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The Political Economy of Perverse Financial Liberalization:

Examples from the Asian Crisis

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Somewhat less preliminary paper than the ISA version.

(More non-Korean examples need to be added. Suggestions appreciated)

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Introduction

This paper highlights the importance of what we refer to as "perverse liberalization" as a cause of resource misallocation and financial crisis. There has been a lot of disagreement among economists concerning the culpability of financial liberalization in causing the Asian financial crisis. Some argue that financial liberalization prematurely exposed the Asian economies to destabilizing financial flows, financial panic, and self-fulfilling speculative expectations. Others argue that poor economic fundamentals and perhaps not enough liberalization are to blame. We're interested less in determining the merits of financial liberalization in general and more in being able to describe the mechanisms by which financial liberalization can lead to less than desirable outcomes. That is, how and why does financial liberalization so often take place in ways that generate perverse incentives for private sector behavior? We argue that in the Asian crisis countries, financial liberalization gave rise to perverse incentives in one of two ways. Either it gave private market actors more scope to operate on perverse incentives generated by pre-existing government policies, or the inappropriate sequencing of reform policies themselves gave rise to new perverse incentives.

The last two decades have seen notable developments in the financial sectors of many, if not most, developing and formerly communist countries. The good news is that the costs of financial repression have become much more widely recognized and (at least partially) as a result financial sector liberalization, both domestic and international, became the dominant mantra of governments across the globe. Thus, the apt relabeling of such countries as "emerging markets". While the international financial institutions (IFIs) such as the International Monetary Fund and the World Bank and the neo-liberal finance ministries in countries like the United States played a strong role in spreading the gospel of financial liberalization, the case for liberalization became accepted by many governments in the developing and transition countries, i.e., there has been a good deal of host government ownership of liberalization programs. Increasing financial globalization also played an important role, as this made the costs of financial restrictions more apparent. Indeed, with the collapse of the Soviet Union some opined that the philosophical debate over economic systems had reached an end.

By the late 1990s however, things looked rather less rosy than in those heady days in the early 1990s when

the Berlin Wall came tumbling down. Although there were prior warnings that heaven had not yet come to earth such as the Mexican crisis of 1994-95, the real sea change came with the Asian crisis of 1997 and the Russian crisis in 1998. Suddenly financial liberalization did not look like such an obviously wise policy. Had the world been sold a bill of goods by neo-liberal ideologies? Many on the left argued yes – that these crises showed the inherent instability of capitalism. Several prominent economists such as Jagdish Bhagwati [1998], Dani Rodrik [1998], and Joseph Stiglitz [1998] joined this chorus- although generally with more nuanced arguments that other economists had oversold the benefits of the free movement of financial flows internationally. It is not hard to agree with these critics that the benefits of liberalization were sometimes oversold and that the qualifications to the arguments for liberalization were not always stressed sufficiently, but this need not imply a wholesale rejection of the case for financial liberalization.

So far, despite the sharp rhetoric of critics, the policy reactions against domestic and financial liberalization have been surprisingly mild. The sharp reversal of liberalization called for by many in the late 1990s has so far failed to materialize on a broad scale. (The imposition of capital controls in Malaysia is an important exception) However, while many of the crisis countries are continuing to follow liberalization programs, there are signs of reform fatigue.

How one interprets the apparent link between financial liberalization and financial crises is crucial to the evolution of much of the global economy. This paper starts with an acceptance that there has been a strong empirical link between financial liberalization and crises that goes far beyond the examples of the late 1990s.[2] It argues, however, that this need not imply that liberalized financial markets are inherently highly unstable. There may be some degree of causal connection between liberalized financial markets and excessive (i.e., unjustified) volatility. Economists are divided on this issue. Efficient market types tend to make fun of those who argue that financial markets are susceptible to major swings of excessive optimism and pessimism while many market observers (including George Soros (1998) and Susan Strange (1988)) take such swings as axiomatic. The emerging sub-field of behavioral finance is attempting to bridge a gap between the extreme versions of these opposing views.[3]

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[2] See, for example, Eichengreen, Rose, and Wyplosz (1996), Alesina, Grilli, and Milesi-Ferretti (1994), and Montes-Negret and Landa (2001). Include Caprio et al and Kaminsky & Reinhart.

[3] See for example, Shefrin (2000) and Shleifer (2000). For an application of aspects of the view to the behavior of

While declining to take a stand on this important debate, we do feel brave enough to assert that while imperfections in private capital markets may explain some of the incidence (and more likely the depth) of recent crises, a much more important factor has been at work. As will be discussed below, in the crises that we have analyzed carefully, i.e. the Asian and Russian cases, the primary causes can be traced to the rational behavior of private market actors responding to perverse incentive structures generated by government policies and/or market failures.

In many cases, problems were exacerbated by poor management practices in the private sector. Typically these resulted in the absence of sufficient early warning signals in the financial markets, lack of sufficient protection against the risk of crises, and possibly overreactions to the early stages of crises, but they were not the major reasons for the crises. We argue in section I that in none of these cases would the crises themselves have been avoided even if private market had been perfectly efficient. If our argument is accepted, even in part, then this focuses key attention on why financial liberalization so often takes place in ways that generate perverse incentives for private sector behavior.

Of course, one obvious answer is the rent seeking behavior of the private sector actors themselves. Who does not want access to subsidized credit and government guarantees to cover their losses? What rational rent seeking financial sector actors would like is partial liberalization that gives them increased freedom of action to pursue profit opportunities while retaining barriers to competition from others, access to subsidized inputs, and protection against losses. The resulting increase in rents can be used to reward the consenting bureaucratic and politicians with plenty left over for the financial sector actors themselves. Thus we would expect that much, if not most, of the support for liberalization coming from the financial sector is for partial, not full, liberalization.

