) Glick and Rose (1999) and Fratzscher (1998) find some empirical evidence for the importance of real linkages in spreading recent crises across markets.

Exogenous shifts in investor beliefs (or referred to as *sunspots*) are usually attributed to herd behavior in financial markets. Shifts in investor beliefs are exogenous in the sense that they are neither related to country-specific or common fundamentals nor to interdependencies across economies. Calvo and Mendoza (2000) show how herding can be rational as the globalization of financial markets reduces the incentive for investors to collect first-hand information and encourages them to follow common investment strategies. A related argument by Goldstein (1998) is that a crisis in one country may constitute a “wake-up call” for investors to reassess fundamentals in other countries, thus raising the degree of financial market comovements and possibly spreading the crisis across economies.

Some of the literature has defined only this third type as contagion and referred to the first two of these categories as merely interdependence or spillovers (e.g. Forbes and Rigobon 1999, Masson 1998). However, whatever terminology one may choose to adopt, it should be emphasized that the central goal of this paper is to analyze whether the *normal* degree of real and financial interdependence across economies during tranquil periods (what I include in the definition of contagion) can help us understand and predict to which countries a crisis will spread and whether it can explain the crisis’ severity.

3 Empirical methodology: Linear infection functions and non-linear Markov-switching VAR models

3.1 Infection function: Fundamentals versus Contagion

The most commonly used empirical model in the literature is to pin down the role of country-specific economic fundamentals in causing currency crises by using a linear function of the form

$$y_{i,t} = \alpha_i + \beta_X' x_{t-1} + u_{i,t} \quad (1)$$

with $y_{i,t}$ as a measure of currency crises in country i , x_{t-1} a vector of fundamentals and β_X as the vector of coefficients. Economists have been trying hard to test an ever wider range of

fundamentals and to raise the number of crises under consideration in order to increase the explanatory power of their models. However, as Berg and Pattillo (1998) show convincingly, the explanatory power and in particular the predictive power of such models have remained small.

One reason for the poor performance of fundamentals-based models is that fundamental causes of currency crises may differ sharply across countries and across crises episodes, thus making it extremely difficult, if not impossible, to find a single set of fundamentals underlying all crises. However, fundamentals-based models have tended to ignore one important element that has been common to many financial crises of the 1990s: the almost simultaneous occurrence of crises in various countries. What this suggests is that recent crises may contain a strong systemic element in that they may have been transmitted due to countries' financial and real interdependence rather than their economic fundamentals. To formalize this hypothesis, I define the following linear *infection function*

$$y_{i,t} = \alpha_i + \beta_X x_{t-1} + \beta_R \sum_{j \neq i} (y_{j,t-1} \times REAL_{ij}) + \beta_F \sum_{j \neq i} (y_{j,t-1} \times FIN_{ij}) + u_{i,t} \quad (2)$$

with $y_{j,t}$ measuring the severity of a crisis in country j and $REAL_{ij}$ and FIN_{ij} indicating the degree of real and financial interdependence between economies i and j . Thus, this *infection function* allows for two sources of a crisis: weak economic fundamentals x_{t-1} and contagion.

The important feature of this *infection function* is that it allows exchange market movements y_j in *all* countries j to influence the pressure on the home currency y_i . The extent to which the home economy i is affected by exchange market movements or crises in other countries j depends on its degree of real integration ($REAL_{ij}$) and financial interdependence (FIN_{ij}) with these economies. It should be emphasized that both integration parameters are time-invariant and are measured during tranquil periods in order to account for the possibility that integration may intensify during crisis periods, i.e. in order to insure that the integration variables are exogenous in the model.

Unlike many other papers on contagion, the *infection function* of equation (2) explicitly incorporates *cascading effects*, i.e. the possibility that shocks may be transmitted not only from a single country where a crisis originated, but also from other countries that were affected subsequently. Given the systemic nature of many currency crises of the 1990s, such as in the ERM in 1992-93, in Latin America in 1994-95, in Asia in 1997-98 and through Russia in 1998, it seems imperative to explicitly allow and test for such *cascading effects*.

3.2 Markov-switching VAR methodology

It is crucial to emphasize that finding statistically significant coefficients from models (1) or (2) does not necessarily imply that these models provide a satisfactory explanation of crises. Indeed the fit of a model with fundamentals and contagion may still be poor despite finding some significant coefficients. An important shortcoming of the linear infection function of equation (2) is that it ignores the possibility that changes in expectations and private sector beliefs, which are explained neither by fundamentals nor by contagion, may also be the cause of a crisis or at least exacerbate it (Calvo and Mendoza 2000, Goldstein 1998). It is extremely

difficult, however, to develop a proper empirical test for the role of changes in investors' expectations because determinants of these changes (such as herd behavior, fund managers' incentives or beliefs about future fundamentals) tend to be unobservable.

Due to the unobservable nature of changes in expectations (or what I call sunspots), I employ a non-linear Markov-switching VAR (MS-VAR). The MS-VAR model used here is based on the one first developed by Hamilton (1989, 1990) for the analysis of US business cycles.³ The basic rationale for using an MS-VAR methodology for the analysis of currency crises is that it allows a comparison of the role of observables (fundamentals and contagion variables) with the importance of unobservable factors (sunspots). If unobservable factors in the model are dominant, then the observable factors in the model are not very useful in explaining crises. If, however, the MS-VAR model shows that observable variables are more important than unobservables by eliminating regime shifts due to unobservables, then the model may be a good one in explaining and anticipating currency crises.⁴

The basic starting point for the MS-VAR model is the observation that the parameters Ω of a VAR process may not be time-invariant, as assumed by standard OLS models, but that they vary over time. More precisely, the MS-VAR model makes a very specific assumption about the behavior of the parameters Ω of the system: Ω are time-invariant as long as a particular regime prevails but they change once the regime changes. With M as the discrete and finite number of feasible regimes s_t , the conditional probability density of a vector y_t can be written as

$$p(y_t|Y_{t-1}, s_t) = \begin{cases} f(y_t|Y_{t-1}, \Omega_1) & \text{if } s_t = 1 \\ \vdots \\ f(y_t|Y_{t-1}, \Omega_M) & \text{if } s_t = M \end{cases} \quad (3)$$

where Y_{t-1} is the set of past observations of the vector y_t , Ω_m is the VAR parameter vector for regime $m=1\dots M$, and $f(\cdot)$ describes the density function of the normal distribution.

The question that arises now is what constitutes the *regime-generating process*, i.e. what determines which regime s_t prevails at any one point in time. If the timing of switches across regimes were observable, one could easily solve this problem by using indicator functions and appropriate dummies to condition the system. However, for the analysis of exchange rates it is not clear *when* and *whether* regime switches occur. In other words, in the framework of section 3.1 it is not clear whether movements in the exchange rate (the dependent variable) are due to changes in observables (contagion and fundamentals) or due to unobservables (sunspots).

³ See also Kim and Nelson (1998), Krolzig (1997), and Diebold, Lee and Weinbach (1994) for a thorough theoretical discussion of Markov-switching VAR models and different empirical applications.

⁴ The use of Markov-switching regimes models to analyze foreign exchange markets is still rather new. Martinez-Peria (1998), Gomez-Puig and Montalvo (1997) and Engel and Hakkio (1994) estimate a Markov-switching model for ERM currencies. Jeanne (1997) and Jeanne and Masson (2000) find that a Markov-switching model with two regimes performs better for the French Franc in 1987-93 than a linear OLS estimation.

