The Asian financial crisis: Why some countries were more vulnerable than others, using Russia and China, in particular, as case studies.

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Miles Harris

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CONTENTS

Chapter Six:

SUMMARY

In my study I attempt to show that all of the emerging market financial crises of the 1990s have particularly affected those economies that exhibit certain fundamental weaknesses.

Chapter One discusses the rapid growth of the Asian region and outlines the fundamental weaknesses that caused the Asian financial crisis in 1997. Subsequently, I examine the sustainability of the economic recoveries in Asia.

Chapter Two considers the effects of the Asian financial crisis on the Russian economy, highlighting Russia's vulnerability to crisis and the indirect causes of these fundamental weaknesses. Russia's current economic trends are investigated.

Chapter Three outlines China's similar weaknesses to the crisis-hit economies. But the Chinese currency was not forced to abandon its exchange rate peg. I will, therefore, analyse China's avoidance of the Asian financial contagion, and the obstacles which may jeopardise China's long-term economic growth.

I then discuss the controversies that have arisen from the experiences of East Asia, Russia and China. This primarily concerns reducing the vulnerability of emerging markets to financial crises. Chapter Four considers the dangers that global financial integration presents for emerging markets. I appraise initiatives that attempt to maximise the benefits of capital account liberalisation while minimising the costs.

Chapter Five seeks to examine the exchange rate dilemma, outlining the costs and benefits of the various regimes available, and the suitability of each arrangement for emerging market economies.

Chapter Six examines the current role of the International Monetary Fund (IMF). I analyse the Fund's push for free capital mobility and its financial assistance programmes prescribed to Thailand, Indonesia and South Korea. A discussion on the future role and proposed reforms of the IMF follows.

Introduction

Following Thailand's devaluation of the baht on July 2nd 1997, investors began to re-evaluate their exposures to Thailand's regional neighbours. Foreign creditors became greatly concerned with the Asian region's microeconomic risks, which included the quantity of short-term dollar debt and the significant debt/equity ratios of the corporate sector. It was clearly evident that other Asian economies would find repayment of dollar debts extremely difficult if the nominal exchange rates were to fall. This realisation prompted both foreign investors and domestic residents to sell local currency and buy U.S. dollars to hedge their exposures. The Asian financial virus soon affected other areas of the world economy, including the commodity producing countries of Australia, Canada, Chile and Mexico. Moreover in 1998, Russia was forced to devalue the rouble and default on its debt. This shocked the world's financial centres, prompting the U.S. Federal Reserve to cut interest rates on three occasions between September 29th and November 17th 1998, in an effort to stave off a global slowdown. Brazil received financial assistance from the IMF totalling $41.5 billion, but later devalued the real in January 1999. Yu Yongding laments that the: "The Asian financial crisis ... developed into the most severe global financial crisis since the breakdown of the Bretton Woods agreement."[1]

Prior to Asia's regional meltdown it was evident that there were four crucial preconditions which made the Asian countries particularly vulnerable to a financial panic.[2] 1. Extremely high levels of domestic savings, Asia is the highest saving region of the world. Household savings were inter-mediated by banks to enterprises. This resulted in a deep structure of domestic debt. 2. The fallacy of the pegged exchange rate regimes seemingly removed the potential for exchange rate losses, for both borrowers and creditors. 3. Asian capital accounts were liberalised and domestic financial systems were de-regulated allowing inexperienced domestic banks to borrow through foreign markets while regulatory mechanisms remained weak. 4. Excess liquidity, primarily in Japan and Europe, sought greater investment returns in newly opening 'emerging

[1] Yongding, Y. Economics blue book of the Peoples Republic of China. 1999. p.482.
[2] Identified by Wade, see p.1541. The Asian debt and development crisis of 1997-?: causes and consequences. World Development, Vol 26, No.8.

markets'. Asian financial intermediaries could borrow internationally at approximately half the cost of the domestic interest rate and re-lend at home, converting dollars into local currency, thereby allowing them to reap the interest rate differential.

Nonetheless, there has been widespread debate regarding the exact cause of the Asian financial crisis. There are primarily two main explanations. First, the fundamentalist or death throes of Asian state capitalism viewpoint, which concerns internal, real economy causes. The second belief contends that the crisis was a largely gratuitous financial panic that triggered a debt deflation in a basically sound but under-regulated system. This account essentially focuses on the short-comings of the international financial system and externally related causes.

