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# GLOBALIZATION OF FINANCIAL MARKETS AND THE ASIAN CRISIS: SOME LESSONS FOR THIRD WORLD DEVELOPING COUNTRIES

By Jong H. Park\*

## INTRODUCTION

Very broadly, one of the main causes of the Asian crisis lies in the ever-rapidly increasing globalization currently taking place in the world economy. The Asian countries (and for other non-Asian countries as well) have been simply too slow to fully appreciate the new challenges posed by the rapidly globalizing financial markets and, consequently, they have been too slow to formulate appropriate responses. Globalization has increased the speed and magnitude of market reaction, and consequently has magnified the costs of bad policies and weak, inefficient institutions.

In 1996, there was a record capital inflow of \$93 billion into Thailand, Malaysia, Indonesia, the Philippines and Korea (hereafter called the Asian 5). But the following year 1997 saw a net outflow of \$12 billion. This amounted to a reversal of \$105 billion, equivalent to 11 percent of the combined GDP of the Asian 5. This was the greatest reversal of private capital flows ever recorded in the world economy, and represents "the most significant geo-financial adjustment to date in the relatively new era of globally integrated capital markets."<sup>1</sup> It was this reversal of capital flows that precipitated the Asian currency crisis, eventually pushing "miracle" economies into a dramatic financial meltdown with serious economic, social and political consequences.

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To be sure, the root causes of the Asian financial crisis go much beyond this reversal of capital flows. Among others, this crisis stemmed from over-investment, unhealthy corporate financial structure and inefficient financial system. Unlike the case with Latin America in the 1980s, the Asian crisis did not originate from a macroeconomic financial insolvency caused by over-consumption, fiscal imbalance, and rampant inflation. The Asian 5 (four South-east Asian countries of Thailand, Malaysia, Indonesia and the Philippines, and Korea) had no such problems. Their government budgets were generally in balance, and inflation was low. The IMF austerity programs imposed on these countries in exchange for the "bailout" were essentially the same old medicine for a new illness. These measures were applied to the Latin American countries when they defaulted on their loans in 1982.

The purpose of this paper is twofold: to examine the causes of the Asian financial crisis and to draw some lessons and implications for a series of issues, which may be of particular relevance to the Third World developing countries. These issues include: the appropriate role of the International Monetary Fund as an international agency in charge of helping member countries to maintain financial stability; the choice of an appropriate exchange rate regime and use of restrictions on private capital flows in the face of rising globalization; and the debate on the East Asian model of economic development.

## GLOBALIZATION OF FINANCIAL MARKETS

### **Financial Market Liberalization in Developing Countries**

Since the early 1990s, financial markets in the world have been integrating rapidly. This has led to surges in private capital flows to developing countries and other "emerging market economies." Major advances in information technology have reduced transaction costs. Foreign investors saw higher long-term rates of return and the new opportunities for risk diversification in developing countries. At the same time, ongoing economic reforms and financial liberalization have made developing countries more attractive to overseas investors.

The greater integration of international financial markets improved access to the pool of global saving for many developing countries. Many countries have been able to invest more and hence grow faster than otherwise, while generating higher yields for international investors and giving them the opportunity to reduce risk through portfolio diversification. Thus, the process of financial market integration and the associated increase in international capital



mobility has been viewed as a welcome development.

One of the arguments for the case of an open, integrated financial market is that of reducing the cost of capital. A market that is open to global investors reduces the cost of capital for local companies by allowing stockholders to achieve efficient portfolio diversification. Stock markets also lower the cost of capital by increasing the liquidity of investments. For developing countries, opening their capital markets to foreign investors will bring about the spillover effects in the form of technology, managerial and organizational systems, which will help boost efficiency in the domestic market. For instance, the new competition from foreign financial institutions that accompanies the opening of the capital market will invariably put pressure on host countries to find ways for improving financial services, and so forth. In addition, foreign investors will demand greater transparency and improved disclosure rules that will enable them to monitor corporate performance and capital allocation.<sup>2</sup>

It should be noted, however, that this discussion of the potential benefits of financial integration and increased international capital mobility abstracts from foreign exchange risk and problems associated with the intermediation of foreign capital through the banking and financial systems of recipient countries. In fact, it is these two factors that can expose recipient countries to the possibility of abrupt reversals of international capital flows.

### **Great Reversal of Capital Flows to Emerging Markets**

Outstanding economic performance of the Asian "miracle economies" in the late 80s and the early 90s attracted a surge in private capital inflows into these emerging economies. That surge in capital inflows helped fuel the increase in the bank credit-financed investment boom. At the same time, however, the surge in private foreign capital made these economies extremely vulnerable to a financial panic. According to the Bank for International Settlements (BIS), the total net private capital flows into the Asian emerging markets during 1994-96 amounted to a whopping \$184 billion. In 1996 alone, \$93 billion entered the Asian 5. With the onset of the crisis in the second half of 1997, markets overreacted and international investors panicked. Off they ran with \$105 billion! As mentioned previously, this was the greatest reversal of private capital flows ever recorded to date. Even Stanley Fischer, deputy-managing director of the IMF, conceded: "[M]arkets are not always right. Sometimes inflows are excessive, and sometimes they may be sustained too long. Markets tend to react fast, sometimes excessively."<sup>3</sup> Of course, one cannot blame multinational banks and other international investors for taking advantage of new opportunities in the emerging markets for better returns and for diversification of their invest-

ment portfolios. But, it must be noted that both lenders and borrowers are equally guilty of making reckless lending and investment decisions without careful risk analysis. Thus, Catherine Mann of the Institute for International Economics conceded: "Limiting international capital flows is not without cost. Yet, it is clear that international capital markets have not worked well over the last several years, including not just the obvious turmoil of the last two years but also the breakdown of the European Monetary System in 1993. Avoiding such systematic financial distress requires that borrowers and lenders accurately price and manage risks in their portfolios."<sup>4</sup> So, we all are responsible for the crisis in one way or another.