We know from the economic theory of the second best that where there are a number of sources of inefficiency, improving efficiency on one margin can sometimes reduce rather than increase overall efficiency. The experience with financial sector liberalization demonstrates that this is not just a theoretical curiosity. For example, take Charles Calomiris' [1998] description of a not atypical process of banking sector privatization in an emerging market country. Because of some combination of political connectedness and the "too big to fail" doctrine, what

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international financial markets see Willett (2001).

one often gets is only privatization of profits combined with the continued socialization of losses. As the theory of moral hazard demonstrates, such a regime creates incentives for insufficient evaluation of loans and excessive risk taking. Combined with an absence of effective prudential regulation and oversight, such a regime is a prescription for high levels of non-performing loans (NPL's) and eventual bank insolvency. This problem is especially severe in emerging markets, where well-trained regulatory personnel are often scarce. However, the savings and loan crisis in the United States, the Swedish banking crisis of the 1990s and the ongoing difficulties of the Japanese financial system show that this is not just a problem of underdevelopment. Perverse incentives can strike anywhere.

Nor do we think that their prevalence is due entirely to rent seeking behavior. Also important we suspect is the use of incorrect theories or wrong mental models by government officials who are attempting to do a good job. We use theories and mental models in a broad sense to include not only formal economic models but also how issues are framed and what important assumptions are overlooked. Thus we will argue that one of the problems with the process of international financial liberalization in Korea was that influential actors viewed this primarily as a balance of payments issue rather than one of financial stability. Likewise, especially in the transition economies, many economists advocated liberalization without a good understanding of the legal and other types of infrastructure necessary for financial markets to work well. (This occurred in large part because many Western economists took the infrastructure which exists in their countries as a given and hence did not focus on the implications of its absence in countries they were advising)[4].

Of course, one might question who are we to decide what is correct and what is incorrect in theory. We think we have a reasonable answer. We do not take sides on specific disputes about what is correct. And there are many of these. But even monetarists and Keynesians agree about some things. In a similar vein, there is a large literature on the optimal sequencing of financial liberalization, which is far from free of dispute.[5] But while there is considerable disagreement among experts about the optimal sequence (and on what it depends), there is widespread agreement on some sequences that should be avoided. Yet we see such bad sequencing behind many crises. Thus while we will typically be agnostic about the correct model, we do feel justified in characterizing some models or

[4] After the recent Anderson and Enron scandals, economists are rethinking just how good is the financial infrastructure in industrialized countries.
[5] See Wihlborg and Dezseri (1997), Edwards (1994), Harwood and Smith (1997), McKinnon (1991)

views as wrong.

Because perverse financial liberalization causes resource misallocation and financial crises, we argue that it is not safe to assume, as economists and officials often have, that imperfect liberalization is always better than no liberalization. This is not to support continued financial repression, but to argue that liberalization must be carried out carefully and with full attention to the dangers of "capture" of the liberalization process by special interests. Thus advocates of financial liberalization need to focus as much on political economy as on purely technical considerations.

In order to aid this process, there is much we need to learn about the positive political economy of financial liberalization. This has become a major topic of research in recent years.[6] Most of this literature has focused on the causes of liberalization without differentiating between perverse and benign forms of liberalization. Thus while there is much in this literature on which we can draw, this paper highlights the need to focus explicitly on the causes of perverse liberalization in hopes that this will give us clues about what to try to avoid and how to steer reform processes into safer and more productive channels.

As an initial step, we discuss several major categories of perverse liberalization and give examples from the Asian crisis. We also offer initial conjectures about the political reasons why such perverse liberalization's were adopted. This is obviously only a preliminary step, but we hope that it will help stimulate interest in developing a more complete typology of perversities to be avoided and in undertaking careful case studies of the political economy of the liberalization process across different countries and episodes in order to give us insight into how to do it right – at least in the sense of knowing what to avoid.

It will also be important to focus on the costs of different types of crises. Crises are not something that should always be avoided at all costs. Indeed, it has been argued that crises may often be a necessary and desirable way of attracting the high level political attention necessary to undertake fundamental reforms. As R. Barry Johnston [1997] points out, "In some countries, financial crises may have been necessary to promote a consensus on the need for action on restructuring the banking system and to overturn entrenched vested interests" (p.41)[7]. He also

[6] See, for example, Haggard, Lee and Maxfield (1993), Haggard (2000), Keohane and Milner (1996), Horowitz and Heo (2001).
[7] See also the discussion in Wihlborg and Willet (1997)

notes the danger that crises can likewise result in the reversal of reforms. Furthermore, even if we were sure that the net effect on the reform process would be positive, one must balance this against the costs of the crises. In the case of currency crises in the European Monetary System in the early 1990s, these costs were low and may even have been negative in the relatively short term. In Asia the situation was quite different, however. Thus while some crisis may be optimal from the stand point of the political economy of the reform process, not all will be.

I. The Asian Currency and Financial Crisis [8]

It is not difficult to understand why so many commentators have blamed the Asian crisis on financial panic and the poor workings of liberalized international financial markets. There was a substantial international dimension to the crisis, and there had been a great deal of financial liberalization. Huge capital inflows in the early and mid-1990s came to an abrupt halt, followed by massive outflows. Furthermore, one could not find a justification for this sharp reversal of flows in the behavior of the countries traditional macroeconomic variables. In all of the crisis countries, inflation was low, investment was high, and budget deficits were small or non-existent. Thus it is easy to see the attraction of explanations based on destabilizing speculation, financial panic, and self-fulfilling speculative expectations.

