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The East Asian Crisis

A Global Problem Requiring Global Solutions

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1 Introduction

This IDS Bulletin presents the key background papers from a major conference on the East Asian Crisis held at the IDS in July 1998.[1] This conference brought together a distinguished group of international participants with different perspectives, experiences and institutional affiliations. Included were experts on international finance, macroeconomic and social policy, and development strategy. The discussions from the IDS conference then fed into a seminar on the Asian crisis, hosted by the Secretary of State for International Development.[2]

At each turn, the current international financial turmoil has defied prediction. In the first instance, it was unforeseen. The speed with which it struck, its magnitude and the extent of its contagion have combined in a major blow to policymakers everywhere. It has stubbornly refused to respond to a standard package of international rescue measures. In the four months since the IDS conference, we have witnessed a spreading contagion that has destabilised currency and stock markets around the world and converted this year's annual meeting of the World Bank and IMF into a forum on the threat of recession and global deflation. Markets, especially in Europe and North America, have rebounded since mid-October, but heads of state and finance ministers, evidently far from reassured, continue to express publicly their deep fears of a major downturn in 1999.

Furthermore, in late 1998 the world economy is significantly different from a year ago, as what started as a crisis in Asia grew into a global crisis. According to World Bank estimates (in its Report on Global Economic Prospects and Developing Countries 1998/9), 36 countries that account for more than 40 per cent of the developing world's GDP and more

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[1] We would like to thank the Department for International Development (DFID), the Canadian International Development Agency (CIDA) and the International Development Research Centre (IDRC) for their valuable financial and intellectual support for this conference. We are particularly grateful to the Secretary of State for International Development, Clare Short, to Charles Clift from DFID, to Soe Lim from CIDA, and to Rohinton Medhora from IDRC.

[2] A summary of the discussion from the DFID seminar is presented by Charles Clift in this volume.

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than a quarter of its population is likely to see negative per capita growth in 1998; in contrast, in 1997, per capita income fell in 21 countries, that accounted for 7 per cent of the developing world's population. For all developing countries, per capita growth is expected to slow down from 3.2 per cent in 1997 to 0.4 per cent in 1998.

The crisis in East Asia has led to significant increases in poverty. The region's impressive social gains of previous years that came to be a defining feature of the 'East Asian Miracle' are now under threat. The collapse of commodity prices, a direct result of events in Asia, now threatens the same consequences in other developing countries. There are also signs that reactions to the crisis may serve to undermine a range of recent policy advances, such as those towards more open trade, in developing and transition economies. Under these circumstances, international investors have become increasingly risk-averse, pulling out of all but the safest investments. The fear that this liquidity crunch was spreading from emerging to more developed economies was confirmed by the near-collapse of a major US hedge fund.

The increasing global reach of the crisis has produced a growing consensus that to understand what is happening we must think less in terms of an emerging market crisis and more in terms of an international crisis originating in emerging market economies. Not only has this crisis become clearly international in its coverage, imperfections in the international financial system itself are now viewed as among its root causes. Recent events have highlighted the stark inconsistency between international financial markets, which are increasingly dynamic and sophisticated, and the adequacy of the existing institutions, both national and international, designed to uphold and regulate them.

It is now clear that the crisis countries in Asia will experience a sharp contraction in GDP of around 8 per cent in 1998. Global growth will also be reduced sharply. Even more serious are indications that the severity of the economic contraction is fuelling a socio-political crisis in East Asia and beyond. Unemployment has already risen significantly. Real fears are now expressed concerning the possibility of extreme political scenarios in some of the worst affected countries.

Given this perspective, it comes as no surprise that many of the papers in this Bulletin and much of the discussion at the IDS conference focussed on how to prevent and better manage future crises. There was also lively debate on steps to be taken immediately. The conference did not result in agreement on all points, but there was strong consensus that measures are urgently needed that can address both the magnitude of the crisis and the complex underlying issues giving rise to it. It is hoped that the IDS conference discussions and policy proposals as represented in the following collection of papers may provide a useful contribution for engagement with these issues and assist in the formulation of the range of actions and responses that are so urgently required. At the time of sending this Bulletin to press, some positive policy steps have been taken that should help economic recovery worldwide. These include an easing of monetary policy first in the United States and then in Europe, progress with bank revitalisation in Japan, approval by the US Congress for greater funding for the international financial institutions, and approval of a package (both domestic and international) for Brazil that will hopefully lessen the severity of any possible crisis in Brazil.

However, as pointed out, more fundamental reforms are urgently required to make such developmentally costly crises less likely and to manage them better if, unfortunately, they do occur. We hope this Bulletin can contribute to this important debate.

