
PREVENTING FINANCIAL CRISES IN EAST ASIA

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The early 1970s breakdown of the Bretton Woods system of fixed exchange rates marked the last momentous change in the evolution of the international monetary system, producing the heterogeneous array of exchange rate arrangements that now operates. Yet, equally important in the development of global finance has been the massive growth in the volume of international capital flows since then. This growth is mostly due to the dismantling of the broad range of exchange controls previously put in place to facilitate exchange rate management by central banks under the surveillance of the International Monetary Fund (IMF).

Though exchange controls have been progressively dismantled since the early 1970s, their removal in emerging economies was accelerated significantly in the early 1990s, according to an index of capital controls devised by the IMF.¹ Institutional investors in advanced economies increasingly became more aware of opportunities to diversify portfolios through the 1990s and more internationalized banks were readier to lend in emerging markets.² By the mid-1990s, emerging economies were absorbing 40% of global foreign direct investment compared with 15% in 1990 and received 30% of global portfolio equity flows, as against only 2% at the beginning of the decade.³

The presumption that international merchandise trade was to be encouraged after the war through a supranational institution like the General

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1. International Monetary Fund (IMF), *World Economic Outlook: Interim Assessment* (Washington, D.C.: IMF, December 1997), p. 242.

2. The emerging economies comprise a culturally and geographically diverse group of debtor countries that includes Argentina, Brazil, Chile, Colombia, Hungary, the Czech Republic, India, Indonesia, Israel, Malaysia, Mexico, Pakistan, Peru, the Philippines, South Africa, Thailand, Turkey, and Venezuela.

3. World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (London: Oxford University Press, 1997), p. 9.

Agreement on Tariffs and Trade, the World Trade Organization's (WTO) predecessor, did not extend beyond trade in goods to include freer international trade in savings or financial services. Indeed, there was widespread antipathy toward free international capital movements at the time, as reflected for instance in a statement by John Maynard Keynes, an architect of the Bretton Woods monetary system, that "nothing is more certain than that the movement of capital funds must be regulated."⁴ Interestingly, the IMF now actively promotes capital account liberalization for member economies, in contrast to its Bretton Woods-era policy of sanctioning the earlier wide-ranging measures that restricted international capital flows.

In theory, greater international capital market integration can confer economy-wide benefits on advanced and emerging economies alike. For instance, international capital flows (see Figure 1 and Table 1) supplement domestic savings in recipient economies and allow more investment in regions where profitability is higher while simultaneously enabling savers in international creditor economies to gain from higher returns and portfolio diversification. However, at the same time it can increase the vulnerability of host economies to sharp capital flow reversals of the magnitude witnessed in East Asia and other emerging economies in the late 1990s. In those countries worst affected, this caused great social misery and political upheaval. The many households that had attained middle-class status through the overall rise in pre-crisis prosperity had their income and wealth slashed back to poverty levels. Political violence in Indonesia precipitated a change in leadership and Malaysia has remained unsettled politically. In light of the social, political, and economic disruption that capital reversals can cause in the short term, it is not surprising that the earlier Keynesian-inspired aversion to highly mobile capital has resurfaced through calls for the reimposition of Bretton Woods-style capital controls for emerging economies.⁵

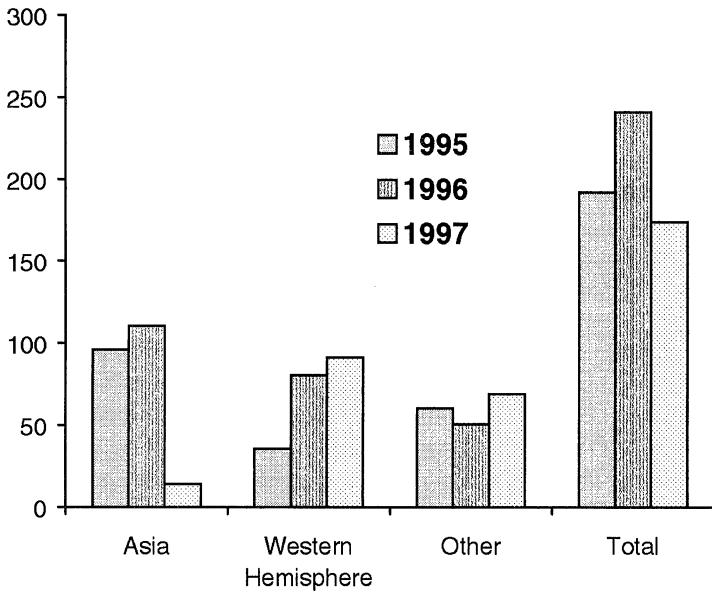
Contemporary advocates of capital controls stress the differences between free financial flows and free trade in goods and services. These differences include the far greater volatility of financial asset prices compared to prices of goods and services, problems related to information asymmetries between borrowers and lenders, and poor bank management. As a result, economists such as Bhagwati⁶ maintain that the apparent costs of allowing international capital mobility outweigh the benefits.