The problem with this story is that it does not look at a broad enough set of fundamentals. The primary causes of the Asian crisis were the interactions of exchange rate and financial sector problems. The crisis started in Thailand and was due to a combination of a good old-fashioned overvalued exchange rate and severe weaknesses in the domestic financial sector. The high level of aggregate investment in Thailand tended to obscure the fact that many of these investments had not been wisely chosen. While the domestic macroeconomic indicators remained strong, at the micro level the loan and investment portfolios of many of the Thai banks and finance companies were in bad shape. But published statistics such as the level of non- performing loans failed to give an accurate picture of this worsening situation.

As the problems in the financial sector began to become more apparent, this interacted with growing concerns over the extent of overvaluation of the Thai baht's pegged exchange rate, generating a reversal of capital

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[8] This section draws heavily on the analysis in Willett (2000) and Willett et al (2001). For a representation sampling of other views on the Asian crisis see Radalet and Sachs (1998), Furman and Stiglitz (1998), Pempel (1999), Horowitz and Heo (2001), Haggard (2000), Noble and Revenhill (2000), and Woo, Sachs and Schwab (2000),

flows and mounting speculative pressure on the baht. The vulnerability of the Thai financial system to a currency crisis was exacerbated by the high levels of unhedged short term borrowing from abroad that had been stimulated at least in part by beliefs that these enjoyed government protection against major depreciations. Excessive capital inflows may also have been generated by the expectation of IMF bailouts as many critics on the right have charged, but the composition of capital inflows shows that this cannot be the whole story (See Willett (1999) and Willett et al (2001)). As depreciation of the baht became a plausible possibility, borrowers scrambled to cover their positions, leading to large capital outflows and in turn making depreciation more likely. There were some outflows by outright speculators such as hedge funds, but they were small in comparison.[9] The baht was in a sense brought down by self-fulfilling expectations, but these were based largely on sound, if belatedly recognized, analysis of the problems in the Thai financial sector and the overvaluation of the baht. As will be discussed below, each of these salient features of the Thai crisis was due in substantial part to the operation of perverse incentives generated by government policies. Financial liberalization gave private sector actors more scope to operate on these incentives and this magnified the size of the resulting problems, but it was the perverse incentives, not liberalization, that was the basic cause.

Another reason why financial markets have been blamed so often as the cause rather than the messenger of the Asian crisis was the spread of the Thai crisis to a number of seemingly innocent victims. While most analysts agree that the Thai baht was overvalued, this was not obviously the case for Indonesia, Korea, or Malaysia. And their domestic macroeconomic indicators were good. Thus the spread of the crisis could easily look like unjustified financial contagion resulting from panic.

There is some truth to this argument, but it misses the main story. There was some panic after the Thai devaluation and this was felt in a fairly undiscriminating way in currency and financial markets throughout Asia.[10] These blanket repercussions were short-lived, however. The serious speculative attacks against Korea, for example, did not start until October, while Thailand abandoned its peg in early July. It is hard to tell a story based on panic that is delayed by a number of months. Rather, the causes of the crises in countries like Indonesia and Korea were

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Agenor et al (2001), Classen and Frobes (2001), Goldstein (1998), Glick et al (2001), Macleod and Garnaut (1998).

[9] See Eichengreen and Mathieson (1998) and Willett et al (2001),

[10] See, for example, Baig and Goldfajn (1998).

the growing recognition that their financial sectors faced problems similar to those in Thailand that had not been clearly visible in the aggregate statistics available[11]. As in Thailand, this was combined with large unhedged short-term debt. Recognition of the seriousness of the situation rationally turned capital inflows into outflows and this caused the previously reasonably priced currencies to become seriously overvalued and hence generate rational speculative outflows. (Political instability was also an important factor in Indonesia). This then set off an interrelation of currency and financial sector problems similar to what had occurred in Thailand. Thus in our judgment, the Asian crisis was due primarily (although not necessarily exclusively) to fundamentals- but these were financial, not macroeconomic fundamentals.

Even if one takes a less favorable view of the rationality of market behavior than we do, there can be little question that perverse incentives generated by national governments played a major part in the Asian tragedy. Thus it is clearly important to try to gain a better understanding of why these perverse incentives were put in place. We will also see, however, that the international official community was not entirely blameless in this process. Pressure from the IMF and national governments in the industrial countries for the Asian countries to open to their financial markets often gave insufficient attention to issues of sequencing and the existence of perverse incentives. And the Basle Accord designed to strengthen financial standards had the unanticipated consequence of contributing to excessive capital inflows into several emerging market countries including Korea.

Section II: Perverse Liberalization

Thus, the basic link between financial liberalization and crisis in Asia centers around two undesired outcomes: a weakening banking sector crippled by a high percentage of non-performing loans; and the rapid increase in short-term foreign debt. This section focuses on explaining the mechanisms by which liberalization resulted in such perverse outcomes. For a variety of reasons, liberalization seems to have generated perverse incentives both for excessive risk-taking and over-borrowing.