2 Causes of the Crisis

Domestic factors

In the case of the Asian and other currency crises, domestic causes generally have their roots in the large capital inflows experienced by those countries (Reisen). Indeed, so-called domestic causes, such as overvalued real exchange rates and rapidly growing asset prices, were, to an important extent, endogenous effects of massive net capital inflows. It is extremely difficult to separate domestic from international factors.

Weakness of the financial system

Financial fragility in Asia, together with an under-supervised banking sector, was certainly a contributing factor. Although financial reforms were

introduced during the 1980s and the 1990s, enforcement of financial sector regulation did not keep pace. It was emphasised at the conference that even in developed economies, such as the Scandinavian countries, liberalisation of the domestic financial sector is typically not accompanied by sufficient improvements in financial sector supervision, nor, especially, by appropriate enforcement of such supervision. Kaminski and Reinhart (1996) find that for the period 1970–95, financial liberalisation, followed by private lending booms, played a significant role in explaining the probability of banking crises, and that banking crises help predict currency crises.

In the East Asia case, lending was increasingly channelled towards property and non-traded activities. Inadequate banking supervision together with poor assessments of financial risks largely contributed to the sharp increase of credit towards unproductive investments. Credit was combined with the prevalence of large unhedged foreign-currency-denominated corporate and bank debt.

Overproduction

The Asian crisis was not a crisis of overconsumption, as was the case in Mexico in 1994, but one of overproduction. The lending boom resulting from capital flows was mainly channelled towards investment. This overinvestment (reaching in the case of South Korea and Thailand levels higher than 35 per cent of GDP during several consecutive years) led logically to overproduction.

A number of external factors seem to have contributed to overproduction. These included the depreciation of the yen against the dollar, which started in mid-1995. This hit the competitiveness of East Asian countries, largely because the East Asian currencies were effectively pegged to the US dollar. The decline in competitiveness was reinforced by upward pressures on real exchange rates due to large capital inflows. Decreasing exports led to overcapacity, particularly in the auto, electronics (semi-conductors), and textile industries. The recession in Japan also contributed to the region's economic problems as it reduced that country's demand for imports.

Park and Song stress that it was foreign capital that led to the investment boom. Looking at the correlation between capital-inflow-to-GDP and current-account-deficit-to-GDP ratios, the authors show that the liberalisation of the domestic financial sector, combined with the opening up of the capital account, increased the availability of foreign capital and thus largely contributed to the financing of new projects: 'capital inflow was driving domestic investment, not the other way around' (Park and Song). This leads us to the factors that relate to the international environment and which certainly played the greatest role in triggering the crisis.

External factors

External capital flows

The five Asian crisis countries received extremely high levels of private external finance between 1994 and 1996, followed by a dramatic reversal of capital flows in 1997. According to figures from the Institute of International Finance (IIF 1998), the five East Asian countries hardest hit by the crisis (South Korea, Indonesia, Malaysia, Thailand and the Philippines) experienced a turnaround of US$105 billion in a single year – from an inflow of US$93 billion in 1996, to an estimated outflow of US$12 billion in 1997. Most of this swing occurred in commercial bank lending, followed by short-term portfolio flows, whilst foreign direct investment (FDI) remained constant.

Not only had the scale of lending grown rapidly in the 1990s, but its maturity was also increasingly short, making these countries more vulnerable to a loss of confidence. In South Korea and Thailand, for example, about 70 per cent of total international bank claims had a maturity shorter than a year. The corresponding figure for Indonesia and Malaysia was around 60 per cent. At the onset of the crisis, the ratio of short-term debt to international reserves in the affected countries ranged from 0.6 for Malaysia to 2.1 for South Korea. This implied a high dependence of those countries on the willingness of foreign creditors to roll over existing short-term credit.

The steep increase in short-term foreign borrowing has several causes. The Bank for International Settlements (BIS) (1996) argues that an increasing differential between local and foreign interest rates driven by tighter domestic monetary policies encouraged foreign borrowing. Reisen, however, stresses that, in part, interest rate differentials in

East Asia may have been due to structural deficiencies in the financial sector. This implies that liberalising the capital account before these structural deficiencies were removed may have been inappropriate.

Changes in perceptions by international investors and lenders

What seems most disturbing about the Asian crisis is that it happened to countries that had been so successful for a long period, not just in terms of economic growth but also in terms of the great dynamism of their exports, their low rates of inflation, high rates of savings and a rather equitable income distribution.