### THE ASIAN FINANCIAL CRISIS: FROM "MIRACLE" TO "MELTDOWN"

#### The Thai Meltdown and Contagion

The February 5<sup>th</sup> of 1997 in Thailand—that was the date when the Asian meltdown actually began. On that day, Somprasong Land, a Thai property developer, made an announcement that the company had failed to make a scheduled \$3.1 million interest payment on its enormous eurodollar bond loan, effectively entering into default. Who would have thought this incident would eventually force the Thai government to allow the *baht* to float on July 2nd, 1997, after 13 years of pegging its currency to the US dollar at Bt 25. With that decision of the Thai government, the catastrophic Asian contagion began.

The reversal of foreign capital, combined with the flight of domestic funds, caused massive depreciations of the currencies of the Asian 5 — the Indonesian *rupiah* by 75 percent, Malaysian *ringgit* and Philippines *peso* by 40 percent, Thai *baht* and Korean *won* by almost 50 percent. These crashes in the currency were soon followed by dramatic stock market falls in these countries as well as in Hong Kong and Singapore. Hardly anyone had expected that the event unfolding in Thailand would eventually lead the "Asian Miracle" into the "Asian Meltdown" in such a short time span and with such a high speed.

Government officials, business executives, and academicians were all pondering just what went wrong in East and Southeast Asia. The "miracle" economies in the region were contracting much faster than anyone had anticipated. What we heard about the events unfolding in Southeast and East Asia were nothing but horror stories. Hundreds and thousands of business firms went bankrupt, including some big *chaebol* in Korea. Unemployment soared in a country where lifetime employment was a norm. How could this happen to the



“miracle economies”? Does this mean the end of the East Asian Miracle? Many thought that the end had come.

### The East Asian Meltdown

The seeds of the 1997-98 Asian financial crisis were sown during the previous decades when East and Southeast Asian countries were experiencing unprecedented economic growth, which has transformed their economies into the East Asian “miracle economies.” Although there have been and remain important differences between individual countries, the Asian 5 shared a number of common elements, all contributing directly or indirectly to the crisis. They include credit-fueled investment boom, weak and unsound banking sector and financial system, pegged exchange rate regime, current account deficits, and loss in investor confidence.

*Credit-Fueled Investment Boom*—During the 1990s, GDP growth in the region exceeded 5 percent per annum and often was closer to 10 percent. Such strong economic growth and the expectation that growth would continue led to an enormous increase in investment. The investment shares in GDP in most Asian countries increased substantially between 1988 and 1996. Between 1990 and 1996, for instance, gross domestic investment grew by over 16 percent per year in Indonesia, 16 percent in Malaysia, 15.3 percent in Thailand, 7.2 percent in Korea. This compares to the investment growth in the U.S. by 4.1 percent and 0.8 percent in all high-income countries.<sup>5</sup> Much of this unprecedented increase in investment was financed by bank credit, and was concentrated either in areas with highly volatile returns such as stocks and real estate or in areas where substantial capacity already existed, thus leading to over-expansion and excess capacity.

*Inefficient Bank-Centered Financial Systems*—One of the elements shared by the Asian 5 has been the weakness of their bank-centered financial systems. The banks in these countries simply failed to develop appropriate procedures for evaluating risks when extending loans. There was little incentive to develop such procedures since the bank managers were subject to direction by the government authorities, and they expected the government to support their borrowers. The government-directed, discretionary policy of credit allocation for rapid economic growth may have achieved its goal. But the financial institutions, including commercial banks, became simply a “silent partner” in the process of economic development. “Financial repression,” characteristic of the East Asian model for development, has been responsible for the unsound, weak, and inefficient financial systems in these countries. Surveillance of bank operations was inadequate, and prudential regulation of the banking system was lax, espe-

cially with respect to capital adequacy requirements. In addition, banks did not have adequate capacity for project evaluation in lending practices, especially in the aftermath of increased financial liberalization in these countries. As a result, when economic conditions worsened abruptly, the quality of the bank assets deteriorated fast, producing non-performing loans.

*Exchange Rate Misalignment* — Mainly as a way of inducing foreign capital, all of the Asian 5 currencies had, in one way or another, been aligned with or pegged to the U.S. dollar or a basket of currencies dominated by the U.S. dollar. This linking of the official exchange rates to the U.S. dollar had one major drawback. As the value of the dollar changed, so did the exchange value of these currencies relative to other currencies that are not tied to the dollar such as the Japanese *yen* and the German *mark*.

The impact of the exchange rate misalignment can be traced back to the Plaza Accord of 1985. As the Japanese *yen* began its rapid appreciation against other currencies, particularly the U.S. dollar, the relative costs of production rose in Japan. In response, Japanese firms shifted their production activities to overseas, mainly to Korea and Taiwan. To counteract the blow of this outward FDI to the domestic economy, the Japanese government used aggressive monetary expansion. This created giant asset bubbles in Japan and massive capital outflows into Korea and Taiwan. By the late 1980s, these two countries came under similar pressures as a result of appreciating Korean *won* and Taiwanese *dollar*. To combat these pressures so as to maintain the exchange value of their currencies in terms of the U.S. dollar, they relied on aggressive monetary expansion. The results were asset price bubbles at home and large capital outflows, this time, primarily to Southeast Asian countries such as Thailand and Indonesia.