Therefore, the regime-generating process is assumed to follow an unobservable Markov chain with transition probability p_{kl} of the form

$$\Pr(s_t = k | s_{t-1} = l, s_{t-2} = n, \dots) = \Pr(s_t = k | s_{t-1} = l) = p_{kl} \quad (4)$$

$$\sum_{k=1}^M p_{kl} = 1 \quad \forall k, l, n \in \{1, \dots, M\}$$

where p_{kl} is the probability of being in regime k in period t if the regime l prevailed in period $t-1$. The Markovian chain of equation (4) therefore states that the probability of being in state k in period t is solely dependent on which regime prevailed in the previous period $t-1$. Accordingly, the Markovian transition matrix P can be written as

$$P = \begin{bmatrix} p_{11} & \cdots & p_{1l} & \cdots & p_{1M} \\ \vdots & \ddots & & & \vdots \\ p_{k1} & & p_{kl} & & p_{kM} \\ \vdots & & & \ddots & \vdots \\ p_{M1} & \cdots & p_{Ml} & \cdots & p_{MM} \end{bmatrix} \quad (5)$$

so that every row describes a different state k in period t and each column stands for a different regime l in $t-1$. An important further condition for the Markov chain to describe the regime-generating process is that there is no absorbing state, i.e. there is no p_{kl} s.t. $p_{kl} = 1$.

So far, we have described the assumptions underlying the *regime-generating process* of the system. We now need to specify the assumptions underlying the *data-generating process* of the VAR process. In its most general form the VAR process of order p [$MS(M)$ -VAR(p)] for any given regime s_t can be written in state-space form as

$$y_t = v(s_t) + A_1(s_t)y_{t-1} + \dots + A_p(s_t)y_{t-p} + \Sigma(s_t)u_t \quad (6)$$

or equivalently

$$y_t = \begin{cases} v_1 + A_{11}y_{t-1} + \dots + A_{p1}y_{t-p} + \Sigma_1^{1/2}u_t & \text{if } s_t = 1 \\ \vdots & \\ v_M + A_{1M}y_{t-1} + \dots + A_{pM}y_{t-p} + \Sigma_M^{1/2}u_t & \text{if } s_t = M \end{cases} \quad (7)$$

with $u_t \sim NID(0, I_K)$.

As the $MS(M)$ -VAR(p) model of equations (6) and (7) illustrates, exogenous regime switches can have four separate origins: changes in the intercept v , in the autoregressive coefficients A , in the mean, and in the error variance Σ (heteroskedastic errors). For empirical applications, it is often useful to allow only for some of the parameters of the model to be conditioned on the

state of the Markov chain while other parameters are regime-invariant. Due to the restricted number of time-series observations and thus the limited degrees of freedom, I model exogenous shifts in beliefs as switching intercepts v_i and changes in the error variance Σ .⁵

Extending equation (6) in order to also include a set of exogenous fundamentals and contagion variables in the spirit of the infection function of equation (2), the state-space form of the Markov-switching model of order $p=1$ for country i becomes:

$$y_{i,t} = v_i(s_t) + \beta_R \sum_j (y_{j,t-1} \times REAL_{ij}) + \beta_F \sum_j (y_{j,t-1} \times FIN_{ij}) + \beta_X x_{t-1} + \Sigma_i^{1/2}(s_t) u_{i,t} \quad (8)$$

where s_t indicates the state in period t , and $u_{i,t} \sim NID(0, I_K)$. The reformulation of the linear infection function of (2) as a non-linear Markov-switching model of (8) therefore now enables us to distinguish between and test empirically for three causes of currency crises: weak fundamentals, contagion, and sunspots.⁶ Equation (8) is the benchmark equation to be used in the empirical analysis in the remainder of the paper.

Building on the methodology developed by Krolzig (1998), the Markov-switching model is implemented empirically by applying the expectation maximization (EM) algorithm, programmed in Ox. With this, maximum likelihood estimates for the regime-switching models can be obtained.

4 Data and definitions: currency crises and contagion

Since the central objective of this paper is to analyze the question whether contagion has played a role in the recent emerging market crises, the focus of the empirical analysis is exclusively on 24 *open* emerging markets, as defined by the IFC plus some transition economies, for the period 1986 to 1998 using monthly frequency.⁷ The reason for choosing this sample and time period is that contagion and crises can affect countries only where capital flows are relatively free and markets are relatively open.

4.1 Definition of currency crises

The two most commonly used measures of currency crisis $y_{i,t}$ have been based on a binary definition in which a currency crisis is defined only if the change in the exchange rate is

⁵ See Krolzig (1997, 1998) for a thorough discussion of the specifications of alternative types of regime shifts.

⁶ It should be noted that one important model assumption is that regime switches reflect changes in expectations that are unrelated to fundamentals or contagion. In other words, sunspots solely reflect unobservable factors. A potential problem with this assumption is that in reality, of course, sunspots may reflect unobservable fundamentals or contagion factors. The empirical investigation of these and other issues is the subject of the sections 4-6.

⁷ See the appendix for a list of the 24 countries, data sources and also for the definitions of included fundamentals.

larger than two or three standard deviations in a particular period (e.g. Frankel and Rose 1996) or have been defined as a continuous exchange market pressure (*EMP*) which is a weighted average of the changes in the exchange rate e , the interest rate i and the foreign exchange reserves R :

$$EMP_t = \eta(\Delta e_{i,t}) + \phi(\Delta(i_{i,t} - i_{US,t})) - \psi(\Delta R_{i,t}) \quad (9)$$

with i and i_{US} as the domestic and US interest rates, respectively, Δ as the change of a variable, and η , ϕ , ψ as weights.⁸

The intuition for using this measure is that when facing pressure on its currency, a government has the option of either devaluing the currency, raising interest rates and/or running down reserves. Hence such exchange market pressure (*EMP*) is a fairly good proxy for the strength of the pressure against the currency regime. Importantly, it also captures speculative attack episodes that fail to cause a devaluation. Since the aim of this paper is to understand not only the timing of a crisis but also its severity, this continuous definition will be used in the estimations below. Overall, comparing the *EMP* measure with the actual occurrence of crises shows that the *EMP* measure performs well in identifying the timing and also the severity of the crises during the 1990s.

4.2 Defining real integration contagion

Attempts to measure real transmission channels for financial crises have been undertaken by Glick and Rose (1999), Caramazza, Ricci and Salgado (2000) and Fratzscher (1998). These papers find some evidence that trade linkages may have played a role in recent financial crises, although the first two papers ignore cascading effects, differences in size of countries' exports as well as the composition of trade. The measure used here builds on Fratzscher (1998) and attempts to account for these difficulties.

The basic idea to be captured through a measure of real interdependence is that a crisis is more likely to spread to a country that is competing and trading strongly with countries that have been experiencing a crisis. Therefore, the importance of country j as a trade competitor for the home economy i is measured as

$$REAL_{ij} = \sum_c \sum_d \left(\frac{X_{jd}^c}{X_d^c} \times \frac{X_{id}^c}{X_i^c} \right) + \sum_c \left(\frac{X_{ij}^c + X_{ji}^c}{X_i^c + X_j^c} \right) \quad (10)$$

The first term indicates the degree of competition of country j for the home economy i in the export market of commodity c (X^c) in the third market d . The intuition for this measure is that country j is a stronger competitor for country i (a) the larger the export market share of country j in region d (X_{jd}^c / X_d^c), and (b) the higher the share for country i of total exports of

⁸ Each of the three measures is weighted by their relative precisions, calculated as the inverse of the series' standard deviation in the past. It has been employed in various studies of currency crises, including Eichengreen, Rose and Wyplosz (1996) and Sachs, Tornell and Velasco (1996).

that commodity c to region d (X_{id}^c / X_i). The second term measures the degree of bilateral trade between the two countries, implying that country i will be affected more by a devaluation in country j the greater the amount of bilateral trade between them.

The source of the trade data is the *World Trade Analyzer*, measures commodities at the 3-digit SITC level and excludes agriculture and natural resources. This data is available and is updated annually for use in the empirical estimations. As an illustration, Table 1 shows the regional bilateral averages of the $REAL_{ij}$ measure for 1996. The table indicates that the degree of real integration is particularly high for economies of the same region. Due to the large economic size and trade volume, Southeast and East Asian countries are the strongest competitors outside their own region, although the degree of competition with these economies is mostly much smaller than with those within the same region. The degree of trade competition proved robust to the choice of weights between bilateral and third market trade. Due to the small size of bilateral trade, excluding it from the measure did not alter the results significantly.