Clearly there were problems in the Asian economies, some of which are discussed in this Bulletin. As Griffith-Jones and Reisen show, these problems did not appear abruptly and cannot explain the scale of the crisis, nor its timing. Clearly another causal factor, relating to the international dimension, and in particular to the behaviour of international capital flows and to the perceptions of investors, is extremely important. These factors are linked to imperfections in international capital markets which, although a constant feature of financial markets through time, have had an increasing impact due to the speed with which markets can react in today's global economy (Griffith-Jones 1998).

Paradoxically, this impact appears strongest for those economies that either are, or are perceived to be in the process of becoming, highly successful. Successful economies offer high returns by way of yields, as well as capital gains. International investors, particularly when their path is eased by capital account liberalisation, tend to rush into such countries, generating a surge of capital inflows that affects key economic variables: exchange rates become overvalued, the prices of key assets, such as shares or real estate, rise quickly and sharply, and there is an increase in both real income and perceived wealth. Banks tend to relax lending standards, lifting liquidity constraints on businesses, as they assume that current trends will continue. The balance of payments deteriorates, often quite rapidly, as both consumption and investment rise. Initially, this is not seen as a problem, as foreign lenders and investors are willing to continue lending or investing. Economic authorities delay the necessary adjustment, confident that their previous success will be continued, and that crises happen elsewhere. This latter problem was particularly serious in East Asian countries, as these countries had a long history of growth and no recent experience of balance of payments crises.

Then, something changes. The change may be domestic or international, economic or political, important or relatively small. This change triggers a sharp modification in perceptions, leading to a large fall in confidence in the economy among internationally mobile investors, that is, both foreign investors and nationals able to take their liquid assets out. The change of perception tends to be both large and quick.

In East Asia, clearly the largest reversal of flows occurred in bank flows, apparently disproportionately by smaller banks, which seem less informed and more prone to herd behaviour. Park and Song also analyse the role played by mutual Asian country funds based in New York in the deepening of the crisis. They find that the crisis spread from Thailand to three Southeast Asian countries, Indonesia, Malaysia and Singapore, and that the funds did play a role as a transmission channel. On the other hand, Howell argues that the narrowness of local capital markets did not allow for large liquidations and thus did not permit foreign institutional investors to liquidate large amounts of their holdings. Howell believes that hedge funds could have played an important role in the foreign exchange markets. In the light of recent studies (Eichengreen and Mathieson 1998), and of discussions at the IDS conference, it seems that institutional investors played a role in triggering the crisis, and particularly in deepening and spreading it within Asia. Clearly further research is required to understand the role which different financial actors play in triggering and deepening currency crises.

Crisis depth and contagion

What was unexpected about the East Asian crisis was not just that it happened, but that it was so deep and prolonged, and that contagion in the region was so virulent. This relates to inappropriate management of the crisis, both by the crisis countries and the IMF, as well as to exogenous factors, such as slow growth and recession in Japan and the close trade links between the East Asian countries,

which though once a source of strength, soon became a source of weakness as recession weakened demand for intra-regional imports.

The East Asian countries had less experience in crisis management than some other regions, such as Latin America. This may have contributed to initial delays in recognising the depth of the crisis and the need to act quickly, as well as to the mistakes in crisis management. Indeed, interesting lessons for Asia on crisis management and resolution can now be drawn from Latin America, such as the urgency for sufficient debt reduction in the initial phases of a crisis.

Furthermore, the East Asian countries and especially the IMF faced a new and difficult challenge. Capital-account-led crises, which relate to rapid changes in the expectations of private investors and lenders, may need different responses to traditional balance of payments crises, provoked by problems on the current account, and caused by public sector deficits. In the new capital-account-led crises, the key challenge is to restore the confidence of private actors. Several conference participants argued that IMF programmes, with their stringent macroeconomic conditions and overambitious requisites for rapid and deep structural reforms, had been counterproductive for restoring confidence.

3 Social and Economic Costs

The East Asian 'tiger economies', prior to the current crisis, were arguably the most remarkable development success story of this century. These countries were not only successful in terms of per capita income growth, but also achieved substantial poverty reduction. Ranis and Stewart report a strong decrease in the proportion of the population classified as poor on the basis of their private income. Despite some improvements in access to social services, such as health and education, the basis of this success in poverty reduction was a sustained period of high and reasonably equitable private income growth.

Limping tigers

The history of high growth was reversed by the financial crisis of 1997 and gave way to a recession. Major GDP contractions are expected for the East Asian crisis countries, whose GDP is expected to fall on average by 8 per cent during 1998. Despite high interest rates, the capital that fled the region has not returned. Financial systems are under great pressure, as private and public debtors stop repayments, tipping more and more companies into insolvency.