Explaining bad loans:

One way to explain the high percentage of non-performing loans among banks in crisis countries is to focus

[11] The extent of direct financial contagion to Indonesia remains in more dispute than for Korea.

on market failure in the form of moral hazard. Moral hazard affects every domestic banking system to some extent even in the most open financial markets because even without capture by special interests, the crucial role played by the banking sector would lead almost any government to take steps to avoid the failure of large banks. This is the "too big to fail" form of moral hazard. Because this is the case, free market reforms in the banking sector will lead to perversities like excessive risk-taking due to moral hazard unless offset by government regulation. However, the weakening of the banking sector is not inevitable and can be mitigated or exacerbated through public policy. Note that the nature of banking systems is such that complete laissez faire is unlikely to be optimal. Because of maturity transformation, i.e. banks borrow short term and lend long term, there is a need for lender of last resort type provisions that will inevitably create moral hazard problems, and hence will require some prudential regulations. But while some moral hazard in the banking sector is inevitable, in the Asian crisis countries, there was much more than necessary. As late as August 1997, the Korean Ministry of Finance announced that it would guarantee all foreign debt, not only creating a huge moral hazard problem, but also sending a signal that the corporate and banking sectors were facing serious difficulties. (Demetriades and Fattouh, 1999, 790)

Yet another problem is that sound private management of banks cannot be relied upon during financial reform to mitigate some of the other problems associated with excessive risk-taking. Sound management is, in fact, unlikely at least immediately following a period of state interventionist financial policy. State-led finance and finance allocation can leave a deficit of risk-management knowledge and experience within the private sector. Under these conditions, market reform can lead to poor decisions and a heavy short-term debt burden. Insufficient evaluation of monetary investments may lead to a misallocation of finance and non-performing loans over and above those resulting just from excessive risk taking. The lack of risk management skills in Korea is of course a by-product of the long-time state-bank-*chaebol* relationship where the banking system served as a conduit for policy loans. By most accounts, that relationship has yet to be fully severed, and it should come as no surprise that the banking industry, throughout Asia, currently suffers from a paucity of risk-management skills.

Another contributor to the financial weakness of the private banking sector has to do with the incentives behind bank ownership. Privatization of state-owned banks constitutes an important component of the financial reform process. Yet the privatization process itself can fall prey to perverse incentives. This can be viewed as an

incompatibility between political motivations and economic incentives, or as political capture of the reform process. For example, privatization in principle should lead to greater overall efficiency as the private sector possesses some comparative advantage over government in making profit-maximizing economic decisions. However, the privatization process is particularly susceptible to political capture/rent-seeking given the stakes involved, as with the charter of new merchant banks in Korea. The government converted twenty-four financially weak short-term financing companies into merchant banks in two separate rounds: nine in 1994 and fifteen in 1996. They proceeded to engage in risky foreign exchange transactions. Among the banks whose licenses were revoked in 1998, five were new entrants from 1994, and ten were from 1996. Thus, government reforms encouraged greater debt exposure in an already overexposed financial system. (Auerbach, 2001, 208) Moreover, in Korea as part of financial reform banks were allowed to open and expand operations overseas. As a result, banks expanded their foreign currency denominated business as aggressively as they did their domestic loan portfolios. The net result was an increase in foreign currency liabilities of overseas branches that was almost as large as the external debts of domestic branches. (Dooley and Shin, 1998, 4)

Build-up of short-term debt:

Obviously the build-up of short-term debt severely weakened the domestic banking sectors of crisis countries in Asia. And clearly the governments had a lot to do with encouraging short-term debt build-up. (Fischer, 1998) One way to understand why short-term debt skyrocketed with financial deregulation is to look at the incentive structures created by state regulation of the financial sector before liberalization and to understand that pre-liberalization those perverse incentives might have been held in check by government oversight. Under these conditions, reform may encourage market actors to take advantage of pre-existing incentives because oversight has diminished.

The starkest example of this kind of perverse incentive is the liberalization of the short-term loan market in the context of an already weakened banking sector. (Demetriades and Fattouh, 1999, 788). Some Korean banks actually had a negative net worth when the loan market was liberalized. The fact that banks with negative net worth could continue to operate obviously is more a function of inadequate prudential regulation in the pre-liberalization period than of liberalization per se. However, in this context of insolvency, liberalization may have actually

exacerbated the problem because banks with negative net worth do face strong (perverse) incentives to load up on short-term debt as a means of gambling for redemption in a liberalized short-term loan market. That is, if the banking system is unsound due to a large debt overhang or a large percentage of non-performing loans that have not yet been written off, these banks have very little to lose by loading up on more risky but potentially highly profitable new loans made accessible as a result of liberalization. This is especially true when viewed in conjunction with the "too big to fail" form of moral hazard. In both cases, the down-side risks of taking on more short-term loan risk is considerably discounted in comparison with the upside of redeeming a failing business enterprise with the infusion of fresh capital.

Governments further encouraged the build-up of short-term debt by liberalizing the loan market while implicitly lowering the perceived costs of foreign borrowing through the pegged exchange rate. (Demetriades and Fattouh, 1999, 788 and Dooley and Shin, 1999, 2). Most of the crisis country governments sharply limited the size of exchange rate fluctuations and fostered the impression that the private sector need not worry about the possibility of large depreciation. Thus the substantial differential between high domestic interest rates in the crisis countries and low rates in Europe, Japan and the U.S was seen as a source of arbitrage profits or low borrowing costs rather than as an indicator of differentials in risk. As a consequence, much of the crisis country foreign borrowing went unhedged. Thus, financial sector liberalization and exchange rate policies interacted perversely. In many countries, often with explicit government encouragement, the private sector came to believe that large exchange rate depreciations would not be allowed, or if such changes did occur nationals would be compensated by the government. This both encouraged foreign borrowing and discouraged the purchase of forward cover as an insurance against the risk of major exchange rate changes.

Not only was short-term borrowing frequently given an indirect subsidy through exchange rate pegging, in some cases governments even gave tax incentives that encouraged short-term borrowing. A prime example of the encouragement of such borrowing is given by Thailand's creation of the Bangkok International Banking Facility (BIBF). While originally designed only to give encouragement to the creation of Bangkok as an international financial center by giving a tax break to foreign borrowings which were then re-lent abroad. By the time the BIBF had traveled from the Finance Ministry through the Thai political process, the requirement that the borrowed capital

be re-exported had been effectively dropped, leaving a net subsidy to foreign borrowing.