Table 1: Real Integration of Regions

REAL _{ij}	country j:	Average Real Integration				
		L. America	Asia	SE&E Asia	S Asia	Others
country i:						
Latin America		0.357	0.078	0.099	0.013	0.044
Asia:		0.038	0.400	0.499	0.103	0.049
Southeast & East Asia		0.042	0.413	0.537	0.039	0.041
South Asia		0.026	0.360	0.382	0.294	0.073
Others		0.037	0.132	0.165	0.034	0.225

Note: Real Integration for 1996, scaled to lie between 0 and 1.
Others: Eastern Europe, Middle East, Africa.

4.3 Defining financial integration contagion

How to measure financial integration contagion is a more difficult and controversial matter. The issue I am interested in here for the purpose of measuring contagion in the financial sector is how an investment decision (bank lending and portfolio flows) in one emerging market affects investment decisions in other emerging markets, i.e. to what extent underlying asset prices and investment decisions are interdependent. As discussed in section 2 above, the literature has emphasized two separate channels through which a crisis may be spread through the financial sector across markets: by the refusal of banks to rollover loans or provide new funds, and by the decision of investors to withdraw portfolio investments. To capture this distinction, this section therefore develops two measures of financial integration:

one measuring the competition for bank funds across countries, and the other being based on the correlation of asset returns in equity markets.

(1) Bank Contagion

Van Rijckeghem and Weder (1999), Kaminsky and Reinhart (2000), and Caramazza, Ricci and Salgado (2000) argue that a crisis is more likely to spread across economies that have the same common lender. Rather than using a common lender dummy, which is more common in the literature, Van Rijckeghem and Weder (1999) create a continuous variable that indicates how strongly a country competes for bank funds with the country where a crisis originated. Their measure, however, uses the same methodology of the trade measure by Glick and Rose (1999), and therefore shares the difficulty of ignoring cascading effects and differences in the size of bank lending. To avoid these difficulties, I use a methodology similar to equation (10)

$$BANKCOMP_{ij} = \sum_d \left(\frac{F_{dj}}{F_d} \times \frac{F_{di}}{F_i} \right) \quad (11)$$

where F_{di} indicates the flow of bank loans from lender country d to borrower i . The argument is analogous to the measure of trade competition above: (a) the higher the share of bank loans received from country d is for country i , and (b) the larger the share of total bank loans (to emerging markets) that go from d to country j , the more likely will a crisis be transmitted from country j to country i through lender d . The explanation is that the more funds a lender d lends to a single country j , the more likely will it be that if country j experiences a crisis d will be forced to withdraw funds or refuse to roll-over debt also to other economies i . The more heavily country i has borrowed from d , the more strongly will a recall of funds by d affect i . The data source is the BIS, includes bank lending from 18 of the main developed countries d , and is updated quarterly.

Table 2: Competition for Bank Loans

BANKCOMP _{ij}	country j:	Average Competition for Bank Loans				
		L. America	Asia	SE&E Asia	S Asia	Others
country i:						
Latin America		0.478	0.307	0.423	0.076	0.230
Asia:		0.267	0.496	0.698	0.094	0.221
Southeast & East Asia		0.259	0.541	0.765	0.095	0.213
South Asia		0.282	0.406	0.564	0.091	0.236
Others		0.304	0.388	0.534	0.096	0.397

Note: Measure for 1997, scaled to lie between 0 and 1.
Others: Eastern Europe, Middle East, Africa.

As an illustration of the $BANKCOMP_{ij}$ measure for 1997, Table 2 shows the strong regional focus of competition for bank lending and confirms Southeast Asia as the dominant emerging market region that absorbs a large share of total bank lending to emerging markets. Finally, it should be noted that $BANKCOMP_{ij}$ is an *indirect* measure of financial linkages, because it analyzes how a crisis in country j may spread to country i *through* decisions made by lenders in country or region d . Data for a *direct* measure of financial linkages, such as bilateral bank lending, is hard to obtain for emerging markets, but it is also unlikely to have played a major role as most of the funding for emerging markets comes from a few developed countries.

(2) Equity Market Contagion

Many emerging markets are not only dependent on bank funds but also on portfolio capital inflows to finance their demand for foreign exchange. To measure the extent to which the similarity in the dependence on portfolio flows may have worked as a contagion channel for recent financial crises, I will employ correlation measures of stock market returns as indicators for the degree of financial market integration. The underlying hypothesis is that the higher the degree of financial market integration between two emerging markets, the more likely a financial crisis will spread from one to the other.

Using correlations of stock market returns is certainly not the ideal way and only an indirect way of measuring financial integration related to portfolio flows. Including data on direct portfolio flows would improve the quality of a measure of financial interdependence but are unfortunately not available for a broader set of countries and for a longer period of time. Nevertheless, using correlations of asset returns should provide a good first proxy for such financial interdependence and also has the advantage of including factors of interdependence that are not directly observable through portfolio flow data.

As a first measure, I use the monthly averages of the correlation of weekly stock market returns across emerging markets.⁹ Since a high correlation of returns may be partly explained by similarities in fundamentals or by the exposure to common external shocks in developed markets, I control for these factors by regressing the country return index r_i on country-specific fundamentals as well as on weighted returns of the S&P 500, FTSE 100 and NIKKEI ($GRET$):

$$r_{i,t} = \beta_1 + \beta_2 TB_{i,t} + \beta_3 i_{i,t} + \beta_4 P_{i,t} + \beta_5 S_{i,t} + \beta_6 GRET_t + \mu_{i,t} \quad (12)$$

with the independent variables as the trade balance (TB), the change in a country's interest rate (i), the rate of inflation (P) and the spot exchange rate (S) for each country i . The second measure of financial interdependence then is the correlation of the residual μ , which should

⁹ Baig and Goldfajn (1998) also look at cross-country correlations of exchange rates, interest rates and sovereign risk spreads during the Asian crisis. None of these three measures is appropriate in the context of this paper because the first two were a policy tool under managed exchange rates prior to the crisis and sovereign risk spreads reflect the market perception of the default risk rather than the interdependence of financial markets.

give a reasonably good idea about the true interdependence of various emerging stock markets:¹⁰

$$FINCORR1_{ij} = CORREL(r_{i,t}, r_{j,t}) \quad (13)$$

$$FINCORR2_{ij} = CORREL(\mu_{i,t}, \mu_{j,t}) \quad (14)$$

Table 3: Financial Interdependence of Regions

	Avg. Return Residual Correlations: FINCORR1 _{ij}					Avg. Return Correlations: FINCORR2 _{ij}				
	L. America	Asia	SE&E Asia	S Asia	Others	L. America	Asia	SE&E Asia	S Asia	Others
Latin America	0.301					0.349				
Asia:	0.147	0.294				0.159	0.165			
Southeast & East Asia	0.131	0.361	0.572			0.179	0.199	0.312		
South Asia	0.173	0.183	0.119	0.472		0.124	0.107	0.122	0.264	
Others	0.187	0.100	0.139	0.035	0.233	0.066	0.095	0.100	0.086	0.198

Note: Correlations are for the period of 1992/Q1-1996/Q4.
Others: Eastern Europe, Middle East, Africa.

Note that the measure of integration used for the empirical implementation is the one of equation (14) and is time-invariant and measured during the relatively more tranquil period of 1992-96 in order to ensure that the integration variables are exogenous in the model. Table 3, which shows averages of bilateral country correlations within regions, confirms that financial market interdependence is significantly higher among regional markets. Two results, however, stand out from Table 3: first, controlling for global and country-specific factors often raises the degree of financial interdependence; and second, the residual correlations are particularly high among Southeast and East Asian markets. This suggests that financial integration contagion is stronger both within regions and in particular in Southeast and East Asia.