The effect of the crisis on Indonesia has been particularly severe, as GDP is expected to fall by at least 15 per cent in 1998. The situation of Indonesia has been complicated by the fact that the country is simultaneously suffering the effects of the financial crisis, of political instability and of adverse climatic conditions. Before the crisis, Indonesia had been one of the most successful newly industrialised East Asian countries (World Bank 1998). Following the dramatic reduction in the proportion of the population classified as poor during the period of rapid growth, to around 15 per cent in 1990, it is now estimated that 'about half of the country's 200 million people will be unable to afford food and basic needs'.[3]

Haunting Asia – the vagaries of the spectre of poverty

The main impact on poverty levels in Asia has come from rising unemployment and falling wages.

Unemployment in the region has increased dramatically since the onset of the crisis and is set to continue increasing in the future. The immediate effect of this has been a dramatic fall in the income of the affected workers, since unemployment provision is almost universally absent (with the partial exceptions of South Korea and Japan).

Other negative effects of this rise in unemployment were underlined at the conference. Employees in the formal urban sector often contributed to the maintenance of dependent family members, who now suffer reductions in transfer incomes as these contributions are no longer available (Robb 1998). Another labour market phenomenon has been increased informal-sector participation which certainly depressed earnings. This has occurred in the

[3] Reuters, 1998.

urban informal sector as well as in rural areas. Increased informal-sector participation is closely linked to rising female participation, which can take the form of prostitution; it has also led to an increase in child labour with the corresponding adverse effects on education (Robb 1998).

Other factors impacting on living standards have been price and interest rate rises. Food price rises in the wake of the crisis have depressed real wages (Robb 1998). Price rises of imported goods as a consequence of devaluation are a particularly major problem. Health service access has worsened as the price of imported medical drugs has increased. Interest rate rises have been damaging not only to local businesses but also to households, who increasingly find it necessary to access informal lenders. Credit on informal markets is expensive, and there are reports of loan sharks increasingly resorting to violence to recover loans.

Households' coping strategies have incorporated attempts at expenditure reduction. The burden of reduced consumption tends to be unequally distributed within households: women and children are likely to suffer disproportionately. Reduced health and education spending can be expected to lead to quantitative reductions in human capital formation or to lower quality of human capital.

In Southeast Asia, perhaps more so than in other regions, welfare issues are closely linked to the performance of the external sector. It is evident, therefore, that global financial instability can exacerbate poverty in Asia in a number of ways, not just during the current crisis but also in the future, through adverse effects on productive capacity and on the quality of the human capital stock.

National policies

If macroeconomic policy measures are to lead to social improvements, it is important that they are designed to avoid further recessionary impacts. This makes it necessary to reconsider the kind of austerity prescription that has traditionally been implemented in Latin American crisis scenarios. The IMF has begun to make some concessions in this direction after insisting initially on contractionary policies.

A number of concerns should be borne in mind considering immediate, short-term policy measures. Ranis and Stewart point out that macroeconomic measures should aim to restrict unnecessary expenditure and that social allocation ratios should at least be stabilised. They also propose a series of relief measures on a microeconomic level. In the long run they suggest that the main concern should be with establishing universally accessible social security systems. A key challenge is to make the implementation of such universal social security systems affordable in the foreseeable future.

Useful as all these proposals may be, in the long run there is a more fundamental concern for the region. Social security systems may help to spread the cost of the crisis over the whole of society – and this can make an important difference to those worst affected. Yet the primary concern should be how to avoid crises of this kind from occurring in the first place. In small, open and highly trade-focussed economies like those of East Asia, any involvement in international financial turmoil is highly disruptive for the countries' external economic relations in general. This can be expected to have a highly recessionary impact which in turn threatens achievements in poverty reduction.

We therefore now turn to the key issues of crises prevention and crises management.

4 Policy Implications

Within present arrangements, there is growing concern that the volatility and reversibility of some categories of capital flows, as dramatically illustrated by the East Asian crisis, implies that the costs of these flows may outweigh their benefits (at least during certain periods). As a consequence, there was broad consensus at the IDS conference that important changes need to be made in the international monetary system as a whole, and in recipient country policies, to avoid costly crises, as well as to manage them better if they do occur. Care must be taken, however, that the measures adopted contribute to broaden access of all developing countries to capital flows, particularly long-term ones.

Crisis prevention

Domestic measures in capital-receiving countries

At the conference, there was consensus that capital account liberalisation should be done in a very

account liberalisation, based on developmental efficiency, rather than on pressure from interest groups.