As all of these examples suggest, one of the most powerful variables in explaining the incidence of recent international currency crisis is a high ratio of short-term foreign debt to a country's international reserves. (Velasco et al, 1996, 265-83: Furman & Stiglitz, 1998: Radelet & Sachs, 1998). Private actors of course have incentives to worry about their liquidity situation within the context of the normal operation of the economy. They typically do not have incentives, however, to worry sufficiently about so-called systemic risk because of the externalities generated by financial interdependence during crisis. Many economists, such as Eichengreen and Stiglitz, argue that because unhedged short term foreign borrowing in emerging markets carries these negative risk externalities, they should be subject to a corrective tax, or regulation. The so-called Chile tax is an example of this approach. Additional foreign currency borrowing by one firm or bank increases not only its own risk but also the risk of other borrowers who would also be hurt if a crisis occurred. This externality presents a case for government oversight or regulation of some types of banking and financial market activities to avoid excessively risky positions. Such interdependence externalities also provide a powerful argument for the government to play the role of a lender of last resort. The classic example is the bank, which has made sound long-term loans but could be forced into bankruptcy by a run on its deposits. This provides a widely accepted rationale for government policies to deal with such panic or crisis. The problem is that by doing so, the government lessens the incentives for the bank to worry sufficiently about the quality of the loans and investments it makes. In other words, the prospect of bailouts creates moral hazard. This in turn provides a need for some form of government oversight to help reduce the likelihood of bad loans. That's supposed to be how it works. And like the industrial countries, all of the major emerging markets had systems of oversight in place. The problem was that they were not very effective.

But excessive risk and short-term borrowing is not just an oversight issue. The sequencing of reform itself can also create perverse incentives. For example, the Koreans liberalized short-term bank lending while maintaining restrictions on the long-term loan market. This is just the reverse of the normalcy recommended sequence of liberalization. This partial nature of liberalization led to perverse incentives for short-term borrowing over and above international financial market trends. Taken together with Korea's status as a successful export-led economy with a balance of payments surplus, the accelerating rate of liberalization attracted a substantial amount of short-term bank

credit from abroad (supply-side). The liberalization of short-term finance in contrast with the continued regulation of the long-term capital market and portfolio investment encouraged businesses to borrow short-term (demand-side). This sequencing of short-term before long-term financial liberalization also encouraged vigorous competition in the short-term loan market by chartering new merchant banks that had an advantage in international borrowing before implementing a prudential regulation system with sufficient oversight capacity and without insuring that new banks (or any banks) possessed adequate risk management skills.

III. The political economy of perverse liberalization

If liberalization as implemented by Korea and many others led to so many perversities and ultimately economic hardship, why did they liberalize in the way that they did? There are two important reasons to take a political economy perspective here. The first is that if even some of the reform perversities were foreseeable, then the only way to explain these policies without assuming irrational policymakers is to look at political influences. The other reason is that sometimes what appears to be a bad economic decision may actually be a best alternative within a political economy context. For example, it could make sense to implement reforms that make economic crisis more likely if one's goal is to further the reform process. As discussed earlier, crises are not always bad. Sometimes the costs may be fairly low and they generate further reforms so that the net effects can be positive in a dynamic sense. Thus, from a political economy perspective, one can argue for initial reforms that will create problems, which will stimulate further reforms. Deregulation of only some interest rates is an example. This will "distort" financial flows and can create a support base for further reforms. Thus optimal sequencing from a political economy perspective can sometimes look quite different than it would from a purely economic or state efficiency perspective. (Wihlborg and Willett, 1997) If the crisis generated is too costly, however, then the whole liberalization process can be set back. (Haggard and Maxfield, 1996) The recent crises in Mexico and Asia were ones where the costs were enormous. Even if they have not set back the general process of liberalization, the costs have been so high that it would be extremely difficult to argue that these episodes reflected points on an efficient path towards liberalization.

What follows is an attempt to explain various influences over the formation of reform policy. We argue that perverse liberalization results from a combination of political pressure from both domestic and international actors

as well as the interplay between policymaking officials and domestic elites and the mental models which actors adopt. The relative strength of these variable influences is likely to vary from one case to another.

a. Interest groups

We start by looking at politically entrenched domestic interest groups and rent-seeking behavior. In Korea, state managers came under significant pressure by 1993 from the *chaebol* to liberalize short-term finance.(Lee et. al., 2000, 1) There is no question the move toward liberalized financial markets fit in with the Kim Young Sam government's "se-gye-wha" globalization priority, and therefore served a political function. But this does not explain why both short-term and long-term credit markets were not liberalized. Ironically, policymakers suggested that one of the strongest reasons for introducing competition in the market for bank loans was to mitigate the considerable economic power and influence of the *chaebol*.