The seeds of the financial turmoil were sown in the mid-1990s when the U.S. dollar started to appreciate against other currencies, especially the Japanese *yen*. The Asian currencies tied to the dollar rose in value and made their exports more expensive to non-dollar buyers and their imports from non-dollar areas cheaper. The weakening *yen* drastically reduced the export competitiveness of the Asian 5 vis-à-vis that of Japan. The result was to increase the current account deficits for the Asian 5. Downward pressures created by the increased current account deficits necessitated increased government intervention to maintain the exchange value of their currencies, depleting their foreign exchange reserves. All this was on top of the adverse impact of the devaluation of the Chinese *renminbi yuan* in 1994.

*Coincidence and Compounding*— None of these elements that are usually put forward as contributing factors are, by themselves, enough to explain the source and extent of the Asian crisis. The interaction of these elements pro-



duced a conjuncture of problems, compounding the sources of vulnerability of these economies to external shocks. Thusly, Grenville sums up the story of the "Asian meltdown":

Large capital inflows led, more-or-less inevitably, to excessive credit growth and growth of the financial sector, because it was not possible to sterilise them fully. The large flows meant, also, that there was easy funding available for projects (both good and bad), and that asset prices were bid up. Similarly, the large capital flows made it difficult to raise interest rates higher (they were already quite high), for fear of inducing even more capital inflow. High domestic interest rates, at the same time, persuaded many borrowers to take the risk of tapping into attractively lower foreign currency-denominated borrowing. Further, with quasi-fixed exchange rate regimes in these countries, there was little incentive for institutions borrowing in foreign currencies to hedge their debt. These issues should have been recognised as sources of vulnerability, but the focus was on growth, without enough concern about resilience in the face of *variance* in growth.<sup>6</sup>

The crucial combination was the large volatile foreign capital flows and fragile financial systems. These two elements, in combination, made the Asian emerging market economies extremely vulnerable to changes in investor *confidence*. Financial markets are supposed to constantly digest and evaluate information to produce a price — an exchange rate — which reflects the "fundamentals." In the Asian emerging markets, however, "the more nebulous concept of 'confidence' dominated 'fundamentals.'"<sup>7</sup> Thus, Jeffrey Sachs of the Harvard Institute for Development lamented: "In a matter of just a few months, the Asian economies went from being the darlings of the investment community to being virtual pariahs. There was a touch of the absurd in the unfolding drama, as international money managers harshly castigated the very same Asian governments they were praising just months before . . . But, as often happens in financial markets, euphoria turned to panic without missing a beat. Suddenly, Asia's leaders could do no right. The money fled."<sup>8</sup>



## SOME IMPLICATIONS OF THE ASIAN CRISIS AND THE THIRD WORLD

The Asian financial crisis has rekindled the debate on the role of international institutions, especially that of the IMF. The crisis has raised a series of questions regarding international financial architecture, including the governance of the international financial system and exchange rate regimes. The crisis has also opened up the debate on the alternative models or approaches for economic development suitable for the Third World developing countries in the era of globalization,

### **The Role of International Institutions**

In the mid-1990s even before the onset of the Asian financial crisis, some observers were suggesting that the IMF should be closed down. The crux of the argument was that in a world of floating exchange rates and globalized financial markets, an agency such as the IMF was no longer needed. Opinions differ widely on whether the IMF has a systematic role as under the Bretton Woods system—such as “managing global exchange rates, coordinating macroeconomic policy, and seeking to ensure that the quantity of international reserves was adequate.”<sup>9</sup>

In “bailing out” the three crisis-stricken Asian countries—Thailand, Indonesia and Korea, charges were made against the IMF for prescribing the same old medicine for a new illness. Take Korea as an example. The immediate cause of the financial crisis in Asia in general and Korea in particular was the abrupt withdrawal of foreign capital, especially short-term hot money flows. Especially for the case of Korea, the crisis was clearly a case of temporary illiquidity rather than fundamental insolvency. The IMF adjustment program called for a severe contractionary macroeconomic policy of higher taxes, reduced spending, and high interest rates, raising a specter of slow or no economic growth and of massive layoffs. The program was applied in the 1980s, when macroeconomic imbalances, government profligacy and hyperinflation were behind the Latin American debt crisis. The prescription was little more than the same old medicine for a new illness, and thus ill-suited as a cure for the troubled Southeast Asian economies in general and for the Korean economy in particular.<sup>10</sup> Unlike the currency crises in Thailand, Indonesia and Malaysia, the currency crisis in Korea spread irrationally from the other currency crises, which were compounded by the so-called “reverse free rider” behavior of foreign lenders. In a sense, therefore, the 1997-98 Asian financial crisis can be characterized as an “international liquidity crisis as much as a fundamental eco-

conomic crisis."<sup>11</sup> What Korea needed was the rollover of their short-term loans. The IMF could have taken initiatives in convincing the international financial community to provide coordinated action by creditor banks in the G-7 (read, developed countries) to restructure Korea's short-term debts, lengthening their maturity and providing temporary credits to help meet the interest obligations.<sup>12</sup>

Others charge that the IMF "bailout" programs for the Asian countries involve tax money being used to "bail out"—rather than "bail in"—multinational banks and financial institutions in the North (read, developed countries or the G-7). These banks and institutions had extended loans "recklessly" without careful risk analysis to private banks and business firms in emerging markets. They were equally responsible for the Asian financial crisis—a crisis of "international liquidity" in this era of globalization. What the IMF was doing in East Asia was a replay of the debt crisis of the 1980s in Latin America, when the Fund recycled public funds through indebted governments in Latin America to the coffers of the heavily exposed banks and financial institutions in the North.