The Asian crisis proved again that capital account liberalisation can only work well if certain preconditions are met, including the appropriate prudential supervision and regulation of the domestic financial system. This is a difficult task, particularly, but not only, in developing countries (as illustrated by the Scandinavian banking crises). Careful limits also need to be placed on foreign currency borrowing by corporate entities, especially local banks. As regards capital account liberalisation itself, the standard recommendation that long-term capital flows need to be liberalised first and short-term flows should be liberalised last has been confirmed by events in East Asia.

There is a strong case for market-based 'Chilean-style' measures (such as non-remunerated reserve requirements on flows of up to one year) to discourage excessive surges of short-term, potentially reversible inflows and to improve the maturity structure of external debt. However, it is important that such measures should not be seen as a panacea, but that they should form part of a package of policy measures that include sound macroeconomic fundamentals as well as a strong and well-regulated domestic financial system. During periods of excessive surges of capital inflows, recipient countries have a greater degree of freedom for policy-making. Counter-cyclical monetary and fiscal policies can play an essential role in reducing excessive growth of domestic absorption, and/or current account deficits. It is important that economic authorities 'lean against the wind' with their macroeconomic policies in periods of large surges of capital inflows and/or domestic credit booms.

A counter-cyclical approach should also be applied to the supervision and regulation of the financial system, and particularly the banking system. In boom times, supervision and regulation of banks, as well as credit decisions by banks themselves, should not be based solely on expectations of a continued growth scenario among borrowers. Good economic periods are bad times to evaluate credit-requirements for banks can also provide a valuable additional cushion for downside risks.

An appropriate exchange rate regime is also essential for relatively small, open economies, so as to make them less vulnerable to currency attack. This is a complex issue, and the choice of exchange rate regime should be linked to the country's specific circumstances. A freely floating exchange rate acts as an automatic stabiliser for capital flows, but can cause competitiveness problems. Fixed exchange rates offer apparently secure yields to very short-term investors, and can encourage domestic corporations to borrow abroad. Furthermore, fixed exchange rates can, when the situation deteriorates, offer fixed goal posts for hedge funds and others to attack. International evidence seems to show that exchange rate regimes using wide bands, with a possible crawling peg element, offer a good combination of flexibility with some desirable guidance to the market and an anchor for monetary policy.

International measures

The current international discussion, in forums like the G-7, the IMF and the G-22, has stressed improved information and surveillance of developing countries as an important mechanism to make future crises less likely. Not enough emphasis is being placed on international capital market surveillance and regulation, which is very important. Furthermore, at the conference there was a general feeling that whilst improved information on countries is extremely valuable, it is clearly insufficient. As discussed above, often the key problem is not lack of information (important as that may be), but how available information is analysed. Indeed, the description of a glass as half-empty or half-full does not depend mainly on whether the glass is clean, but on the mood of the viewer; similarly, with markets' perceptions of emerging economies. Therefore, measures additional to improvement of information are required, including, in particular, better regulation of international capital flows.

There is a growing consensus on the need to complete and improve international prudential

tional regulation of financial markets (Fitzgerald). Griffith-Jones identifies two categories of flows to emerging markets where additional international and/or source country regulation and supervision may be particularly necessary: short-term bank loans and easily reversible portfolio flows. Griffith-Jones shows how these flows played a prominent role in sparking off recent currency crises and proposes changes to, and innovations in, current regulatory practice designed to reduce the likelihood of future crises. In the case of bank lending, modifications to eliminate current regulatory incentives to encourage short-term bank lending are urgently required. In the case of institutions like mutual funds an important regulatory gap exists, as there is no international regulatory framework for taking account of market and credit risks on flows originating in institutional investors; this could perhaps best be achieved by requiring risk-weighted cash requirements on mutual funds' investments (Griffith-Jones).

A dynamic risk-weighted cash requirement for mutual funds (and perhaps other institutional investors) is in the mainstream of current regulatory thinking. The guidelines for market risk would take into account such vulnerability variables as the ratio of the country's current account deficit (or surplus) to GDP, the level of its short-term external liabilities to foreign exchange reserves, the fragility of the banking system, as well as other country risk factors. It is important that quite sophisticated analysis is used, to avoid simplistic criteria stigmatising countries unnecessarily. Introducing risk-weighted cash requirements on mutual funds would help achieve a more precise pricing of risk, as well as help smooth capital flows, thereby avoiding the boom–bust behaviour of institutional investors like mutual funds.