Controlling the excesses of big business throughout the liberalization process was an explicit goal for Korean policymakers. (Auerbach,, 2001, 85-87) The state first embarked upon financial liberalization in 1980 not with the idea of letting market forces reign freely, but rather with the idea of building new institutions between the state and big business that would serve to ensure economic control over big business irregularities and to prevent its dominance in the market. Korean officials saw liberalization as redefining the rules in order to continue meeting prudential objectives and prevented the exercise of cartel-like private market power. (Hughes, 1988, 341) Part of the long-term liberalization plan was to restrict big business's privileged access to policy loans and their oligopolized production in the market. (Rhee, 1994, 154) The reform-oriented officials firmly believed that economic liberalization would not be successful without preventing further business concentration. State control over big business served not only the state's economic goals but also its political goals. The Chun regime (1981-88) put an emphasis on the political goal of the "welfare and justice society" against the previous regime's collusive state-big business ruling coalition, thus pinning the new regime's legitimacy on its ability to control big business. (Rhee, 1994, 193)

But despite rather explicit state goals to avoid such outcomes, there is considerable evidence that the content and sequence of Korean liberalization ultimately reflected *chaebol* influence and allowed the *chaebol* to take advantage of perverse incentives. That is, the rather unbalanced form that financial opening took was partially a result of the unyielding pressure from the *chaebol*, and reflected government officials "giving in where pressures

were strong and holding back where it was not." (Cho, 2000) Given the short-term nature of NBFI (non-bank financial institution) borrowing, the liberalization of the short-term market prior to the long-term market was an understandable outcome of interest politics. During the 1994-1996 investment boom, large enterprises accounted for 45.7% of debt, while small and medium-sized enterprises accounted for only 17.7%. (Haggard and Mo, 1999, 4) The financial sector also showed signs of increasing concentration with the top eight nationwide banks together accounting for two-thirds of the entire commercial banking sector, and three-quarters of total commercial bank assets. (Dekle and Ubide, 1999, 7) Between 1994 and 1996, foreign bank lending to Korea went from $52 to $108 billion. About $60 billion of debt outstanding in 1997 was used by the *chaebol* to finance direct investments abroad. Korean banks invested in foreign assets with funds borrowed from foreign banks in the range of $23 billion.(Haggard and Mo, 1999, 7) The reliance of the *chaebol* on bank borrowing--as opposed to equity or bond financing-- increased leverage ratios and made the *chaebol* highly susceptible to bankruptcies when hit with shocks. In turn, the health of the banking sector became heavily dependent on the viability of the *chaebol*, since such a high fraction of bank assets are in the form of lending to these enterprises. (Dekle and Ubide ,1999, 18) Korean financial institutions were over-exposed to foreign-exchange risk and a high proportion of foreign liabilities had relatively short maturities. So at the very least, deregulation of the financial sector in the early 1990s, together with ongoing features of the government-banking-*chaebol* relationship, increased Korea's vulnerability to outside capital flows by creating the incentive for short-term indebtedness. (Haggard and Mo, 1999, 22)

Also despite government efforts to prevent such an occurrence, government relaxation of controls over entry and ownership led to the largest business groups dominating both the ownership of commercial banks and non-bank financial institutions. As a result, credit became concentrated with the largest thirty business groups receiving over 70% of total short-term credit. (Rhee, 1994, 203) One potential sticking point for Korean officials was that in order to strengthen banks, it was necessary to end the ban on *chaebol* ownership of them. But bank privatization only strengthened the already powerful *chaebol*. (Pollack, 1997)

b. Foreign pressure

Foreign international pressures for financial liberalization can come through several channels. One is through impersonal market forces. That is, the degree of international capital mobility can influence the costs and benefits of a wide array of financial strategies. Actions by other emerging market governments may also have

important effects through this channel. Liberalization of competitors raises the costs of continued restrictions in the home country.

A second is through influence on actors' mental models. While the extent of influence is open to debate, there can be little question that attitudes toward financial liberalization had become much more favorable in the 1990s than in the 1970s, and that the international transmission of ideas has a good deal to do with these changed attitudes.

A third channel is through direct pressure. This can come via direct lobbying on emerging market governments by international financial interests, but such pressures are perhaps more commonly intermediated by national governments in the industrialized countries (Bhagwati's Wall Street-Treasury complex). Of course lobbying, persuasion, arm-twisting, etc from industrial country governments and the international financial institutions can come from sincere beliefs that liberalization is in the best interests of the emerging market countries. The relative influence of interests and ideas or ideology in this context will often be difficult if not impossible to tease out.

Assuming that bureaucrats throughout Asia have been reluctant to cede discretionary power to the private sector, one could interpret the decision to liberalize short-term finance as the result of market pressure. That is, international finance brought the most market pressure to bear in the short-term credit market in part because the volume of short-term financial flows was so much greater. In other words, bureaucrats failed to liberalize long-term finance because they possessed the capability to resist, whereas they could not resist the tide of market forces in the short-term financial market. Also long-term lending by its very nature can tolerate deviations away from market prices because of non-monetary criteria such as "recurrent contracting" which may lower transactions costs. (Williamson, 1975)

External pressure for financial markets opening can be extremely powerful. This is an area in which unintended consequences are of major importance. Sometimes the effects on emerging markets are the result of industrial country policies. Fluctuations in credit conditions in the rich countries have been shown to have strong effects on the size of international financial flows to emerging markets. Less inevitably, the efforts of the industrial countries to develop better standards for risk management by the major international banks resulted in incentives for the banks to shift from longer term to short term lending. (Goodman and Pauly, 1993; Cohen, 1996) The so called

Basle Accord on capital adequacy standards for banks reflected a substantial achievement of international cooperation, but few noticed at the time that this was followed quickly by a dramatic increase in the ratio of short term to long term bank loans going to emerging markets. This was the result of the much higher ratios of capital required to back bank loans of over one year.

The Czech Republic, Mexico, and Korea were hit by a double whammy. By achieving sufficient economic and political success to be allowed to join the industrial countries as members of the OECD they automatically qualified under the Baste rules for a lower schedule of capital charges, and sure enough, their admissions were followed by surges of capital inflows (concentrated of course on the short-term end). This problem has at last become well recognized. Indeed, it was rumored that at one point the U.S. government argued against the admission of Slovakia to the OECD on the grounds that there was a danger this would lead to a financial crisis.