4. John Maynard Keynes, "The Origins of the Clearing Union" in *The Collected Writings of J M Keynes*, 25 (London: Macmillan for The Royal Economic Society, 1941), p. 23.

5. See, for instance, Paul Krugman, "The Confidence Game," *New Republic*, October 5, 1998; and Robert Wade, "The Asian Debt-and-Development Crisis of 1997-?: Causes and Consequences," *World Development* 26:8 (August 1998).

6. Jagdish Bhagwati, "The Capital Myth: The Difference Between Trade in Widgets and Dollars," *Foreign Affairs* 77:3 (May/June 1998).

FIGURE 1 *Capital Flows by Region (US\$billion)*



SOURCE: IMF, *International Capital Markets: Developments, Prospects and Key Policy Issues* (Washington, D.C.: IMF, September 1998), p. 13.

TABLE 1 *Capital Flows to All Emerging Markets Annual Averages (US\$billion)*

	1977-82	1983-89	1990-94	1995	1996	1997
Total net capital inflows	30.5	8.8	120.8	192.0	240.8	173.7
Net foreign direct investment	11.2	13.3	46.2	96.0	114.9	138.2
Net portfolio investment	-10.5	6.5	61.1	23.5	49.7	42.9
Other ¹	29.8	-11.0	13.5	72.5	76.2	-7.3

SOURCE: International Monetary Fund (IMF), *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, D.C.: IMF, 1995), p. 33, and (*ibid.*, 1998), p. 13.

¹ Includes bank lending; 1977-89 figures exclude economies in transition and some Middle Eastern emerging markets.

Against such a view, this article argues that there is a strong theoretical case for free international trade in saving, provided a sound institutional framework exists for channeling foreign savings to ultimate borrowers in emerging economies. That is, it contends that what makes many emerging economies more prone to macroeconomically debilitating financial crises is not excessively mobile international funds, but relatively poorly developed domestic banking and financial systems. As a corollary, it suggests that reimposing capital controls, such as those implemented by the Malaysian government in late 1998, is an inappropriate response to the financial turmoil experienced in East Asia and could prove costly to long-term development.

In advancing this view, I first highlight the economic benefits that liberal international capital markets can bestow on economies, as well as the key factors that precipitate capital flight in emerging economies. A straightforward analogy is then proposed to clarify some of the main international public policy issues involved. I conclude that international capital movements can usefully signal the need for necessary economic and financial policy reforms in emerging economies.

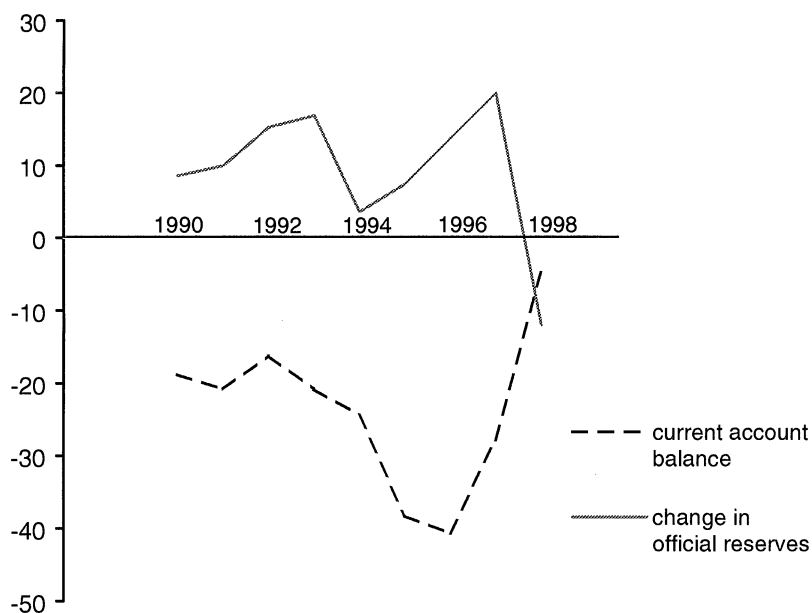
The Role of Capital Flows in Emerging Economies

Private capital inflows have tended to raise current account deficits, reduce domestic interest rates, and raise aggregate investment rates in host economies. To the extent that the higher current account deficits that match increased capital inflows (see Figure 2 and Table 2) reflect an excess of domestic investment over domestic saving, the external deficits themselves should not be considered problematic, in and of themselves. Indeed, external imbalances can simply be interpreted as manifestations of increased international trade in savings that can contribute to higher world income growth.