4.4 Evaluating and comparing different sources of contagion

Tables 1-3 above show the degree of integration and interdependence across regions while Table 4 below ranks for the three contagion variables the ten countries for which Mexico and Thailand (i.e. the countries that were the first victims of the Latin American crisis in 1994-95 and in Asia in 1997) were the strongest real competitors and had the highest degree of

¹⁰ Wolf (1998) shows that another potential bias, apart from similarities in fundamentals, may result from the similarity of the sectoral composition of countries' stock market indices. I.e., if the sectoral composition of two indices is similar, then it is possible that comovements of these indices are caused by changes in one particular sector which in turn may be due to global developments. However, Wolf finds that the correlation of returns in many cases is higher after controlling for such similarities, thus confirming the importance of contagion.

financial integration. Comparing the three different contagion variables yields a number of important results.¹¹

First, integration and interdependence have a very strong regional character, with countries of the same region being much more integrated and competing more strongly with each other than countries of different regions. Second, Southeast and East Asian countries tend to be the dominant emerging markets. The reason for this dominance is not only the larger relative size of these economies, but also reflects the greater degree of openness (both real and financially) of the economies of that region.

Table 4: Comparison of Most Integrated Countries with Mexico and with Thailand

ranking	with MEXICO			with THAILAND		
	REAL _{ij}	BANKCOMP _{ij}	FINCORR2 _{ij}	REAL _{ij}	BANKCOMP _{ij}	FINCORR2 _{ij}
1	Venezuela	Peru	Argentina	Pakistan	Indonesia	Malaysia
2	Chile	Colombia	Colombia	China	Malaysia	Philippines
3	Colombia	Venezuela	Chile	Mexico	China	Mexico
4	Brazil	Argentina	Malaysia	Malaysia	India	Indonesia
5	Korea	Chile	Brazil	Sri Lanka	Korea	Korea
6	Thailand	Bolivia	Venezuela	Philippines	Hungary	South Africa
7	Peru	Brazil	Philippines	Indonesia	Philippines	Chile
8	Pakistan	Philippines	Korea	India	Czech Republic	Argentina
9	Argentina	South Africa	Indonesia	Korea	South Africa	Brazil
10	Malaysia	Poland	Pakistan	Poland	Pakistan	India

Note: REAL is defined in equation (10), BANKCOMP in equation (11), FINCORR2 in equation (14). Mexico and Thailand are country *j* in each of the equations, therefore the table indicates which countries are the most likely victims based on the strength of the contagion measures.

Third, Table 4 ranks the countries by integration with Mexico and with Thailand. The results are mostly intuitive and confirm that both Mexico and Thailand tend to be more integrated with countries of the same region. However, it is striking that the three countries with the strongest degree of *real* competition with Thailand and with Mexico were countries that escaped the crises relatively unscathed. This provides a first indication that real integration contagion may not provide a very good explanation or at least not be the sole explanation for the dynamics of the two financial crises of 1994-95 and 1997.

In contrast, the rankings for the two *financial* contagion variables correspond much more closely with the list of countries that became the main victims of either the Latin American crisis or the Asian crisis, thus suggesting that the crises were more likely to have spread through financial interdependence. For instance, South Asian markets have a low degree of financial interdependence with Southeast and East Asia (Table 3) despite having a relatively high degree of real integration with that region (Table 1). Thus the lack of their financial market integration and financial openness may offer an explanation as to why contagion did not hit South Asia during the 1997-98 Asian financial crisis.

¹¹ One potential problem that could constitute a bias in an econometric analysis is the possibility that the different contagion variables may be highly correlated, if they are picking up similar elements of integration. However, Table 5 (see appendix) shows that the correlation of the contagion variables is low (except for the two stock market correlation measures), thus there should be no significant bias due to multicollinearity stemming from contagion.

5 Empirical results: explaining currency crises

To distinguish empirically between the role of contagion and the importance of country-specific fundamentals and sunspots, I follow a three-pronged testing strategy. First, the univariate Markov-switching model of equation (8) is employed in section 5.1 to analyze the extent to which exchange rate movements in emerging markets in the 1990s are explained by contagion versus by fundamentals and sunspots. Second, a panel data analysis then investigates in section 5.2 how robust these results are for a broad sample of 24 emerging markets. And third, the predictive power of the model is tested in section 6.

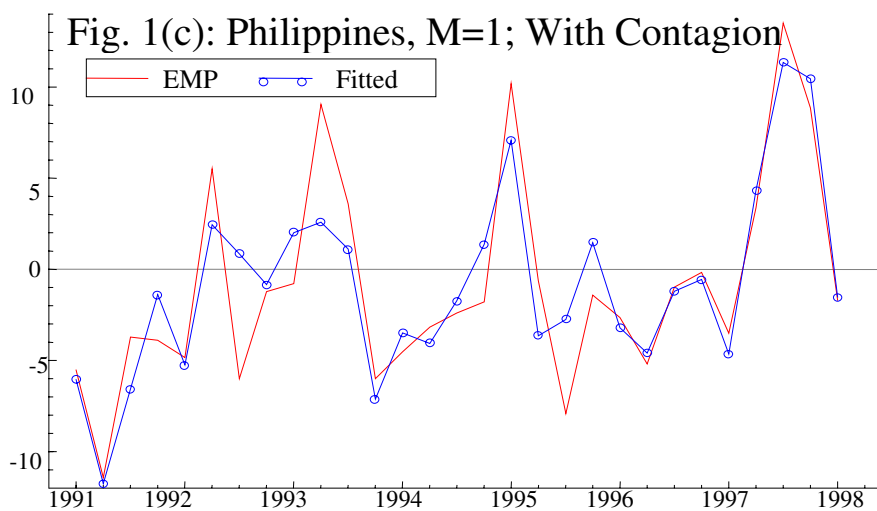
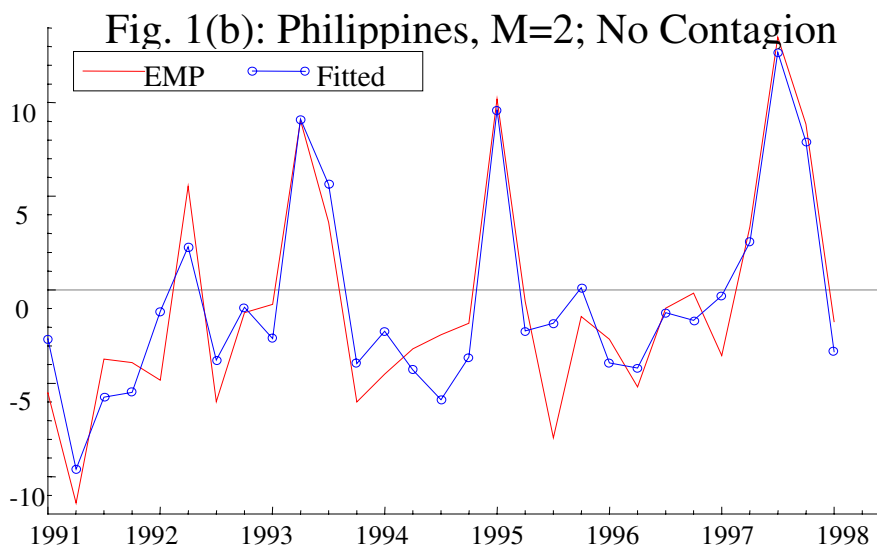
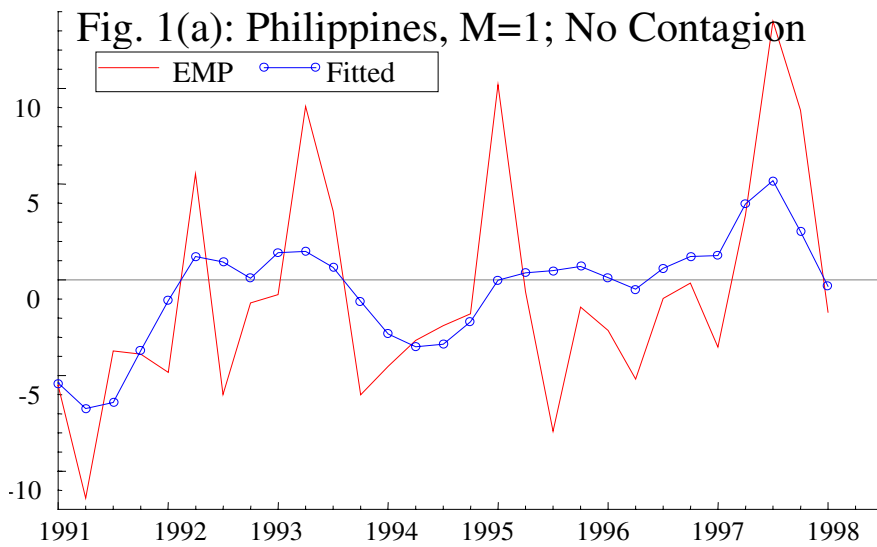
5.1 Contagion versus fundamentals in a univariate Markov-switching framework