These industrial country institutional innovations had little influence on the portfolio managers that are so often blamed for international financial crisis; but perceptions of their influence are often highly exaggerated. When one looks at the statistics on the composition of the capital outflows from Asia during the crisis, the effects of the actions of the staid old international bankers were far larger than those of the portfolio managers. Indeed, while it is hard to get data, many observers argue that so called capital flight by domestic nationals was much larger than for international portfolio investors. It is well documented that the run on the peso in 1994 was initiated by Mexican nationals, not international investors.

But we cannot totally discount the more formal external pressures to liberalize. In Korea, President Kim's desire to join the OECD, combined with pressure from the IMF and the US government may have led to the liberalization of domestic financial markets before existing weaknesses in the banking system, including poor regulatory and supervisory framework, could be addressed. (Demetriades and Fattouh, 1999, 791) So while liberalization may have taken place in the absence of foreign pressure, the nature and timing of liberalization may have been acutely affected.

c. Popularism

In the case of Korea, as with economic policymaking in many countries, it is difficult to separate the concept of popularism from nationalism. The long history of discouraging foreign direct investment in Korea underscores the effect of popularism on foreign economic policy. Because foreign direct investment happens to be

one of the more stable forms of capital flow, especially when compared with portfolio capital, these restrictions take on added importance given the role of excessive short-term capital flows in exacerbating if not causing crises. Why was the Korean government so reluctant to allow foreign direct investment? It is difficult to explain this on the basis of nationalism alone if one considers that Mexico has historically been extremely nationalistic, but has now welcomed foreign direct investment. Moreover, one might have expected a strong demonstration effect given the timing of Mexico's success in allowing FDI, and the Korean financial crisis. Yet if we consider the economic and political costs and benefits, the Korean reluctance to allow FDI does make political sense. The NAFTA package required Mexican officials to abandon or at least step back from the nationalistic banner, but it also offered something in return, access to the vast U.S. market. For Korea, the prospect of allowing FDI was more of a unilateral political cost up front for the promise of greater economic performance later. But even the long-term benefits of FDI were not uniformly accepted by Korean policymakers because Korea could point to a long record of economic growth and development in the absence of FDI.

Popularism may also play a pervasive role in blocking the reform process in general, insofar as there are considerable short-term costs associated with financial liberalization. Government officials may find it difficult to dismantle a system of policy loans if the recipients of those loans have played an important welfare function, as the *chaebol* did in Korea. (Pempel, 1999, 124) In Mexico, financial-industrial conglomerates similarly served the function of dispersing government credit, especially to the rural sector, in the days of heavy government intervention in the financial sector. (Auerbach, 2001, 31) One clear indication that Korean officials have especially resisted reforms that were likely to be unpopular is that only with the IMF providing a shield for the regime post-crisis, has there been any attempt to implement unpopular reforms like legalizing layoffs and allowing corporate bankruptcy. (Woo-Cumings, 1999, 130-131) But it may not just be the IMF shield that has made structural reforms more palatable. It may also be the case that market reform is more likely to be taken up as a populist cause in a post-crisis environment. This has certainly been the case in Latin America as well as Eastern Europe. (Horowitz and Petras, 2002; Demmers, Fernandez Jilberto, and Hogenboom, 2001)

d. Policymaking mistakes and bad mental models

In addition to the political influences of outside forces on government policy, we must look at the interests and perspectives of state policymakers themselves, some of which has already been discussed in the form of

incentives created by government policy. But in addition to creating unintended perverse incentives or falling prey to political influences (both domestic and international), there is considerable evidence that in countries like most of the NICs in question, policymakers possessed some policymaking autonomy or insulation from constituent pressures.

One particularly troubling aspect of perverse liberalization shared by most of the crisis countries is the lack of prudential regulation. The poor quality of bank supervision--lax prudential rules and financial oversight-- led to a sharp deterioration in the quality of banks' loan portfolios in countries like Korea and Mexico. (McLeod and Garnaut, 1998, 270) While most economists agree on the need for capital-account liberalization, they have also come to believe that banks should first upgrade their risk-management practices and supervisors should strengthen oversight of financial institutions. (Eichengreen, 1999, 2) There is quite a bit of consensus among experts that prudential regulation is a key ingredient in any successful liberalization effort. This makes the lack of such safeguards even more puzzling. But this too can be explained as rational actors, in this case policymakers, facing perverse incentives. By definition, prudential regulation must be initialized and carried out by government officials. Yet, this process involves a high degree of incentive incompatibility because state bureaucrats are enmeshed in a patronage system that they themselves are supposed to be charged with cleaning up. Even if that system is now proving to be increasingly inefficient, the direct participants in the system may still be benefiting in some way while the costs are dispersed among the broader population.