Host economies benefit because their capital stocks expand through extra investment that enables more production, whereas foreign investors gain to the extent that they can earn higher returns than in their home markets. Moreover, through international portfolio diversification, such institutional investors as pension, superannuation, and mutual funds are in principle able to reduce overall volatility of portfolio returns to the extent that movements in national share market prices are unsynchronized.

Exchange Rate Risk

At the same time however, international investment in financial assets is especially sensitive to changes in investors' expectations, including expected exchange rate devaluations that can spark massive capital outflows. Indeed, in financial crises, changes in investors' exchange rate expectations become self-fulfilling. Investors expecting a future currency collapse will rush to sell

FIGURE 2 *Emerging Asian Economies: Balance of Payments (US\$billion)*

SOURCE: IMF, *World Economic Outlook* (Washington, D.C.: IMF, May 1998), p. 41.

TABLE 2 *Emerging Asian Economies: External Financing (US\$billion)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Net external financing	26.4	32.6	31.5	39.5	52.4	59.4	63.4	23.5	-6.0
Nondebt flows	8.0	9.6	10.9	11.3	11.6	14.3	19.5	18.5	12.7
IMF loans	-1.0	0.2	0.1	0.4	-0.3	-0.4	5.7	—	—
Other borrowing	19.3	22.8	20.5	28.1	20.4	45.3	44.3	-0.7	-24.2

SOURCE: IMF, *World Economic Outlook* (Washington, D.C.: IMF, 1998), p. 196.

financial instruments denominated in that currency to avoid capital losses. Accordingly, the severe contraction in demand for the currency can put official exchange rates under intolerable pressure, depleting foreign exchange reserves of central banks and perhaps pushing up short-term interest rates in the process.

In the East Asian case, foreign investors had initially misjudged the extent of exchange rate risk by effectively presuming that many Asian central banks were bearing the foreign exchange rate risk through maintaining pegged exchange rates. For instance, in the decades preceding the Asian crisis, the central banks of Korea, Malaysia, Thailand, Indonesia, and the Philippines had provided domestic borrowers and foreign lenders alike a measure of exchange rate certainty as these economies had adhered to fixed exchange rates or had strictly limited exchange rate flexibility. As a result, capital flows responded strongly to interest rate differentials and foreign borrowings remained unhedged against the possibility of large currency depreciations.

The Role of the IMF

Government ownership of many Asian banks signaled an implicit government guarantee against loan default. This encouraged foreign lenders to understate the default risk, thus creating the "moral hazard" problem of too much borrowing and lending in the first instance. From the foreign lending side, there was another moral hazard effect that arose from the expectation that the IMF might bail out creditors in the event of possible default action. By intervening during financial crises, the IMF effectively acts as an international lender of last resort in arranging bridging finance at highly concessional rates so as to ease external debt servicing burdens and prevent possible default.⁷

Other criticisms have also been leveled at the IMF about macroeconomic policies it prescribes during episodes of financial distress.⁸ For instance, it has been argued that the standard IMF condition for providing financial assistance is a sharp tightening of monetary and fiscal policies. However, these policies are often necessary to avoid a downward spiral of depreciation and inflation that would ultimately be counterproductive in assisting recovery. In the East Asian case, it has generally been the case that those economies that did tighten macroeconomic policies as recommended by the IMF managed to avoid sustained inflation.

Another criticism of IMF bailouts is that they may encourage excessive international borrowing and lending activity and reinforce the problem of moral hazard. This is because the default risks associated with such activity may be underestimated if the IMF is automatically assumed to provide financial assistance in the event of future such crises. It is argued that IMF bail-

7. The value of loans pledged to the IMF by member countries for this purpose in 1998 for Thailand, Indonesia, and South Korea exceeded US\$100 billion. Funds are to be raised as necessary from numerous sources, mostly from Japan and the U.S.

8. Feldstein and Sachs criticize the role of the IMF and the nature of its policy responses to financial crises. See Martin Feldstein, "Refocusing the IMF," *Foreign Affairs* 77:2 (March/April 1998); and Jeffrey Sachs, "The IMF and the Asian Flu," *American Prospect* 20:10 (1998).

out assistance effectively subsidizes those foreign lenders with longer-term loans who are unable to liquidate their assets quickly and would otherwise have lost funds through default action. Moreover, loan default would teach financial institutions such as banks and mutual funds operating globally to assess the fundamentals of foreign economies more carefully before rushing to judgement with their funds.