To obtain information about the relative importance of contagion, I proceed in two steps. In the first step, I exclude contagion from the analysis and compare the linear model of equation (1) with the non-linear Markov-switching model of equation (8). The idea is that if fundamentals are of key importance in explaining exchange market movements and currency crises, then not only its coefficients should be significant but there should be no need for regime shifts that are independent of fundamentals. In the second step, I then also include the contagion variables in order to check whether the inclusion of contagion improves the explanatory power of the model and helps explain the occurrence of currency crises.

Starting with the first step, I find that fundamentals perform modestly in explaining the exchange rate dynamics of most emerging markets in the 1990s, in particular when large jumps in exchange rates occur (see Figure 1(a), and regressions 1 of Table 6 in the appendix). On the contrary, the Markov-switching model with two or three regimes performs well for most countries if the contagion variables are not included (see Figure 1(b) and regressions 2, Table 6).

This finding is intuitively convincing because when looking at the data on exchange market pressure, one can detect three regimes for most countries: a tranquil one where the exchange market pressure is around zero; a second one where there is a high degree of exchange market pressure and low credibility as during times of speculative attacks and crises; and a third one where there is a negative exchange market pressure, i.e. a currency appreciates, interest rate differentials fall and reserves rise, which often occurs immediately after devaluations.

Turning to the second step, when including contagion the coefficients for financial contagion, and sometimes also for real contagion, are mostly large and significant and the fit of the model is improved, indicated by the drop in the variances and log-likelihoods (regressions 3 and 4, Table 6). More importantly, the inclusion of contagion often eliminates the existence of regime shifts, which can be seen from the fact that the linear model (regressions 3) performs as well as the non-linear Markov-switching model (regressions 4) for a number of countries. This suggests that contagion in many cases explains regime shifts that can not be accounted for by fundamentals.



This finding that regime shifts are eliminated when contagion is included, i.e. the fact that the linear model of equation (2) performs about as well as the non-linear Markov-switching model of (8), is a crucial one. It is crucial because it indicates that the factors that explain currency crises, i.e. the regime shifts, are not unobservable but in many cases are captured through the inclusion of contagion variables. On the contrary, in cases where regime shifts persist one can not make any meaningful inference about the cause of a crisis because the regime shift in the Markov-switching model is unobservable, i.e. one has no information about which unobservable factors, e.g. expectations about future fundamentals or elements of contagion not included in the model, have caused the crisis.

The case of the Philippines provides a good example: a Markov-switching model with two regimes and no contagion (Fig. 1(b)) performs much better than the linear model (Fig. 1(a)), with the solid line showing the actual exchange market pressure (dependent variable) and the dotted line in Fig. 1(a) indicating what is explained by fundamentals alone. The linear model with no regime change but with contagion (Fig. 1(c)), however, performs about as well and thus eliminates the need for regime shifts that are not due to changes in fundamentals. Note that contagion not only helps to explain the countries increased exchange market pressure during the Asian crisis and Latin American crisis but also during tranquil periods. Similar conclusions apply to some other countries which were victims of either of these two crises (Korea, Indonesia, Mexico; see Table 6) while contagion does not explain regime shifts for other countries which were affected less by the crises (Chile, India).

Although there is no single economic fundamental variable that is significant in the analysis for *all* countries over time, these findings do not imply that fundamentals are worthless in explaining crises. For most countries, either the large size of foreign debt, fast domestic credit expansion (“Lending Boom”) or an overvalued exchange rate is important in understanding movements in foreign exchange markets. Thus, looking at these three fundamental variables *together* should indeed improve our understanding of developments in foreign exchange markets. Nevertheless, not knowing which fundamental variable is relevant for which country and under what circumstances makes it very difficult, if not impossible, to find a common explanation for different crises and makes it even harder to predict crises reliably with fundamentals alone.

A number of robustness checks were conducted. For instance, other fundamentals than those listed in Table 6 did not prove significant, such as external variables (growth and interest rates in industrialized countries) and other domestic variables (government deficit, capital flows). It is also important to emphasize the shortcoming of the Markov-switching methodology of tending to “over-fit” the data. I.e. the model with multiple regimes has a good fit but also in some cases produces coefficient estimates that do not make sense (showing either a large change in the coefficient or the wrong sign). Moreover, a formal test of the regime-switching hypothesis via likelihood ratio tests is not possible due to a bias of the test in the regime-switching framework (Krolzig 1997). Otherwise the Markov-switching model appears sound from various test statistics, such as the switching probabilities p_{kl} . The Markov transition matrices confirm that the probability of remaining in a particular state is usually about 50% or higher (see Table 6). Only very few regimes are characterized by one or two events, and most regimes are reached at least three times over ten or eleven years.

5.2 Contagion versus fundamentals in a panel data framework

The key purpose of the panel data analysis is to test whether the results for individual countries outlined in section 5.1 are robust across countries and whether we can detect factors that were common to the majority of countries and crisis episodes. In particular, the weakness of the analysis for individual countries is that it fails to explain why some countries with more healthy fundamentals were affected so severely while others with worse economic conditions manage to escape unscathed. This subsection presents the results for a panel data analysis with random effects based on the infection function of equation (2).¹²

The key result of the panel data estimation (Table 7) is that contagion has been a key driving force behind exchange market movements in emerging markets. The primary channel of contagion was the channel of financial sector interdependence (in particular equity market interdependence), whereas the coefficient of trade integration is smaller though still significant. The importance of contagion is underlined when comparing the Full Model (including both fundamentals and contagion variables) with the Fundamentals Model (with only fundamentals) and the Contagion Model (with only contagion) and their log-likelihoods: the Full Model has a much better fit than the Fundamentals Model.

**Table 7: Panel Estimation: Random Effects Model (MLE)
for 24 Emerging Markets Worldwide, 1989/Q1-1998/Q2**

	Continuous Contagion						Crisis Contagion			
	FUNDAMENT. MODEL		FULL MODEL		CONTAGION MODEL		FULL MODEL		CONTAGION MODEL	
	(1)		(2)		(3)		(4)		(5)	
	Coef.	Std Err.	Coef.	Std Err.	Coef.	Std Err.	Coef.	Std Err.	Coef.	Std Err.
Capital Flows	0.045	0.046	* 0.085	0.040			* 0.067	0.036		
Short-Term Capital Flows	0.001	0.001	0.003	0.005			0.001	0.001		
Lending Boom	7.021	4.808	* 9.124	4.456			5.637	3.984		
Foreign Debt	** 10.708	3.827	** 10.468	3.732			* 7.451	3.549		
Short-Term Debt	* 4.719	2.373	* 3.150	1.628			* 4.941	1.999		
Overvaluation	** 6.225	1.941	* 5.303	1.970			* 3.388	1.722		
Reserves	-0.559	0.401	-0.531	0.386			-0.246	0.366		
Trade Balance	2.141	3.168	3.845	2.871			3.373	2.825		
Real Contagion			** 1.741	0.590	** 1.890	0.623	* 2.575	1.217	* 2.858	1.706
Equity Market Contagion			** 12.864	2.639	** 13.009	2.774	** 14.959	4.182	** 15.923	5.855
Bank Contagion			** 1.139	0.114	** 1.832	0.659	** 12.148	3.332	** 12.308	4.547
Constant	** -4.639	1.391	* -3.362	1.310	-0.401	0.288	** -4.336	1.185	-0.455	0.350
Log Likelihood	-1778		-1296		-1419		-1570		-1956	

Note: Regressions for "Crisis contagion" include contagion variables only for the crisis episodes of 1994/Q4-1995/Q2 and 1997/Q3-1997/Q4. ** and * denote statistical significance of coefficients at the 99% and 90% level, respectively.