In Korea for example, lax prudential regulation allowed heavy concentration of lending and the disproportionate growth between Korean banks and non-bank industries. In a three-year period alone leading up to the crisis, merchant banks acquired $20 Billion in foreign debt. (Chang, Park, and Yoo, 1998, 738) Regulation was especially lax for newly licensed merchant banks whose capital requirements in proportion to loans were woefully inadequate. This fact alone significantly further increased the vulnerability of the banks to business failure. But the lack of prudential regulation, an act of omission, also interacted with the removal of various government restrictions on foreign borrowing, an act of commission, to exacerbate banking sector weaknesses. Financial liberalization and tight money kept domestic interest rates above world rates, which encouraged domestic banks to rely on foreign credit. The pegged exchange rate also encouraged the perception that foreign capital was relatively cheap, contributing to the wave of excessive short-term foreign borrowing that was intensified by ineffective prudential

supervision. And because private actors considered the pegged exchange rate system quite credible, they made borrowing decisions under a false sense of security. (Demetriades and Fattouh, 1999, 788)

Perverse liberalization may also result from policymakers with good intentions getting it wrong in one of two ways: either by focusing on the wrong issue or employing a flawed economic model. An example of the former is that Korean policymakers were overly concerned with current account balance rather than debt structure. In practice, this meant that policymakers were unwilling to allow substantial exchange rate flexibility for fear of losing control over an important trade policy tool. Political incentives to give too much weight to short-run exchange rate stability led these countries to practice insufficient flexibility. Why did the external balance loom so large as to overshadow concern with the rapidly growing short-term debt structure of Korean enterprises? One reason might have been that Korea's ability to attract foreign capital has, in part, been based on its reputation for export competitiveness. Losing control over trade policy meant not only losing control over the trade balance but financial flows as well. There is some evidence that the balance of payments turning to deficit prior to the crisis did in fact affect Korea's credit worthiness, which suggests that the linking of trade with loan availability in the minds of policymakers was not completely unfounded.

Also, from a domestic political perspective, the Kim Young Sam government's mandate depended upon continued international competitiveness. His administration had declared globalization as its top priority. (Dooley and Shin, 1998, 3) In Mexico, on the other hand, where the norm was a balance of payments deficit prior to 1994, policymakers were not expected to deliver international competitiveness, but rather domestic stability. This explains in part the resistance to devaluation in Mexico. What policymakers did bank on was the idea of delivering NAFTA.

With respect to economic theories, one could argue that policymakers in countries like Korea and especially Japan never really bought into the benefits of financial liberalization. That is, no paradigm shift has taken place from an interventionist developmental state model to a free market liberalization model. Here it is instructive to compare Korean with Mexican liberalization with respect to world-view and the belief in alternative models to the Western Free Market model among policymakers. Mexico had to abandon the state-led model in the early 1980s (debt crisis), but Korea hung on to it. This even though both come under international pressure to liberalize from IMF/US. Also, the economic success experienced by Korea in the 1980s and early 1990s reinforced the interventionist model in the minds of policymakers while simultaneously encouraging excessive and speculative

short-term capital flows that helped destabilize the Korean economy, especially in the context of perverse liberalization. In Mexico, success did the same thing in the early 1990s, which contributed to the 1994 crisis, but the 1980s had seen a more thorough dismantling of the state-led financial system than in Korea.

Concluding remarks: An agenda for research

We hope that the preceding has been sufficient to convince the reader that the causes of perverse financial liberalization, both domestic and international, should be an important topic for political economy research. A major part of this will involve continuing the recent research on the political economy causes of financial liberalization in general. Especially important here we believe are more detailed delineation and investigation of the various channels through which market pressures generate incentives for liberalization. Much of the recent literature takes it as axiomatic that increasing globalization generates strong pressures for liberalization. This is undoubtedly true, but just as with financial crisis, governments can respond to these pressures in many ways including imposing more barriers. We also know relatively little about the relative influence on liberalization of different types of capital flows and financial actors and about the relative importance of government perceptions of anticipated market reactions to policies and developments versus direct lobbying by market actors and indirect lobbying via institutions such as the IMF and US Treasury.

Turning to perverse liberalization per se we need to develop a more comprehensive analytical taxonomy of the major types of perverse liberalization and begin to investigate more systematically their incidence under different types of circumstances. For example, are some types of political systems more subject to perverse liberalization than others? We would expect governments that are strongly beholden to concentrated financial interests to be more susceptible to perverse liberalization. The influence of popularism seems less clear. One can easily conjecture scenarios where this could go in either direction. We would expect elite bureaucracies to reduce the incidence of perverse liberalization, but the case of Japan illustrates that an elite bureaucracy is not sufficient protection against severe bad loans problems. And both China and Japan illustrate that the maintenance of heavy government direction and regulations is also no guarantee against the development of major bad loan problems in the financial sector.

Another important issue for investigation is whether patterns if perverse liberalization vary across countries with different economic ideologies and developmental strategies. Are there correlations between the incidence of

perverse liberalization and countries' levels of development, legal traditions, degree of political freedom, and numerous other factors being identified in the rapidly expanding literature on institutions and economic performance. Other questions include whether the degree of IMF and World Bank involvement influenced the success record of liberalization and how the track record of crisis induced liberalization compares with liberalizations emanating from other sources.

We may hope that such positive political economy research will give us insights into normative policy issues and that by taking political economy considerations into account countries will be able to find greater scope for liberalization that avoid the types of perversities highlighted in this paper. While there is much analysis and research to be done, one conclusion of which we are confident is that the development of good policy will not be aided by continued ideological debate at the level of states versus markets.

For markets to operate well they need considerable infrastructure that must be provided by the state, but state involvement has often been perverse. The issue is how states and markets can best complement. Market critics need to recognize that most of the recent currency and financial instability has been caused less by any inherent instability of financial markets than by financial markets reacting to perverse economic incentives generated by governments. Likewise market enthusiasts need to recognize that in the absence of an appropriate infrastructure of law and institutions, markets are unlikely to work well and where perverse economic incentives are in place that liberalization can sometimes do more harm than good.

Slogans about government versus the market miss the point. The question is their appropriate relationships. Financial liberalization is an important requirement for economies to reach their long run growth potential. But liberalization is a process that must be managed carefully and requires as much attention to patterns of political influence as to technical economic issues. This will not be an easy task, but looking at the right questions can be a big help.

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