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CURRENCY CRISIS AND STOCK PRICE BEHAVIOR : EVIDENCE FROM THE KUALA LUMPUR COMPOSITE INDEX

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ABSTRACT

This research uses an error correction model to explore the asymmetric effects of five different exchange rates on the Kuala Lumpur Composite Index (KLCI) during the period of currency crisis. Order of integration was checked using the Augmented Dickey Fuller and Phillip-Perons tests for unit root. The Johansen approach was used to test cointegration in a multivariate system involving long run and short run estimations. The empirical evidence obtained from this study shows an existence of a significant long run and short run relationship between the exchange rates variability and stock price behavior of the KLCI. Based on the asymmetric effects of the exchange rates and KLCI, we posit that the Malaysian Ringgit vis-à-vis Deutschmark and US Dollar has more exposure on the Financial Theory of Arbitrage i.e. the depreciation of the Ringgit will lead to the downfall of the KLCI. Nevertheless, the study found contrary evidence of the Malaysian Ringgit vis-à-vis Japanese Yen, Great Britain Pound and Singapore Dollar which follow the Macroeconomic Theory of Trade Channel i.e. the depreciation of the Ringgit stimulates the performance of the KLCI. Finally, the overall findings suggest the fragility of the existing flexible exchange rate regime and the risks associated with such environment. Therefore, this research supports the call by the Prime Minister for a "New Global Financial Architecture".

OVERVIEW OF THE RECENT CURRENCY CRISES

The recent currency crisis that hit most of the ASEAN countries back in early 1997 caught many people off-guard. The country and the government were completely unprepared to deal with the seriously deteriorating economy (Prime Minister, The Malaysian Currency Crisis, 2000). The sudden meltdown of the regional financial market were unprecedented, and unleashed a new set of challenges for both the academicians as well as the practitioners. The recent currency crisis is the most disruptive international economic phenomenon of the 1990s. The sudden capital outflow revealed systemic economic flaws at the fundamental level and exacerbated by concerted speculative attack (Krugman 1997). The International Monetary Fund (IMF 1992) defines currency crisis as "a speculative attack on a particular exchange rate that results in a severe depreciation of the currency and prompted the central bank to defend the peg to restore the equilibrium level by using huge amount of international reserves or by sharply raising the interest rate[1]".

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[1] Bank Negara raised overnight interest rate twice to counter the speculative attack on the Ringgit in mid May 1997 (18.75%) on 10 July 1997(40%), Following the depreciation of Philippine Peso on 11 July 1997, it was recognized that global capital outflows involved huge amount of funds and raising interest rates to support intervention process would be

Prior to the crisis, the Malaysian economy was nothing short of a miracle. The country used to be the central focus for global investors portfolio capital allocation. (See Table 1) The rapid economic growth was driven mainly by the dynamic stock market movement coupled with the strong Ringgit. The Kuala Lumpur Composite Index (KLCI) hit its all-time-high level of 1314 points in January 5, 1994[2] and the Ringgit had been competitively valued at around 2.5 level against the US$ for a long period of time. At the end of 1995, real Gross Domestic

Table 1 : Stock Market Performance and Recommended Global Portfolio Weightings

Comments /Changes	***Country***	***Emerging Markets Index***	***(USD) % Change***	***Recommended Portfolio Weight %***
	Venezuela	General	48.09	0.02
	India	SSE Sensitive 30	40.12	1.46
	Taiwan	Weighted	23.82	1.52
	Turkey	Istanbul Composit	16.51	0.14
	MALAYSIA[3]	**KL COMPOSITE**	**14.36**	**1.78**
	KOREA	KOPS1	12.13	1.40
Raised to overweight	Colombia	IBB	10.60	0.12
	Indonesia	Jakarta Composite	9.165	0.54
	Mexico	Boise	4.94	0.54
	Brazil	Bovespa	3.31	0.89
	Philippines	Composite	3.06	0.34
	Peru	IGBL General	1.44	0.08
	Argentina	Merval	1.22	0.25
Reduced to underweight	Chile	IGPA	0.05	0.42
	Thailand	SET	-5.65	0.97

Emerging Market Performance through 26 April 1996
Source: Merrill Lynch, Global Investment Strategy 30 April 1996