Further study is also urgently required to detect and cover any other existing monitoring or regulatory gaps, for example in relation to instruments such as derivatives, and institutions such as hedge funds. The possible need to supervise rating agencies may also require further investigation, as do the norms that could be set to supervise them adequately.

capital markets as described above. The aim of such a proposal is broadly to slow down speculative, short-term capital flows (which would be more affected, since by definition they cross borders often, and would be taxed every time), while having only a marginal effect on long-term flows. More generally, a multilateral tax agreement (with effective multilateral taxation of corporate profits or perhaps of dividends) could be a desirable step in this context. Such an agreement, if appropriately structured, could not only improve the fiscal revenue position of developing countries and reduce the use of tax incentives to foreign investors, thus increasing resources for social infrastructure, but also contribute to the stabilisation of financial flows.

It can be concluded that a package of measures is needed to make currency crises in emerging markets far less likely, and therefore ensure the efficient operation of the market economy in emerging markets, which should be a basis for sustained development. The objective of crises avoidance requires some discouragement and regulation of excessive and potentially unsustainable short-term inflows. Such measures would be most effective if they are applied both by source and recipient countries (though the main responsibility lies with recipient countries), if these measures avoid discouraging more long-term flows (which on the contrary need to be encouraged), if the rules designed are simple and clearly targeted at unsustainable flows and, particularly, if they are complemented by good policies in the emerging economies.

Crisis management

Though prevention is far better than cure, if prevention fails and major currency crises do unfortunately occur, measures need to be in place to manage them as well as possible. Thus, measures for better crisis management, both nationally and internationally, are clearly complementary to measures for crisis prevention.

National measures

The policy options at a domestic level once a currency crisis explodes are very limited, and the

trade-offs are very problematic. The standard response required by the markets includes sharp increases in interest rates and significant fiscal tightening, the latter even in countries with fiscal surpluses. There was a great deal of discussion at the conference about appropriate macroeconomic responses to speculative attacks on currencies, with some disagreements, especially on the correct response of monetary policy.

Some participants, drawing on the experience of countries like Brazil, Chile and the Czech Republic, stressed that interest rate increases could be effective in some cases in preventing large currency depreciations, especially if they were timely, sharp and temporary. However, other participants argued that a positive correlation between exchange rates and interest rates was uncertain, especially in East Asian countries where companies have high debt equity ratios. Also, in countries like Malaysia, large corporations that borrow abroad were hit by depreciation, whilst small companies that borrow domestically were hit by high interest rates. More generally, the possibility of a 'Laffer-curve type' interest rate – exchange rate link was raised; this would imply that exchange rates could be defended effectively, using interest rates up to a certain level, but that the relationship failed to hold beyond a certain point. There was also broad agreement that sustained high real interest rates had important negative effects, both on the financial system and on the real economy. As a consequence, it seemed desirable that East Asian economies should continue prudently to lower interest rates. However, further research is required on interest rate policies in open economies, that are consistent with currency stability, strong financial systems and, above all, sustained growth.

International measures

The first response internationally when a large currency crisis starts unfolding in one or more countries is to activate quickly a sufficiently large financing package, led by the International Monetary Fund, to provide liquidity. A key problem is that the resources which official sources, and particularly the IMF, can command are relatively small, in proportion to the scale of private sector flows. According to some participants at the conference, the limited funds of the IMF imply that a very high proportion of its loans goes indirectly to the creditors; furthermore, because creditors are aware that official funds are limited, they are insufficient to restore confidence, and may indeed provide an additional incentive for such funds to leave the country quickly. For these reasons, though official financing is very large, little of it stays in the domestic economy to help sustain economic recovery. The effects of official financing packages therefore benefit creditors more than developing countries.

To overcome the shortcomings of the current arrangements, three avenues can be pursued. The first one is to enhance resources for official, and other, financing. Given the large scale of the resources required, and the limitation of IMF resources, complementary avenues for sufficient provision of early liquidity need to be explored. One possible modality is via enhanced central bank cooperative arrangements, through greatly enlarged swap arrangements, both within regions as well as particularly between G-10 members and non-members. These could be, for example, coordinated by the BIS. Another possible avenue is via pre-committed stand-by arrangements with private banks, as Argentina and Mexico have arranged; however, these latter arrangements are still untested, and it is unclear how well they would operate in a severe crisis.