Against these views and in defense of IMF actions, it may be argued that the IMF, in conjunction with the World Bank, does have a useful role to play in advising on ways that emerging economies can best reform their banking and financial systems. This important sector of many emerging economies has been fragile for a number of reasons.

Financial Sector Problems

Prudential supervision of domestic banks—the institutions that channel the bulk of foreign lending in emerging markets—has in general been weak and nonsystematic. In particular, banks in many emerging economies have been established with inadequate capitalization and accumulated high levels of foreign debt without adequate hedging against foreign exchange risk. There was also a lack of effective competition within the local financial systems of emerging economies that allowed locally run institutions to charge high interest rates to domestic borrowers, which in turn encouraged further foreign borrowing (see Table 3).⁹

Information on the extent of nonperforming loans and the nature of the linkages between governments and business concerns was also limited. This lack of transparency for some time obscured the nature of the underlying structural problems of the financial institutions in East Asian economies, but foreign investors quickly switched to relatively safer investment alternatives elsewhere in the world upon realizing that emerging markets seemed inherently riskier than previously judged.

The reversal of capital inflow to East Asia and other emerging markets that began midway through 1997 happened after foreign investors sold off East Asian financial assets on a large scale upon realizing that their funds were at greater risk than had been believed. Yet, the substantial financial asset divestment by foreign investors, including the large, U.S.-based hedge funds, was not the only factor that generated the subsequent crisis. In addition, the panic withdrawal by resident East Asian investors of their own funds from

9. Goldstein and the IMF further detail institutional weaknesses in the Asian financial sector. See Morris Goldstein, *The Asian Financial Crisis: Causes, Cures and Systemic Implications*, Policy Analyses in International Economics, no. 55 (Washington, D.C.: Institute for International Economics, 1998); and IMF, *International Capital Markets: Developments, Prospects and Key Policy Issues* (Washington, D.C.: IMF, November 1997).

TABLE 3 *International Bank Lending to Five Asian Economies at End 1996*
(US\$billion)

	<i>U.S. Banks</i>	<i>Japanese Banks</i>	<i>European Union Banks</i>	<i>Total International Lending</i>
Indonesia	5.3	22.0	21.0	55.5
Korea	9.4	24.3	33.8	100.0
Malaysia	2.3	8.2	9.2	22.2
Philippines	3.9	1.6	6.3	13.3
Thailand	5.0	37.5	19.2	70.2

SOURCE: Bank for International Settlements (BIS), *Annual Report* (Basel: BIS, 1998), p. 84.

local financial institutions converted a sharp correction of financial asset prices into the major financial crisis that followed.

An Analogy

The turbulence in the financial markets of emerging economies in the wake of the Asian crisis has revived demands for restrictions on the volume of international capital flows. This international public policy prescription is, however, essentially at odds with the economic proposition that foreign savings contributes positively to economic development. In what follows, an analogy is therefore developed to suggest why restoring capital or exchange controls is an ill-advised means of improving long-term economic welfare in emerging economies.

According to the standard theory of economic growth, savings acts like a vehicle carrying an economy from one stage of development to another. However, though not explicitly recognized in the traditional neoclassical model of economic growth, savings may come from both domestic and foreign sources. To get to the destination of higher national income, domestic and foreign funds flow through an emerging economy's financial system. In East Asia's case, locally owned and controlled banks were mainly responsible for intermediating the flow of domestic and foreign savings to ultimate borrowers. Hence, the banking system itself can be thought of as playing a role similar to a road or highway. The sounder the road, the safer the journey and the lower the chance of accidents.

This vehicle-destination-highway analogy can be used to compare ways of minimizing occasional crises, or accidents, that economies may have along the route to higher economic growth. Of course, road transport is not the only means of reaching a desired destination, just as domestic and foreign savings is not the only factor that contributes to higher national income. For

instance, improved human capital or greater liberalization of trade in goods and services also assist development, just as air and rail transport provide complementary modes of getting from one place to another.

One option for reducing the number of accidents on highways is to prohibit imported vehicles, thus reducing the overall flow of road traffic. This option has been adopted by Malaysia and advocated by numerous economists.¹⁰ Relatedly, Chile's example of restricting inflows is often cited as an example for other emerging economies to follow. In the past, the Chilean monetary authorities have required that a portion of external borrowings be deposited at the central bank without interest. This has meant higher short-term interest rates than necessary. Continuing the analogy, although such means of limiting road traffic would minimize road accident risk, it is also likely, however, to mean that fewer passengers can reach their desired destination, implying that the option is not the first best public policy response.