¹² The ordinary panel data model with random effects or with fixed effects does not explicitly allow for exogenous shifts in beliefs as the Markov-switching model does. The reason for why an MS-VAR analysis can not be conducted in this panel data context is that regime shifts across the set of 24 emerging markets are very distinct. Although comovements and common regime shifts exist for some regional groups, such as in Southeast Asia, no common regime shifts are present for countries of different regions because there are few similarities across currencies to be found within regimes. E.g., a particular regime may indicate an appreciation and high volatility for some countries while at the same time showing depreciating currencies and low volatility for others.

Second, contagion seems to be of particular importance during crisis periods (the 1994-95 Latin American crisis and the 1997-98 Asian crisis) as indicated by the increase in the size of the coefficients (regressions 4, 5 in Table 7). There is a particularly strong increase in the coefficient for bank contagion during crisis episodes, suggesting that decisions by banks to withdraw funds and refuse the rollover of debt may have played a significant role in the transmission of recent emerging market crises. However, contagion variables are still relevant during tranquil periods, suggesting that exchange market movements are transmitted not only during crises.

Third, the fundamentals that are significant are the level of total and short-term foreign debt/GDP, a prior change in the ratio of domestic credit expansion to GDP (“*Lending Boom*”), and the overvaluation of the exchange rate. Many other variables were tested but did not show any significance (such as changes in the US dollar value vis-à-vis the mark and the yen, a country's government deficit, the current account, the trade balance).

Finally, the results are robust to changes in variable definitions and the time span but are sensitive to country groupings. To test for differences across regions, I employ an analysis of variance (ANOVA) methodology that takes for each country i , analogously to equation (2), the following form:

$$y_{i,t} = \alpha_i + \gamma_i z_{i,t-1} + u_{i,t} \quad (15)$$

with z as the vector of fundamentals and contagion variables. The null hypothesis of interest is that the coefficient for an individual country (γ_i) is equal to the coefficient for the country grouping as a whole (β):

$$H_0 : \gamma_i = \beta$$

**Table 8: Analysis of Variance (ANOVA)
of Panel Estimation for Full Model (EMP)**

	Global		Asia		Latin America		Others	
	Global Coef.	ANOVA H ₀	Regional Coef.	ANOVA H ₀	Regional Coef.	ANOVA H ₀	Regional Coef.	ANOVA H ₀
Capital Flows	* 0.085	11 / 24	0.116	4 / 9	0.041	4 / 8	0.042	3 / 7
Short-Term Capital Flows	0.003	11 / 24	0.008	4 / 9	-0.008	2 / 8	0.007	2 / 7
Lending Boom	* 9.124	13 / 24	1.107	4 / 9	* 15.71	5 / 8	5.703	3 / 7
Foreign Debt	** 10.46	13 / 24	* 14.54	5 / 9	2.573	3 / 8	* 9.873	3 / 7
Short-Term Debt	* 3.150	11 / 24	* 4.431	5 / 9	* 2.968	5 / 8	2.086	2 / 7
Overvaluation	* 5.303	10 / 24	0.717	4 / 9	* 8.851	5 / 8	* 4.517	4 / 7
Reserves	-0.531	10 / 24	-0.306	3 / 9	-0.514	4 / 8	-1.703	3 / 7
Trade Balance	3.845	9 / 24	7.143	4 / 9	-14.40	2 / 8	1.343	2 / 7
Real Contagion	** 1.741	12 / 24	* 1.971	6 / 9	1.235	4 / 8	0.597	2 / 7
Equity Market Contagion	** 12.86	14 / 24	* 14.56	7 / 9	* 8.384	6 / 8	* 11.41	4 / 7
Bank Contagion	** 1.139	15 / 24	* 1.456	7 / 9	* 1.189	6 / 8	0.938	2 / 7

Note: ANOVA shows how many of the countries' coefficients are statistically equal to their group's coefficient at the 90% significance level. The contagion variables are continuous variables as defined in the infection function of equation (2). ** and * denote statistical significance of coefficients at the 99% and 90% level, respectively.

The results reveal significant differences in the size and significance for many coefficients across regional groups. On the contrary, the size of the coefficients for the contagion

variables are reasonably robust within those regional groups as indicated by the acceptance of H_0 for usually more than half of the countries within the same region (Table 8). Another important finding is that financial contagion seems to have been particularly strong across Asian countries and less significant, though still positive, in Latin America. On the contrary, the overvaluation of the exchange rate was more of a driving force in Latin America than in Asia.

Overall, the results of the panel data estimation and its analysis of variance largely support and strengthen the results of the Markov-switching analysis for individual countries in section 5.1. In particular, while crises have diverse causes and no single fundamental variable is significant for every country and every time period, looking at the size of foreign debt, the rate of domestic credit expansion and the competitiveness of a country *together* helps in getting a good understanding of the movements in foreign exchange markets. But even after controlling for fundamentals, real integration contagion and in particular financial integration contagion still seem to have played a major role in the foreign exchange markets of many emerging markets.

6 Empirical results: predicting currency crises

Empirical models of currency crises have been subject to the critique that they are often a “data-mining” exercise: they test a wide variety of fundamental variables but they find statistically significant results without knowing whether there really exists a causal relationship between the variables and the occurrence of currency crises. Berg and Pattillo (1998) confirm this critique by showing that models which are good in explaining crises *ex post* have failed to predict the 1997 Asian crisis. The models they analyze tend to predict crises in countries that were relatively unscathed and often failed to anticipate crises where they did occur.¹³ Therefore, a model that fails to predict crises has very little value for policy-makers whose aim is to implement policies that prevent or lessen the impact of future crises.

The approach used in this paper is equally open to the data-mining critique. A wide variety of fundamentals were tested and Tables 6-8 present only those that proved significant in the estimations. The defense of this approach in this paper is twofold: first, to confirm Berg and Pattillo’s finding that fundamentals alone fail to predict crises out-of-sample, and second, to analyze whether including contagion improves the predictive power of the model. The findings confirm that contagion variables are important not only in explaining but also in predicting the transmission of crises.

¹³ They evaluate and compare the predictive power of three of the most cited models, each representing a different type of model: Kaminsky, Lizondo and Reinhart’s (1997) signalling approach which identifies when fundamentals provide signals for potential future crises, Frankel and Rose’s (1996) panel data analysis with probit techniques reaching back to the 1970s, and Sachs, Tornell and Velasco’s (1996) cross-sectional approach which focuses on a set of 20 open emerging markets during the Latin American crisis in 1994-95.