The second avenue is for the IMF to play a far greater role in facilitating orderly debt workouts between developing countries and their creditors, by encouraging debt reschedulings where the problem is one of liquidity, and debt reduction where necessary (for interesting proposals on this, see the 1998 UNCTAD *Trade and Development Report*). Also this makes it very important for the G-22 proposals on orderly debt workouts to be implemented. The proposed changes would mean that the official sector, rather than bailing out private creditors, could bail them in by enforcing early debt negotiations. Several participants at the conference argued that, specifically in the case of some East Asian countries, debt reduction may be needed to avoid a 'lost decade to development', as occurred in Latin America in the 1980s. Furthermore, as was shown in the case of Latin America, a reduction in the debt overhang can help restore confidence to private investors, both foreign and domestic.

The third avenue to be pursued is to reduce the likelihood of currency crises, with preventive

measures along the lines discussed above, which will limit moral hazard and discourage surges of short-term capital inflows.

Apart from the crucial issue of resources, a number of other important issues arise relating to the IMF's role as provider of liquidity, including timing and conditionality. The issue of timing is crucial as currency crises happen so quickly, due to the speed with which markets move and overreact. Under current arrangements, a great deal of damage can occur in the affected country before official financing is put in place, and the crisis can spread due to contagion. A solution worth considering is to have recourse to IMF-supported preventative programmes; a country could make a request for the right to borrow from the IMF before a crisis happens, and accept conditionality then. The country would only be able to draw on this facility if a crisis occurred, but could then do so immediately.

A final issue is the nature of IMF conditionality that should accompany large financial packages, linked to currency crises. Radelet and Sachs (1998) and others have argued that some of the IMF conditionality (e.g. on bank closures) not only was inappropriate, but actually added to, rather than ameliorated, panic in international credit and capital markets. It is therefore crucial that, in the new capital-account led crises, IMF conditionality contributes to rebuild, and not undermine, markets' confidence in countries. As far as possible, IMF conditionality should focus on macro-economic policies (and these should not be excessively contractionary); it should not be too intrusive and comprehensive in relation to structural reforms.

A new financial architecture

In our discussions at the conference, both on international measures for currency crisis prevention and management, the focus was on how existing institutional arrangements might be improved, and existing gaps might be filled. However, almost inevitably the discussion was broadened to the deeper issue of what global governance would look like if it is to meet development needs in the context of new and globalised private capital and credit markets.

In particular, three functions of global financial market management need to be met appropriately:

1. The provision of appropriate surveillance and prudential regulation of financial intermediaries, both in developing and developed countries. Though part of this task is carried out by the Basle Committee and other coordinating regulatory mechanisms, important gaps particularly in international, but also in national, prudential regulation remain. An interesting question is how these new needs should be met. An important proposal in this context is that presented by Gordon Brown and Clare Short in the October 1998 Development Committee, for 'a new and permanent Standing Committee for Global Financial Regulation, which would bring together the Basle Committee and other regulatory groupings on a regular – perhaps monthly – basis.' This Committee, which would also include the IMF and World Bank, would be charged with developing and implementing a mechanism to ensure that the necessary international standards for financial regulation and supervision are put in place and properly coordinated. If and when adopted, this would be an extremely valuable step, particularly if it also completed existing regulations, by filling regulatory gaps. More radical institutional proposals, like the creation of a World Financial Authority (Eatwell and Taylor 1998) would have the advantage of corresponding even more closely to the new needs of the global economy, but would be complex to establish and perhaps difficult to agree internationally; however, these proposals could possibly best be developed sequentially, with a Standing Committee for Global Financial Regulation being a very valuable initial step.

2. The provision of international official liquidity to the market, including last-resort lending in distress conditions. Currently, this function falls implicitly on the IMF – although it has, at present, insufficient funds and can only lend to governments, and only does so to emerging economies' governments. Though performing valuable functions, the IMF does not act as a classical lender of the last resort, as it does not have unlimited liquidity and does not lend to international banks. Through what mechanisms/institutions should the provision of official liquidity be enhanced? Should it continue to be provided to emerging economy governments, so as to indirectly help finance

international creditors? Should other institutions, like the Bank for International Settlements, or regional bodies, play a larger role in the provision of official liquidity.

3. There are limited methods for orderly debt workouts, and therefore the weight is on developing country adjustment and, occasionally and often too late, on relatively *ad hoc* debt reschedulings and reductions. How should such international debt workout arrangements best be developed? What should the institutional mechanisms for its operation be?

Major changes in institutional structures may be difficult and time-consuming to achieve. However, it seems highly desirable to develop a clear vision of an appropriate international framework that would allow an orderly global financial market to continue to support the development process and would help avoid developmentally and financially costly crises like the Asian one.

5 Research Implications

Six major research topics clearly emerged at the conference, as being highly relevant for policy design and as having very important implications for long-term development prospects.