Other critics of the IMF contend that the Fund's approach to Asia was simply a "continuation of its policies since the early 1980s, when, together with the World Bank, it imposed programs of 'structural adjustment' on over 70 Third World developing countries." The indebted countries in Latin America and Africa were allowed to use the IMF-released funds to service their debts only on condition that they accept programs of radical liberalization, deregulation, and privatization.<sup>13</sup>

In its rescue package for Korea, the IMF demanded a fundamental overhaul of the Korean economy. There is no denying that many of the structural reforms that the IMF included in its program for Korea (in exchange for the \$57 billion bailout) would improve the long-term performance of the Korean economy. Failure to undertake some of the badly needed structural reforms earlier was, no doubt, one of the root causes of the Korea's financial crisis. However, "a nation's desperate need for short-term financial help does not give the IMF the moral right to substitute its technical judgments for the outcomes of the nation's political process."<sup>14</sup> The structural reforms "demanded" by the IMF were those well recognized by Korea, but they were not needed for Korea to gain access to capital markets. The legitimate political institutions of the country, not an international agency such as the IMF, should determine the nation's economic structure and the nature of its institutions. But, then, one has to recognize that significant institutional changes that have taken place in Korea in recent years would not have been enacted in the absence of the painful and (to many Koreans) "humiliating" implementation of the IMF regime.



## **The International Financial Architecture**

The Asian crisis has shown once more that there are serious systematic problems inherent with the current global monetary and financial arrangements that we have. It has increased our awareness of the need for global governance of international finance so as to prevent the recurrence of similar crises in the future. One of the main problems with the current international financial system is that there is no governance of international financial transactions similar to that found in the area of international trade. The present structure is designed to discipline international borrowers rather than international lenders. International institutions and arrangements that we now have are designed to manage rather than to prevent crisis. With ever-rapidly increasing degree of financial integration taking place in the world economy, the global impact of interest and exchange rate policies has become much more important than before. There is no effective surveillance mechanism in these areas. There is also a dire need for the orderly workouts based upon rules and bankruptcy procedures that govern international debtor-creditor relations. All countries in the international community need to focus their attention to these issues as part of their efforts towards improving the governance of international finance.

Among many proposals for strengthening the international financial system, two questions stand out: One is the question of choosing appropriate exchange rate regimes, and how flexible they should be. The other is the question of liberalizing international capital flows, and how rapid it should be. The recent Asian crisis has shown that in the world with increasing degree of capital mobility, the traditional means of fixing the exchange rate do not work. The goals of exchange rate stability and capital mobility are simply incompatible as can be explained in terms of the so-called "open economy trilemma."<sup>15</sup>

### **Alternative Foreign Exchange Regimes and the Open Economy Trilemma**

Countries have three choices in determining the monetary linkage between their economy and the rest of the world: (1) Flexible regimes where countries let their currency float in the exchange markets against all other currencies; (2) Fixed regimes where they can fix the price of their currency against a specific foreign currency or a basket of foreign currencies; (3) Intermediate regimes where they let their currency float to some extent but intervening to limit those fluctuations according to some pre-determined parameters such as "target zones," "crawling bands," and so forth. Table 1 shows definitions of nine exchange rate regimes out of three main categories, ranging from the most flexible to the most fixed-rate commitment.

**TABLE 1**  
**DEFINITIONS OF ALTERNATIVE EXCHANGE RATE REGIMES**  
**FROM MOST FLEXIBLE TO MOST FIXED**

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**Flexible Corner:**

1. Free floating -- the absence of regular intervention in the foreign exchange market.
2. Managed float -- the absence of a specific target for the exchange rate.

**Intermediate Regimes:**

3. Target zone or band -- a margin of fluctuation around some central rate.
4. Basket peg -- fixing not to a single foreign currency but to a weighted average of other currencies.
5. Crawling peg -- a pre-announced policy of devaluing a bit each week.
6. Adjustable peg -- fixing the exchange rate, but without any open-ended commitment to resist devaluation or revaluation in the presence of a large balance of payments deficit or surplus.

**Fixed Corner:**

7. Truly fixed peg -- fixing, committing to buy or sell however much foreign currency is necessary at a given exchange rate, with a firm and lasting intention of maintaining the policy.
  8. Currency board -- three defining characteristics: fixing not just by policy but by law, backing increases in the monetary base one-for-one with foreign exchange reserves, and allowing balance of payments deficits to tighten monetary policy and thereby adjust spending automatically.
  9. Monetary union -- the adoption of a foreign currency as legal tender. This includes the special case of official dollarization.
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Source: J.A. Frankel, *The International Financial Architecture*, Policy Brief No. 51, (Washington, DC: Brookings Institution, June 1999).