**Table 9: Predicting the Spread of the 1997-98 Asian Crisis:
Comparison of the Model of Equation (2) and of Alternative Models**

	MODEL EQUATION (2)									ALTERNATIVE MODELS					
	Actual		Full		Fundament.		Contagion		Sachs et al. (1996)			Frankel&Rose(1996)			
	Crisis		Model		Model		Model		Actual	Model	Model	Actual	Model	Model	
	Index								Index	3	4	Index	2	4	
	rank	size	rank	size	rank	size	rank	size		rank		rank			
country:			(1)		(2)		(3)		country:	(4)	(5)	(6)	(7)		
Indonesia	1	42.0	4	14.2	19	-2.7	3	13.7	Indonesia	1	14	9	2	7	
Korea	2	32.6	5	8.6	16	-0.4	8	4.3	Thailand	2	7	5	3	7	
Thailand	3	27.4	3	19.2	10	1.4	2	15.3	Korea	3	12	11		11	
Malaysia	4	27.0	1	26.7	6	3.5	1	18.5	Malaysia	4	6	6			
Philippines	5	22.4	2	20.8	2	4.8	4	13.1	Zimbabwe	5	23	12			
Colombia	6	9.1	7	6.2	5	3.7	22	-2.2	Philippines	6	1	1	7	8	
Russia	7	4.5	8	5.9	9	1.9	18	0.4	Turkey	7	9	13	1	3	
Sri Lanka	8	4.3	6	7.6	3	4.7	10	3.5	Colombia	8	18	4	8	8	
India	9	2.6	16	3.5	17	-0.8	9	3.8	Taiwan	9	11	22			
Poland	10	1.6	13	4.0	11	1.3	13	2.3	Pakistan	10	17	20	6	11	
Jordan	11	1.4	17	3.4	1	5.8	20	-0.4	Uruguay	11	3	3	4	2	
South Africa	12	1.1	10	5.2	18	-2.1	7	6.8	South Africa	12	15	16			
Brazil	13	0.6	21	0.0	14	0.3	19	0.3	India	13	5	19	14	13	
Pakistan	14	0.1	15	3.5	21	-2.7	12	3.2	Brazil	14	4	21	10	6	
Chile	15	-0.6	14	3.7	8	2.7	5	8.7	Sri Lanka	15	16	17	11	14	
Hungary	16	-1.3	20	1.4	15	0.0	16	1.5	Chile	16	19	14	15	9	
Peru	17	-2.4	11	4.2	7	2.9	21	-0.5	Jordan	17	20	15			
Argentina	18	-3.4	19	2.4	13	0.4	11	3.3	Mexico	18	21	18	12	4	
China	19	-4.5	9	5.7	4	3.7	15	1.6	Israel	19	10	8			
Mexico	20	-5.9	18	3.0	22	-4.0	6	8.0	Peru	20	8	23	9	1	
Venezuela	21	-6.9	22	-0.4	20	-2.7	17	0.5	Venezuela	21	22	13	5	10	
Turkey	22	-9.0	12	4.0	12	1.1	14	1.6	Bolivia	22	13	10	13	12	
									Argentina	23	2	7	16	5	
Spearman correlation			0.738		0.228		0.411			0.110	0.230		0.330	0.120	
P-value			0.000		0.309		0.057			0.612	0.295		0.253	0.694	
R ²			0.464		0.407		0.441			0.010	0.050		0.110	0.020	

Note: R² is obtained from a regression of predicted on actual values of EMP.

Predictions are out-of-sample, using 1997/Q3-Q4 for the Asian crisis as the crisis period for the Model of Equation (2).

Source: Berg and Pattillo (1998), Table 14, p. 54, for the predictions of the models by Frankel and Rose (1996) and Sachs et al. (1996).

Table 9 shows the predictive power of the model developed in this paper in comparison to that of alternative models in the literature. The results are based on out-of-sample estimations, i.e. they were obtained by estimating the model till the end of 1996 and then using these coefficients to get the out-of-sample estimates for the Asian crisis. The table indicates that our Full Model for the Asian crisis (model 1) is superior in terms of ranking to all of the models tested by Berg and Pattillo (models 4, 5, 6, 7), based on a comparison of the Spearman rank correlations. The superiority mostly stems from the inclusion of the contagion variables in the Full Model because the Fundamentals Model alone does not have a much better predictive power than the other models by Frankel and Rose (1996) and by Sachs, Tornell and Velasco (1996) which are both built entirely on fundamentals.¹⁴

The Full Model does not only forecast accurately the *ranking* of how strongly countries were affected by the Asian crisis, but it also performs relatively well in forecasting the *degree* of severity. Indonesia and Korea are the only countries for which the Full Model underestimates the degree of the crises substantially, indicating that fundamentals and the extent of real and financial interdependence did not seem to warrant the severity with which these countries were hit.¹⁵ The overall results prove robust to various sensitivity analyses, such as altering the forecasting horizon and using in-sample prediction to test for parameter constancy, and altering the size of the country sample to check for the impact of individual countries.

What makes us believe that the model presented in this paper is a superior model? First, the Full Model presented in this paper has the advantage of being able to estimate both the rankings of countries as well as the absolute severity of a crisis, i.e. it allows us to understand not only why some countries are affected more than others, but also why a particular country is hit so severely. Including a time dimension in addition to a cross-sectional dimension as in the model here has the added advantage of allowing a better understanding of the dynamics of exchange rate changes. The results confirm that variables that help explain exchange rate movements during tranquil periods may become even more important during crises. This was shown to be the case in particular for contagion through bank loan competition among economies.

7 Conclusions

This paper has argued that the main reason for the poor performance of standard models of currency crises lies in their neglect of the role of contagion - the fact that crises may be transmitted across countries through their interdependence with others. The empirical analysis, using Markov-switching models and panel data models, found compelling evidence that the Latin American crisis of 1994-95 and the Asian crisis of 1997-98 were indeed contagious, spreading across countries which were not only vulnerable economically but which were closely linked financially. The model performs remarkably well in predicting the

¹⁴ The model by Frankel and Rose (1996) is based on probit estimates using annual data for more than 100 countries reaching back to the 1970s. The model by Sachs, Tornell and Velasco (1996) is a cross-sectional one for the Latin American crisis of 1994-95 alone.

¹⁵ Political factors were probably another important reason for why Indonesia was the main victim of the Asian crisis. Such factors are not analyzed in this paper and are difficult to include on a cross-sectional basis; a discussion of the role of political factors can be found in Drazen and Masson (1994).

spread of the Asian crisis. The results therefore suggest that one of the most important indicators for predicting which countries will be affected by a particular crisis are the degree of real and financial interdependence with already affected countries.

It is imperative to emphasize that the empirical findings of this paper do not imply that the financial crises of the 1990s were entirely the result of fickle capital flows and nervous investors. It would be wrong to deny that countries that were hit by recent crises were vulnerable and showed weaknesses in their economic foundations. It would be equally wrong, however, to deny that rapid capital account liberalization and the opening to international markets, which lead to increased real and financial interdependence among emerging markets, played a crucial role in explaining both the timing as well as the severity of those crises.

The central lesson from the findings of this paper is that no open emerging market, even one with relatively sound fundamentals and policies, is capable of insulating itself from events in the rest of the world. The powerful role of contagion suggests that the most effective measures for crisis prevention and resolution may require a global, coordinated policy approach. Many of such policy proposals have been rejected or not been implemented, including calls for the creation of a global lender of last resort, the imposition of certain capital controls, or contingency funds (e.g. Eichengreen et al. 1995, Radelet and Sachs 1999, Rodrik 1998). The relevance of a global, coordinated policy approach has nevertheless been widely recognized, as also underlined by a recent IMF proposal in favor of a debt standstill for debtor countries in order to facilitate the resolution of sovereign debt crises (Krueger 2001). However, the difficult challenge still faced by emerging markets is how best to reap the benefits of a more open economy while minimizing the risk of becoming the victim of a potentially devastating financial crisis inherent in the liberalization process.

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Appendix: Data Definitions and Sources

Country Sample

The 24 countries of the sample are: Argentina, Bolivia, Brazil, Chile, Colombia, Mexico, Peru, Venezuela; China, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Sri Lanka, Thailand; Czech Republic, Hungary, Jordan, Poland, Russia, South Africa, Turkey.

