

# [A case study of hong kong’s financial crisis](https://assignbuster.com/a-case-study-of-hong-kongs-financial-crisis/)

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The Asian Financial Crisis was a result of massive speculative attacks in the foreign exchange market on local currencies, specifically on East Asian currencies. The problem started with the devaluation of the Thai baht in 1997 which then spread to speculative attacks on other Asian currencies. This resulted in economic crises in Malaysia, Indonesia, Philippines, Korea, Singapore, China, and Hong Kong. (Kawai, 1998)

The reasons for the spread of economic decline in the countries were easily traced and the resulting effects were similar although varying in the degree of intensity. A clear difference between Hong Kong and the other Asian countries affected by the 1997-1998 economic crisis, however, was in the way that Hong Kong handled the threat to its economy.

Compared to the other Asian countries, Hong Kong was able to maintain its peg when the financial crisis first broke out. This was, however, maintained at a great cost. Monetary authorities of the country spent approximately US$ 1 billion in order to defend the currency. Although other countries also undertook mass efforts to defend their currencies, Hong Kong was the only one to be able to maintain its peg. This, however, was only short-term.

The economic attack continued and Hong Kong found itself needing to increase its inflation rates. Other countries such as the Philippines resorted to this strategy as well in order. What made Hong Kong different in its strategy, however, was the government’s role reversal from being a passive regulator to an active market participant.

The government ended up using approximately US$15 billion in buying shares, blue-chip shares, in various companies. This active intervention insured the relative stability of the Hong Kong market as compared to the other Asian markets during that time.

2) Hedge funds, by their very nature, utilize opportunistic trading strategies on a leveraged basis. For a market with a limited liquidity, such as that of Hong Kong’s, a small gamble on the part of a large hedge fund could result in a large transaction that could have large-scale effects on the said market.

For Hong Kong’s economy, there have been numerous instances wherein hedge funds have tried to exploit the local market. This is not to say, however, that Hong Kong has not put up a valiant effort to protect and maintain the stability of its vulnerable market – owing to its small size and low liquidity status.

According to Kara Tan Bhala (1998), the mechanism employed by hedge funds to try and makemoneyout of Hong Kong involves two steps. Initially, Hong Kong equities and stock-index futures are sold short by speculators.

Next, the speculators resort to short-selling the Hong Kong dollar. Short-selling the dollar will force the Hong Kong Monetary Association to try to maintain the peg of the Hong Kong dollar to the US dollar. This would mean resorting to an increase in interest rates and to buying the local currency.

Share prices on the stock market thus decrease in value. In these instances, it is clear that all that hedge funds aim to do are to gain profit for themselves rather than to contribute to the greater scheme of advancing Hong Kong’s economy. They gain profit first from the short selling of the equities and stock-index futures.

They gain the difference from the higher priced short-selling of the instruments and the resulting lower cover prices. Hedge funds gain profit secondly from a probable depreciation in the Hong Kong dollar. Again, the difference between the short and cover prices. (Bhala, 1998)

Although not all hedge funds are to be frowned upon, as the presence of hedge funds is not an absolute evil on the market, these instances serve as a warning to the fact that there are markets that can be put under great threat as a result of the presence of hedge funds.

References

Kawai, M. (1998). The East Asian currency crisis: causes and lessons. Contemporary Economy Policy, 16, 157-172

Bhala, K. T. (1998). In Praise of Intervention. Far Eastern Economic Review, 9