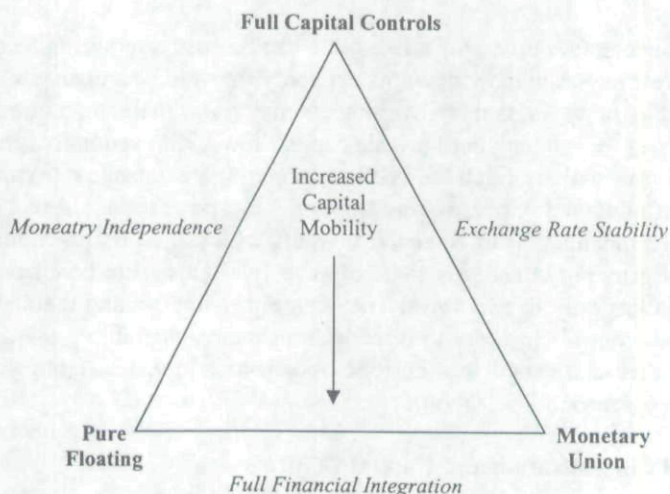


The choice of exchange rate regime depends on the particular circumstances facing the country under question. One proposition is that countries should move toward increased exchange rate flexibility. Those who take this position point to the consequences of the futile attempts to maintain the fixed rates in Thailand, Indonesia, Korea, Russia, and Brazil, which all ended in costly currency crashes. Another proposition is that all countries should move toward making institutional commitment to firmly fixing the exchange rate. For instance, use of currency boards in Hong Kong and Argentina has enabled these economies to weather successfully the storms of financial crises in recent years.

In the wake of the Asian financial crisis, however, there appears to be an increasing consensus on the view that the intermediate exchange regimes are not sustainable in a world with large scale capital flows, and consequently, countries are increasingly forced to choose either free-floating or firm-fixing. The logic behind this proposition can be explained by the open economy trilemma. The principle says that with its open economy, a country simply cannot achieve all three goals of exchange rate stability, monetary independence, and financial market integration simultaneously; it must give up one of three goals at a given time. As shown in Figure 1, one can attain any pair of attributes at an apex, but not all three attributes because one cannot be on all three sides simultaneously. Two goals of exchange-rate stability and monetary independence can be attained at the apex marked *capital controls*; in other words, the goal of financial market integration with increased capital mobility must be sacrificed. Likewise, at the point marked *monetary union*, two goals of exchange rate stability and capital mobility can only be achieved at the expense of giving up the autonomy of monetary controls. With freely floating exchange rate regime (at the apex marked *pure float*), currency volatility is the price for attaining goals of monetary independence and free capital mobility.

The globalization of financial markets has increased the degree of cross-border capital movements in recent years. In terms of the open economy trilemma diagram, this trend of greater financial integration has pushed most countries toward the lower part of the triangle. If further financial liberalization efforts push these countries to the bottom line of the triangle, the choice will be narrowed down to choosing either free-floating or firm-fixing as in the case of a monetary union. As emphasized by Jeffrey Frenkel, however, "there is nothing to prevent the country from choosing an intermediate solution between floating and monetary union" even under perfect capital mobility.<sup>16</sup>

Figure 1: The Open Economy Trilemma



Source: Jeffrey A. Frankel, *The International Financial Architecture*, Policy Brief #51 (Washington, DC: Brookings Institution, June 1999); Asia Development Bank, "The Financial Crisis in Asia," in *Asian Development Outlook 1999* (Manila: Asia Development Bank, 1998), pp. 22-46.

Free-floating allows a country to maintain its freedom in conducting monetary policy and other macroeconomic policies since it does not have to use them to defend the exchange rate. However, markets can overshoot the economic fundamentals: They can push the value of currency far below its underlying economic value, generating inflationary pressures and raising debt servicing costs, or they can push the exchange value far above the true value, hurting the country's export competitiveness and therefore its trade balance. On the other hand, fixed exchange rates can help countries avoid those costs if the governments can successfully establish the rate at a sustainable level and convince the markets of their willingness and ability to maintain the rate at that level. Fixed exchange rates also reduce the transaction costs of international trade and



investment. Moreover, the option for adjusting the fixed rate according to some predetermined parameters provides countries with "an additional policy tool that can be used to correct an excessive external deficit or surplus."<sup>17</sup> In fact, this has been the most important rationale for adopting a variety of intermediate exchange rate regimes (see Table 1) by many countries, including the Asian 5, since 1976.

Successful defense of a fixed rate can be costly, requiring a country to raise interest rates and slow down its economy to avoid speculative attack. The main trouble, however, is that governments may try to maintain a rate at unsustainable level for too long until private capital flows will eventually force devaluations or revaluations. Such "forced" adjustments in exchange rate can become very devastating and costly, as was amply demonstrated by the Asian crisis. In the era of globalization of financial markets with huge private capital flows, there is a growing consensus that countries can enjoy the benefits of fixed exchange rates only in two ways. They can either impose and maintain extensive capital controls in order to directly limit their vulnerability to speculative attack or they can establish a currency board as adopted in Hong Kong and Argentina (or read, dollarization).

### **Financial Liberalization and Capital Controls**

One lesson we have learned from the Asian crisis is that opening up the financial market before nurturing a sound financial system and institutions is a very risky business. Korea, for instance, has overestimated the potential benefits of joining the OECD (Organization for Economic Cooperation and Development)—sometimes referred to as a "rich boys' club." One of the requirements for joining the club was to liberalize its financial market.