A slightly different crisis minimization option is to tax the use of imported vehicles differentially. Relatedly, a so-called "Tobin tax," originally espoused by James Tobin of Yale University, would apply to foreign currency conversions arising from short-term capital flows worldwide.¹¹ Yet, this option is also likely to have adverse implications for short-term domestic interest rates and hence development. Moreover, such a tax would be difficult to implement in practice and avoidance problems would arise if some economies refused to participate.

Continuing the analogy, it would seem that the best way to minimize road accidents, while simultaneously allowing as much travel as possible, is to upgrade the highway to make travel safer and at the same time ensure there is surveillance of traffic flows to detect instances of reckless driving. With reference to the Asian economies and their financial systems, crisis prevention would therefore be best achieved through major reform of banking practices in the region. More information about economic conditions and improved transparency of financial dealings could prevent future crises, just as advisory signs on highways make road travel safer (see Table 4). Arms-length prudential authorities could also perform a surveillance role by policing the capital adequacy ratios of banks to ensure that financial speed limits are not exceeded. Such fundamental reforms of financial practices in these economies obviously need to be firmly in place and recognized as such by foreign inves-

10. See, for instance, Bhagwati, "The Capital Myth"; Krugman, "The Confidence Game"; Wade, "The Asian Debt-and-Development Crisis"; and Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model vs. the Wall Street-Treasury-IMF Complex," *New Left Review*, March–April 1998.

11. See James Tobin, "A Proposal for International Monetary Reform," *Eastern Economic Journal* 4 (July/October 1978).

TABLE 4 *Sovereign Credit Ratings of Five Asian Economies, July 1999*

	<i>Long-Term Bonds</i>	<i>Long-Term Bank Deposits</i>
Indonesia	B3	Ca
Korea	Baa3	Ba2
Malaysia	Baa3	Ba1
Philippines	Ba1	Ba2
Thailand	Ba1	B1

SOURCE: Moody's Investors Service, on the Internet at <<http://www.moody.com/>>.

tors, including international banks, before substantial capital flows return to the region.

Concluding Comments

The general finding of international trade theory that free trade in goods enhances economic welfare has strong support from international economists and international institutions such as the WTO, whose very brief is to advance trade liberalization. Large trading blocs, such as the North American Free Trade Agreement, the European Union, and the Asia-Pacific Economic Cooperation forum, have been established for the purpose of encouraging greater cross-border trade in goods and services by dismantling impediments to trade, such as import tariffs.

Although the WTO has also been pursuing international agreement on expanding trade in financial services, the idea that international trade in savings similarly confers mutual welfare gains on contracting parties is neither as widely recognized nor accepted.¹² Yet, allowing international capital to flow freely can improve economic welfare in emerging economies for it frees those economies from the constraint of their own savings levels. In this way, foreign savings can complement domestic savings and play an important role in the process of economic growth, for it permits domestic capital accumulation to be higher than otherwise. Meanwhile, the national income of creditor countries may rise to the extent that international lenders earn higher returns than otherwise.

The main qualification to the argument about the benefits of allowing unrestricted flows of funds across borders is that reversals of inflows make emerging economies vulnerable to crises. Capital flight in response to new information about exchange rate risk, default risk, or deteriorating fiscal and monetary policy settings can impose substantial, short-term economic, social,

12. The OECD has also sought to further liberalize foreign investment activities through its attempts to reach consensus on the Multilateral Agreement on Investment.

and political costs on emerging economies. These costs are transmitted in the first instance through higher domestic interest rates and lost output, as well as through large exchange rate depreciations and the associated higher inflation.

Nonetheless, it should be recognized that any sharp re-direction of international investment funds in emerging economies provides a strong signal to domestic policy makers that further growth-enhancing reform is necessary. It is here that the IMF and the World Bank can play useful roles in advising on and facilitating the most appropriate reforms. The challenge of course is to convince domestic economic authorities to strengthen their institutional frameworks by forfeiting long-established practices that have resulted from sectional interest group pressures.

In summary, the recent financial crises in East Asia and other emerging economies have exposed major structural weaknesses in their domestic banking and financial systems, which have acted as the major conduits of foreign saving. More specifically, these crises have underscored the need for a more robust system of bank supervision in line with international standards, for example, one consistent with the principles of prudent banking recommended by the Bank for International Settlements. With a sounder financial infrastructure, appropriately monitored to prevent reckless lending, foreign savings can continue to contribute positively to economic growth in emerging economies.