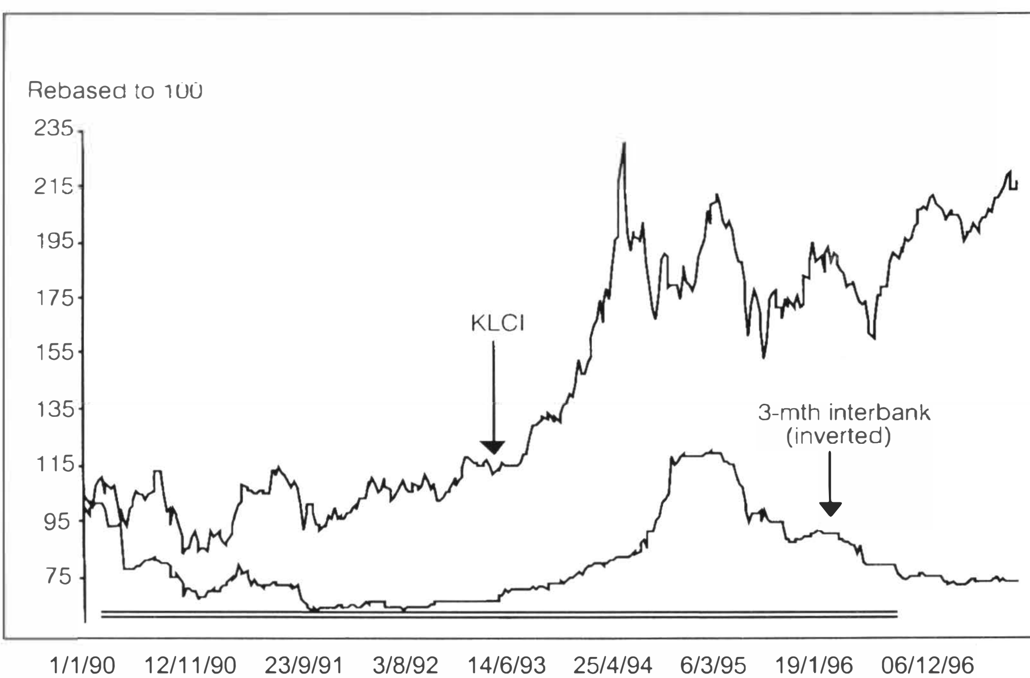
[2] "The Stock Market Report", Malaysian Business, February 1, 2000
[3] Highest global portfolio weight given to Malaysia compared to other emerging market economies, on the back of sound economic position coupled with stable political environment

Product (GDP) reached a record level of 9.5 per cent per annum and managed to have a soft landing of 8.5 per cent in 1996, more than a decade of superb performance. By 1997, the total external trade reached as high as US$ 158 billion, making Malaysia according to the World Trade Organization (WTO), the 18th biggest exporting nation. The country was enjoying a fiscal surplus. The external debt was generally low at 40 per cent of Gross National Product (GNP). The current account deficit had narrowed from 10 per cent to 5 per cent of GNP. Inflationary pressure was capped below 4 per cent. This was mainly due to the cheap and ample capital, high levels of private investment, increasing liberalization and advanced technology[4].

Nevertheless, the expectation of contagious global capital outflow began as early as mid-1996 following the collapse of Bangkok Bank in Thailand. The early signal of currency crises emerged about a year before the speculative attacks reached the country. However, most of the people who tracked the market were caught unprepared. During the conference held in mid 1996 by the Malaysian Institute of Economic Research (MIER), the economists from both the private and public sectors predicted that the economy would remain strong and the stock market was expected to continue its strong rally (see table 2). Many were not aware that the capital inflow-led booming and the unparallel capital resources had been channeled to unproductive economic sectors with only superficial appeal[5]. The eruption of economic bubbles, the free-falling of the Thailand's baht and its interaction effects on the stock market spread to the overall regional economic structure. The massive capital outflow reached Malaysia in July 1997 amid selling pressure on the Ringgit and spilled over to the Kuala Lumpur Composite Index. Since then, the motivation to study the phenomenon of currency crises and global capital outflow has gained considerable popularity.

Table 2

The Kuala Lumpur Composite Index (KLCI) and 3-MTH Interbank Rate



Source: Swiss Bank Corporation, "Global Market Strategy:, March 1997

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[4] "Recipe for Growth", The Asian Wall Street Journal, April 17, 1996

[5] "The World's Worst Fund Manager", Asian Wall Street Journal, June 15, 1996

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