Several lessons can be drawn from the Korean case of premature financial market liberalization. First, domestic financial systems must be liberalized before opening to foreign capital. By and large, the East and Southeast Asian countries were more or less in the same boat as was Korea. Ceilings on interest rate, government-directed lending, insider relationships between banks and borrowers have all served to channel credit without regard for rates of return, thus leading to misallocation of resources. Foreign capital inflows were channeled through the same process of intermediation, leading to excessive investments and maturity mismatches in assets and liabilities. Second, financial liberalization requires strict bank regulation and supervision in order to prevent a reversal in capital flows. This includes the imposition of ceilings on foreign currency exposure for the banks. Third, free capital movement and pegged exchange rates are simply a dangerous mix: Goals of capital mobility and the stability of

foreign exchange rates are not compatible. A fixed exchange rate regime prevents central banks from using higher interest rates to keep the economy from overheating, but it also encourages foreign currency borrowing when interest rates overseas are lower than those at home. Fourth, financial markets require reliable information and transparency to function efficiently. If foreign lenders had better information about the borrowing activities of Korea's private sector, they would have pulled back their funds earlier, and the impact of the abrupt withdrawal of funds on the economy would have been much less severe.

Many in the economics profession argue against capital control measures. They argue that the financial market is the best device for allocating global capital efficiently among countries and between competing uses. Global capital markets will provide capital-needy countries with additional funds for their growth, while allowing investors to diversify their portfolios. If capital is allowed to flow freely, markets will reward countries that pursue sound economic policies and pressure others to do the same. We all become beneficiaries of free capital movement. The Asian crisis, however, has given us an important lesson—that is, financial liberalization must come only after nurturing of the incentive structure and capacity to regulate financial markets. Until then, various measures for restricting capital flows may be in order.

*The Tobin Tax*—One way of limiting international capital flow is to selectively tax capital account related transactions, such as the "Tobin tax" or variants of it. Such a tax involves the differential taxation of foreign exchange conversions arising from capital flows.<sup>18</sup> The Tobin tax provides market participants with an incentive to take a long-term economic outlook rather than short-term hunches in buying and selling foreign exchange and securities. Traders must pay a tax—say, 0.1 %—for every transaction so that they would buy or sell only when the expected returns justify the additional expenses, resulting in fewer transactions. One difficulty for implementing the Tobin tax, however, is that all major currency trading countries must apply the tax at the same time. Otherwise, traders could simply shift their transactions to tax-free countries.<sup>19</sup>

*Controls on Short-Term Capital Flows*—One way of preventing the possible unproductive use of foreign capital when channeled through the domestic banking and financial system is to prohibit its entry by imposing capital controls. Capital control measures used by Chile, for instance, are not designed to discourage inflow of foreign capital at large, but they are specifically aimed at discouraging short-term capital inflows. Local firms that borrow abroad are required to keep 30% of all non-equity capital on deposit at the central bank, interest free for one year. This deposit requirement is tantamount to a tax on capital inflows with a maturity of less than one year; it is aimed at encouraging firms to borrow more for longer-term purposes. Studies have



shown that such capital control measures in Chile have not adversely affected the size of foreign capital inflows, but simply affected the composition of such flows, although capital controls in Chile caused "a large increase in the cost of foreign financing for Chilean companies."

Chile also requires that any foreign money coming into Chile must stay in the country for at least one year. This requirement has discouraged many hedge funds and pension funds from investing in Chile at all. In the wake of the Asian financial crisis, several countries have adopted capital controls. Among them was Malaysia, which imposed currency controls and prevented foreign shareholders from taking their money out of the country for a year. Taiwan dropped its plans for full liberalization of international capital flows by the end of the year 2,000.

Financial liberalization is critical in this era of globalization for a country's long-term growth and development. But financial liberalization should follow a sequence. The East Asian countries made the mistake of increasing their vulnerability by wooing foreign capital through capital account convertibility before addressing their fundamental financial weaknesses in a timely manner.

### **Whither the East Asian Model for Economic Development?**

The Asian crisis has raised a series of questions about the efficacy and sustainability of the so-called East Asian model for economic development. Many questioned whether the model could be considered valid to be followed by other developing countries in their pursuit of economic development. In fact, some suggested that the Asian crisis has not only signified "the end of the Asian miracle," but also signaled that the East Asian model has failed.

The debate on the validity of the model is not that simple, however. For instance, South Korea and Taiwan are known to have followed the model for their successful economic development efforts. This model of state-directed capitalism seemed to combine the dynamic aspects of a market-oriented economy with the advantages of centralized government planning and direction. The model has been credited for transforming East Asian countries into an export powerhouse and for producing spectacular economic growth, unheard of in the past human history. While South Korea, along with other Southeast Asian countries, was hard hit by the crisis of 1997-98, Taiwan has not only avoided the Asian financial contagion, but has also continued to grow at a respectable rate. Why? Is the model itself in crisis or are there any alternative explanations for the different outcomes of the East Asian model as followed by South Korea and Taiwan?

To be sure, there is no established and agreed definition of the East

Asian model of economic development.<sup>20</sup> Compared to its Western counterpart, however, the model has several distinguishing features. The most important one is that governments play an important, proactive role in the process of industrialization and economic development. Both South Korea and Taiwan can be characterized as what Chalmers Johnson called the "developmental state," in which the state recognizes economic development as the primary goal and does not hesitate to intervene in a market-oriented economy to achieve this goal.<sup>21</sup> As a capitalist state, the developmental state is committed to private property and the market system. However, the market is closely governed by the government bureaucrats who formulate and implement strategic industrial policies to promote economic development. Both South Korea and Taiwan also promoted a bank-based financial system under close government control. They also used international trade as the primary means for economic growth and development. Among other things, these commonalities shared by both South Korea and Taiwan help explain their phenomenal economic success achieved in the past three decades.