(i) On the supply side of capital flows

If there is a great development promise in increased access to international capital flows, recent experience also cautions us about the risks involved, including major and costly currency crises. Given the large magnitude of capital flows moving into and out of developing countries, and the large impact of these flows both on national policies and on countries' development, it is remarkable how little studied the complex factors determining the supply of these flows have been. The IDS Conference highlighted the urgency of this research. Research should be directed towards helping to fill the gap in understanding on the complex factors that influence the supply of capital flows moving into and out of developing countries. It should address three specific objectives: first, the improvement of empirical knowledge regarding how, and using what criteria, different institutional investors (pension funds, mutual funds and hedge funds) and their fund managers as well as banks, allocate their assets globally and to developing countries; Second, the analysis of the empirical evidence gathered, to try to determine if a 'ranking of volatility' can be established for different types of institutions; third, the identification of the policy implications arising from this analysis for both developed and developing governments, as well as for international institutions.

(ii) Developmental impact of external capital flows

Standard economic theory assumes that international capital flows contribute to growth and development through a number of mechanisms. However, increasingly, the standard view has been theoretically challenged. Moreover, there is empirical evidence that certain categories of flows (especially short-term, easily reversible flows) have serious development costs, as dramatically exemplified by the East Asian Crisis. Research in this area should aim to contribute to the development of a more consensual view by undertaking further study of the net growth and development effects of different categories of capital inflows and outflows (foreign direct investment, portfolio flows, bank loans of different maturities, etc.) for different types of developing countries. The conclusions of this research would have important policy implications for when and how different categories of developing countries should liberalise their capital account, and what regulatory and other measures should accompany such liberalisation.

(iii) Management of capital flows by developing countries

Research on this topic should examine two categories of issue. The first is macroeconomic management, especially of exchange rates and interest rates, for open developing countries. Again the growth and development impact of different options should be given highest priority in the analysis. Second, research undertaken on this issue should also establish a taxonomy of prudential measures to discourage excessive inflows of potentially volatile short-term capital. This taxonomy should include instruments that already exist in a variety of developing countries (e.g. Chilean-style non-remunerated reserve requirements as one of many possibilities) and those that have been implemented in developed economies. A rigorous assessment of the impact of these instruments would be

carried out, as well as an assessment of how they could best be implemented. This could be helpful in contributing to develop 'best practice' criteria for developing countries on prudential measures.

(iv) Overproduction

The East Asian crisis has two particular characteristics that suggest its importance as a springboard for future research. First, by (researchable) hypothesis it is less a crisis of East Asia but more a global crisis in East Asia. And, second, there are underlying trajectories in the real economy that have interacted with global financial flows, boiling over into the financial turmoil that has beset the region over the past twelve months. Contrary to much conventional wisdom, the contribution of the real economy to the financial crisis is to be found in the use to which national and foreign savings have been put in promoting growth through exceptionally high savings and investment ratios. These investments have been concentrated in sectors and in particular niches of sectors, promoting intense competition. This, in turn, has been reflected in sharply declining terms of trade and the need for some competitive devaluations. However, the nature and extent of this concentrated 'overinvestment' is poorly understood. So, too, are the links between these concentrated patterns of investment, financial flows, corporate organisation (for example high gearing ratios) and domestic financial intermediation. A greater understanding of the specific and generalisable nature of these complex two-way interactions between the real and financial economies will be helpful in developing an appropriate policy response and thereby avoiding similar crises both in East Asia and in other regions.

(v) Global financial market management

Research under this heading should examine the need for development-enhancing management of global financial markets. In that context, it would make suggestions for changes to be made by financial markets themselves (via self-regulation or other mechanisms), by governments, by regulators, by international financial institutions and by better coordination between the different actors. If and where necessary, due to the existence of clear gaps, suggestions should be made for institutional developments. Research should focus on three questions: how can more long-term capital be attracted to developing countries, especially the poorest ones? How can costly currency and financial crises be prevented? And how can currency crises be better managed, if they do occur?

(vi) The design of affordable social protection nets

Currency and financial crises can abruptly increase poverty and disrupt existing protection mechanisms for the poor – even in countries where poverty has been falling rapidly – if social protection nets are not properly developed. The design of affordable social protection nets is both essential and difficult for countries undergoing financial and currency crises, and research is needed on the most efficient and most cost-effective mechanisms, from a poverty alleviation perspective, that can be developed for offering social protection; research is also required on how such social protection can best be funded, e.g. by increased taxes or cutbacks in non-essential government spending. The design of affordable social protection nets must be developed in forms that are consistent with, and encourage, economic recovery.

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