Fundamentals

The set of fundamentals covers a fairly wide range of variables, many of which have been mentioned in the academic literature as potential culprits for some currency crisis or another. Kaminsky, Lizondo, and Reinhart (1997) provide a comprehensive review of empirical work on currency crises and emphasize the lack of empirical consensus on what may cause crises. The empirical analysis starts from a broad approach by including a wide range of variable definitions in order to avoid ignoring potentially powerful factors in the analysis:

- foreign debt: total foreign debt/GDP, total short-term debt/GDP, and short-term debt/total foreign debt. Source: *IMF/WB/OECD/BIS* joint publication.
- capital inflows: total capital inflows/GDP, short-capital inflows/GDP and short-term to total capital inflows. Source: *IMF*.
- trade balance: (exports+imports)/GDP and current account. Source: *IMF*.
- overvaluation of exchange rate: real effective exchange rate (REER) relative to 1990, and the change in REER during the prior one or two years. Source: *JP Morgan*.
- foreign exchange reserves: ratio of total foreign exchange reserves to either M2 or to imports. Source: *IMF*.
- lending boom: rate of credit expansion to the private sector relative to GDP. Source: *IMF*.
- government deficit/GDP and government debt/GDP. Source: *IMF*.
- changes in interest rates and growth rates in industrial countries. Source: *IMF*.
- US\$ exchange rate changes to Japanese yen and German mark. Source: *IMF*.

Exogenous Variable

- Exchange Market Pressure (EMP): definition in text. Source: *IMF* and national central banks.

Contagion Variables

- Real Integration Contagion: definition in text. Source: *World Trade Analyzer* (1986-98); commodities measured at the 3-digit SITC level, excluding agriculture and natural resources.
- Common Bank Lender: definition in text. Source: *BIS/OECD/WB/IMF Joint Database*.
- Financial Market Integration: definition in text. Source: *Datastream/Reuters* and *IMF*.

Table 5: Correlations of Contagion Variables

	REAL	BANKCOMP	FINCORR1	FINCORR2
REAL	1			
BANKCOMP	0.045	1		
FINCORR1	0.012	0.103	1	
FINCORR2	-0.030	0.086	0.641	1

Note: See equations (10), (11), (13) and (14) for definitions of the contagion variables.

Table 6: Results of Markov-Switching Models

	MEXICO				ARGENTINA				THAILAND				KOREA			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Const.(Regime 1)	*-66.05	* -52.00	-66.91	* -64.38	*-9.497	* -18.28	-2.298	* -7.041	4.346	* 3.695	14.30	* 14.70	2.573	4.992	15.237	15.16
Const.(Regime 2)		* -51.98		* -33.15		* -16.72		* -5.739		-0.26		* 14.76		5.087		15.20
Const.(Regime 3)		* -26.87				* -13.61		* -2.654		* 17.37		* 14.98		5.235		15.36
Capital Flows	0.136	0.095	0.058	0.049	-0.015	-0.091	-0.110	-0.080	-0.214	0.708	-0.641	-0.686	-0.035	-0.052	-0.092	-0.092
Lending Boom	-12.49	-8.959	-37.17	5.221	* 10.11	* 14.04	63.41	* 9.358	0.108	* -17.32	-3.578	-3.579	* 69.64	* 59.39	* 90.63	* 90.62
Foreign Debt	* 24.98	* 19.21	* 26.86	* 22.39	-12.38	-13.70	-7.167	-8.323	* 6.725	* 6.081	* 9.962	* 9.964	* 30.55	* 19.17	* 48.69	* 48.69
Overvaluation	* 0.716	0.482	* 0.819	* 0.549	* 12.61	* 12.46	* 13.99	* 17.25	* 48.66	* 40.95	* 54.99	* 54.99	* 18.81	* 23.91	* 25.92	* 25.32
Reserves	-3.248	2.544	-18.33	15.94	-11.24	-9.721	-12.58	-14.87	0.208	* 5.871	-2.663	-2.663	-8.618	-11.33	-23.24	-23.24
Trade Balance	131.6	57.95	116.9	122.1	*-25.51	* -21.10	*-25.61	* -29.31	75.36	22.20	92.16	92.16	-255.7	-184.8	-245.2	-245.2
Real Contagion			* 4.514	* 6.558			1.228	* 1.689			1.178	1.178		* 10.04	* 10.04	
Financial Cont.			0.465	0.450			* 10.11	* 9.109			* 12.79	* 12.83		* 10.21	* 10.52	
Log-likelihood	-132.4	-114.2	-101.2	-82.44	-50.84	-40.57	-46.89	-36.62	-104.7	-77.40	-72.95	-72.95	-121.2	-101.7	-90.44	-90.44
Variance	43.95	10.84	49.73	9.597	2.926	0.317	2.719	0.261	11.00	1.141	7.582	7.581	25.16	22.19	24.32	24.32
ρ_{11}		0.673		0.964		0.531		0.571		0.686		0.686		0.686		0.688
ρ_{22}		0.716		0.382		0.442		0.584		0.912		0.912		0.786		0.669
ρ_{33}		0.299				0.150		0.333		0.499		0.499		0.001		0.615
	PHILIPPINES				INDONESIA				CHILE				INDIA			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Const.(Regime 1)	3.512	2.079	0.656	0.603	*-47.62	* -71.57	* -43.39	*-43.53	3.513	-1.722	*-23.26	* -32.27	-14.12	-55.14	-13.19	* 74.84
Const.(Regime 2)		* 13.30		0.695		* -66.38		*-43.44		* 4.469		* -25.80		-49.65		* 80.29
Const.(Regime 3)						-60.32		*-43.26		2.449		* -22.62		-42.78		* 85.48
Capital Flows	0.043	0.077	-0.084	-0.084	0.276	-0.612	0.030	0.030	-0.509	-0.776	-0.417	-1.126	* 0.316	* 0.496	* 0.324	* 0.309
Lending Boom	12.06	16.68	-52.60	-52.61	* 49.97	* 89.69	* 61.99	* 61.99	-13.04	-17.52	-62.12	-52.87	-98.71	-21.62	-38.48	* -4.854
Foreign Debt	* 4.412	* 8.796	* 14.67	* 14.67	* 25.02	* 19.31	* 15.37	* 15.37	* 9.549	* 10.06	* 6.502	* 4.358	* 24.63	* 3.591	* 19.94	* 17.00
Overvaluation	* 14.42	2.800	* 13.79	* 13.79	*-19.45	* -8.342	* -22.78	*-22.77	-2.160	0.743	* 37.02	* 31.78	0.382	0.678	0.200	* 0.351
Reserves	7.023	* 14.67	* 14.46	* 14.46	59.89	* 90.00	54.86	54.85	-1.632	-1.212	7.158	8.187	1.247	0.770	1.156	-0.275
Trade Balance	88.99	155.5	81.71	81.71	52.14	* -88.64	52.99	53.08	-16.38	-16.98	-112.6	-93.23	* 30.68	* 27.48	220.3	186.2
Real Contagion			* 8.889	* 8.889			* 1.336	* 1.333			5.367	2.774			0.939	* 0.764
Financial Cont.			* 14.29	* 14.29			* 12.32	* 12.31			2.679	* 4.705			* 7.942	* 16.79
Log-likelihood	-111.9	-105.7	-69.49	-69.49	-77.72	-66.81	-65.91	-65.90	-108.6	-101.4	-72.32	-52.71	-64.35	-50.37	-62.86	-52.95
Variance	24.83	6.869	7.063	7.063	12.46	1.383	5.518	5.518	7.321	1.832	7.264	0.388	10.08	0.906	8.947	0.954
ρ_{11}		0.849		0.623		0.198		0.537		0.623		0.568		0.701		0.701
ρ_{22}		0.588		0.744		0.784		0.629		0.407		0.703		0.916		0.916
ρ_{33}						0.690		0.590		0.075		0.109		0.573		0.573

Note: Columns in bold indicate the appropriate number of regimes for each model. ρ_{ii} denotes the probability of regime persistence.

* indicates statistical significance at the 10% level.

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