Although South Korea and Taiwan are the prime examples of the East Asian model of development, the approaches taken by the two in their application of the model were different—a "Big is beautiful" type of approach in Korea and a "Small is beautiful" type of approach in Taiwan. In South Korea, economic policy was geared at achieving rapid economic growth whereas macroeconomic stability was given higher priority in Taiwan. Big business conglomerates, known as the *chaebol*, emerged as the engine of growth dominating the South Korean economy, while in Taiwan small and medium-sized enterprises (SMEs) played a central role in economic growth and development. The different outcomes of the 1997-98 crisis for South Korea and Taiwan can be attributable to these differences in policies and approaches undertaken by the two in their application of the East Asian model of development.<sup>22</sup>

In South Korea, the growth-first policy involved choosing winners through the government-directed, discretionary policy of credit allocation among business firms. The financial institutions were placed under government control, and they became simply a "silent partner" in the process of economic development. In this process of credit allocation, SMEs (small and medium sized enterprises) were given little or no daylight. In Taiwan, on the other hand, emphasis was placed on nurturing the spirit of individual entrepreneurship for SMEs. It is these SMEs who laid a firm foundation for the sound financial system and industrial organization in the Taiwanese economy. In the case of South Korea, there is little doubt that the growth-first strategy with "financial repression" under the government-controlled financial system and the selection of prioritized industries to be developed did serve the purpose of achieving the goal



of rapid economic growth. But unfortunately, the strategy also helped to create a group of giant industrial conglomerates, known as the *chaebol*, which by the end of the 1970s had already become "too big to fail," dominating the South Korean economy. In the 1980s and 1990s, the state deviated from its status as a developmental state, and the *chaebol* became too big and powerful to control, eventually pressuring the government to prematurely deregulate and liberalize financial markets. This greatly reduced the government's ability to control and regulate international short-term capital flows, known as "hot money." The government, rather than directing and guiding business firms towards its developmental goals, began to resemble an agent of the *chaebol*.<sup>23</sup>

As in South Korea, Taiwan also followed the East Asian model of development, but emphasis was placed on economic growth with stability. Accordingly, the Kuomintang (KMT) regime implemented economic policies aimed at preventing inflation, financial instability and the concentration of private capital. To maintain monetary stability, the government nationalized the banking system and placed the entire financial sector under its control. As a result of this tight regulation and control of the financial sector and the policy of avoiding excessive concentration of private capital, Taiwanese firms had to rely on their own funds, small loans from a number of banks, and money borrowed from relatives and friends. This reliance on traditional household networks for financing has been largely responsible for shaping the Taiwanese industrial structure: First, it has limited the size of business firms to be smaller because for Taiwanese firms there were no huge concessionary or special loans made available under the growth-first strategy as in South Korea. Second, the debt-equity ratios for Taiwanese firms tended to be much lower than those of the South Korean counterparts since banks were not willing to lend large sums to individual firms and they could only borrow so much from the traditional household networks.

Taiwan's anti-inflationary policy, along with a high-interest-rate policy, was successful in boosting capital accumulation and growth. Unlike South Korea, Taiwan did not have to depend heavily on foreign borrowing to finance domestic investment. In fact, during the period 1971-1994, Taiwan was able to finance its entire gross domestic capital formation out of internally generated domestic savings.<sup>24</sup> This, of course, greatly reduced its vulnerability to foreign debts and external shocks. While South Korea relied heavily on foreign borrowing and blocked foreign direct investment (FDI), Taiwan opened its door to FDI. Inward FDI into Taiwan not only contributed to capital formation but also served as an important vehicle for technology transfer.<sup>25</sup>

Most important of all, the Taiwanese government never lost its autonomy, and remained a developmental state, maintaining its "commanding heights"

in the economy. Unlike in South Korea where the powerful *chaebol* wielded a strong influence over government policy, Taiwanese firms were not allowed to consolidate their economic power, and they were constrained to conduct their financial and industrial operations in a highly flexible, widely diversified manner. It was these small-scale, flexible and informal household network groups in Taiwan that became highly instrumental in easing the adaptation of the economy to changing circumstances and external shocks.<sup>26</sup>

At least two lessons can be drawn from the South Korean and Taiwanese experiences with economic development. One, economic stability cannot be sacrificed for rapid economic growth. Two, a strong government with an economic bureaucracy that is highly capable but still independent of the business community is an essential institutional prerequisite for successful policy formulation and implementation of the East Asian model of development.<sup>27</sup>

Some argue that the Asian crisis has demonstrated a limited life for the interventionist model for economic development. The model worked out successfully for Japan and East Asian countries, including South Korea and Taiwan, while the following conditions prevailed: First, countries must have a high household savings rate; there must be a political consensus that the benefits of financial repression (favored firms receiving low-cost loans) exceed the costs to consumers or those investors who must use informal or curb capital market; there must be rapid increases in GDP, both to build political support for the intervention and to mask its inefficiencies; countries must run trade surpluses in order to build foreign exchange reserves. And finally, countries should be in the early stages of economic expansion, when capital accumulation matters more to growth than technological progress.<sup>28</sup> Once economic growth begins to slow down because of accumulating inefficiencies and a diminishing marginal product for capital, the inefficiencies would become harder to hide, investor optimism would begin to fall, and political support would erode. The interventionist model for development of the East Asian type carries with it the seeds of its own destruction, and the world integration makes it no longer viable in the long-run.<sup>29</sup>

