

## Contagion in the East Asian Currency Crisis

Mardi Dungey  
Vance L. Martin

When a country or region experiences a financial crisis in the form of large exchange rate fluctuations it is of interest to identify whether the movements can be attributed to idiosyncratic shocks or as a result of contagion. Previous empirical work (Eichengreen et al (1996), Lowell et al (1998)) uses standard techniques to associate financial crises and contagion with specific economic fundamentals. In contrast we specify a latent factor model to distinguish between idiosyncratic and contagion effects for individual exchange rates. As a natural outcome of the model's framework two types of contagion are identified – fixed and variable. Fixed contagion arises from the use of a numeraire currency throughout the analysis whereby a common shock has the same fixed/constant effect on each of the exchange rates. Variable contagion reflects the differing responses in each exchange rate to common shocks. Indirect estimation techniques are applied to quantify the relative importance of contagion to exchange rate volatility in a panel of East Asian currencies comprising the Malaysian ringgit, Thai baht, Indonesian rupiah and Korean won. The results support the hypothesis that contagion in the crisis can be understood as due to the structure of the economy (Krugman (1998)) as opposed to the hypothesis of a sudden shift in expectations put forward by Radelet and Sachs (1998).

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Mardi Dungey  
Department of Economics and Finance  
School of Business  
La Trobe University  
Bundoora Victoria 3083  
ph: +61 3 9479 1514  
fax: +61 3 9479 1654  
m.dungey@latrobe.edu.au

Australia