However, one must keep in mind that a premature relaxation of intervention by the state may bring a disaster. One important contributing factor to the Asian crisis is not "too much of state intervention" but rather "lack of it." As in Korea, for instance, "the crisis stemmed from the uncontrolled debt-financed expansion of the *chaebols*. The government's abdication, in the face of *chaebol* power, of activist state coordination of private-sector investment and its relaxation of controls over the private sector's foreign borrowing were the key factors that precipitated the crisis."<sup>30</sup> In several of the Asian crisis countries, badly managed financial liberalization lifted restrictions on bank borrowing and lend-



ing before putting in place a sound regulatory framework. Many of the problems arose not because governments did too much, but because they did too little, and because "they themselves had deviated from the policies that had proved so successful over preceding decades."<sup>31</sup> In South Korea, as the chaebol became too big to fail and their power increased, the state's power eroded, and, unfortunately in the 1980s and 1990s, the state "evolved in such a way that it came to resemble a racketeering state rather than a developmental one."<sup>32</sup> In Taiwan, however, unlike in the case of South Korea, the government never lost its autonomy even after significant measures of liberalization were introduced in the financial and industrial sectors. The state was able to remain a developmental state, still occupying the "commanding heights" in the Taiwanese economy.

### CONCLUDING REMARKS

In order to understand better the causes of the Asian financial crisis—proximate as well as fundamental—a host of new hypotheses and explanations have been advanced in the academic circle, and they are still in the making. There is, however, one cause that stands out among many. That is the rapidly increasing globalization of business activities and markets continually taking place in the world economy. The Asian countries (and for all non-Asian countries as well) have been simply too slow to fully appreciate the new challenges and risks posed by the rapidly globalizing financial markets. Consequently, they have been too slow in formulating appropriate responses and policies. Globalization has increased the speed and magnitude of the market reactions. It has magnified the costs of bad, inconsistent policies and weak, inefficient institutions. In today's global environment, the forces of globalization are simply beyond one's control. In short, Pacific Asian countries have simply fell victim to globalization.<sup>33</sup>

Globalization, if properly managed, may help push some developing countries into modernity and affluence. But as the Asian financial crisis suggests, embracing global financial markets can also be highly dangerous and costly. The Asian crisis has shown how important it is to have effective state institutions that are capable of successfully mediating the impact of globalization on economic development. "Heightened exposure to world markets will only become a true lever of economic development in the presence of institutions able to mitigate market failures and manage the competitive challenges and domestic dislocations produced by openness. Contrary to conventional wisdom, however, the absence of the requisite institutional conditions is not neces-

sarily self-correcting."<sup>34</sup>

The severity and contagiousness of the Asian financial crisis underscored the need for reforming the international financial system. Numerous proposals have been put forward. The G-7 (read, developed countries)-led reform, however, ignores the problems of the supply side of international finance, and concentrates its efforts on reforming the financial and corporate sectors of developing countries. Again, as in the case of the Mexican peso crisis of 1994-95, the appetite for radical reform of the international financial system has receded considerably in the wake of economic recovery of the crisis-hit countries. From the perspective of developing countries, therefore, it appears that they will remain vulnerable to future financial crises even if they faithfully carry out the kinds of structural reform recommended by the IMF and the World Bank. Given this reality, developing countries may have no choice but to develop their own defense mechanism by establishing a system of capital controls and by adopting an exchange rate regime that lies somewhere between the two extremes—free floating and fixed.

The Asian crisis hardly signifies the end of the East Asian model of economic development. Too drastic measures of liberalization and opening up may weaken the existing relation-based governance structure of the economy before a new and more rule-based governance mechanism could function. Korea and Thailand may be a case in point. In the early 1990s, financial liberalization as well as political liberalization in these countries proceeded, perhaps too fast and too early, before an effective rule-based governance structure was put in place. In short, "[t]he dismantling of too many existing relation-based mechanisms in so short a period can damage the future potential of economies at an early stage of development to continue to catch up," while relation-based governance is still more cost-effective than rule-based governance.<sup>35</sup> For many Third World developing countries, the relation-based East Asian model of economic development, if properly adopted and executed as in the case of Taiwan, can be effective in facilitating catching-up in the early stage of economic growth and development. In the wake of the Asian crisis, the credence of the model has been seriously questioned, but the model itself is not in crisis. It is the strategy or approach to be used in its application that must be carefully weighted and evaluated.

## NOTES

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33. No country is immune to currency crisis in a world of capital mobility. No country could be safe in the face of a massive international capital outflow such as one that took place in Southeast and East Asia in 1997, which precipitated the Asian financial crisis. As discussed earlier in the paper, there was a record capital inflow of \$93 billion into Thailand, Malaysia, Indonesia, the Philippines and South Korea. Then there was a net outflow of capital of \$12



billion in the following year 1997. This greatest reversal of private capital flows ever recorded in the world economy involved \$105 billion, the amount equivalent to 11 percent of the combined GDP of these five Asian countries. In terms of the U.S. economy, this would be equivalent to a change in capital flows of over \$940 billion, which would no doubt wreak havoc on the U.S. financial markets!

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