According to the death throes or fundamentalist story, the Asian crisis was the result of rampant corruption at the local level and excessive government intervention in financial markets, which caused a dramatic mis-allocation of resources. Indeed, the currency strategist Callum Henderson argues that: "The argument that 'globalisation' is to blame for Asia's woes is clearly flawed ... Is it any coincidence that the likes of Mexico, Thailand, Brazil and Russia all had significant black market economies and that they all saw financial and economic crises? No, it is no coincidence at all. The very existence of a large and flourishing black market economy is testimony to the fact that the real economy is not working efficiently and fairly"[3]. Furthermore the IMF's Stanley Fischer listed as causes of the Asian crisis, 7"failure to dampen overheating, maintenance of pegged exchange rates for too long, lax financial regulation, and insufficient political commitment"[4].

The fundamentalist view also asserts that the Asian debacle shows the definitive failure of the Asian model of state-directed capitalism and a world wide acceptance of the Western model of free market capitalism.

The most prominent advocate of the second view is Harvard University's Jeffrey Sachs who claimed that: "Asia is reeling not from a crisis of fundamentals but a self-fulfilling withdrawal of short-term loans, one that is fuelled by each investor's

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[3] Henderson, C. Asian Dawn. p.xxiii.
[4]The Lex Column. Financial Times. March 3, 1998. p.3.

recognition that all other investors are withdrawing their claims. Since short-term debts exceed foreign exchange reserves it is 'rational' for each investor to join in the panic."[5]

Following the Asian crisis the IMF quickly declared that deep structural reforms were necessary before recoveries could begin. Yet these reforms soon stalled and, in 1999, the Asian economies enjoyed spectacular recoveries (the most impressive of which was South Korea which grew some 10% in 1999 after contracting by almost 6% in 1998[6]). The MIT economist Paul Krugman, has concluded that the IMF's claim that massive and immediate reform was required was in fact the wrong response to Asia's crisis. "If you believed ... that the crisis was a punishment for Asia's sins, that it reflected the deep flaws of the afflicted nations' economic systems, recovery should have been only possible after fundamental change. The fact that it came without such change demonstrates that the crisis was simply a panic after all"[7].

Accompanying any financial assistance packages from the IMF are certain conditions which attracted a great deal of criticism in the aftermath of Asia's crisis. One of the most criticised conditions involved additional liberalisation of the capital account prompting Robert Wade to comment. "It seems particularly unwise for the IMF to insist that companies receive even more freedom than before to borrow on international capital markets on their own account, without government co-ordination, when it was their uncoordinated borrowing that set up the crisis in the first place"[8].

However, the IMF request for further capital account liberalisation should hardly come as a surprise. Throughout the 1980s and into the mid-1990s economic policy in the majority of OECD countries adhered to a process involving market liberalisation and privatisation. According to Robert Wade this combined "a belief in fiscal conservatism, in demand management entirely by the finance ministry or central bank, in capital markets as efficient suppliers of capital, in de-regulated labour markets as the cure to unemployment, and in the private sector as inherently more efficient, more effective in

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[5] Sachs, J. The IMF and the Asian Flu. The American Prospect. March-April 1998. p.17.
[6] Henderson, C. Asian Dawn. p.99.
[7] Krugman, P. The Return of depression economics. p.x.
[8] Wade, R. The Asian debt and development crisis of 1997-?: causes and consequences. World Development, Vol 26, No.8. p.1544.

supplying most goods and services than the public sector. The recipe came to be known as the Washington consensus"[9].

But drawing on the experiences of the Latin American debt crisis in the early 1980s, the Mexican crisis of 1994, Asia in 1997 and Russia in 1998, illustrates that the Washington Consensus has had the unanticipated effect of causing financial instability. Such instability has been avoided by India and China who are yet to adhere to the Washington consensus, and the Chinese economy has continued to enjoy very high rates of growth despite the absence of reforms.

The case of China is of particular interest to this study. The Chinese economy exhibits a nominal exchange rate peg, widespread corruption, nepotism and an inefficient and bankrupt financial sector – weaknesses that contributed to the onset of the crisis in the Asian region. But despite these weaknesses the Chinese economy enjoyed GDP growth in the region of 7.8% in 1998, at the same time, many of China's regional neighbours were experiencing devastating contractions in GDP growth.

In my opinion, all of the recent developing country crises have been borne of a growing vulnerability to a financial panic. As I see it, financial vulnerability stems from, what I will refer to as 'fundamental weaknesses'. I have identified six weaknesses that have contributed to the financial crises in the developing countries of Mexico, Thailand, Malaysia, Indonesia, South Korea, Russia and Brazil. They are as follows:

1. A fixed exchange rate, which has tended to lead to an underestimation of exchange rate exposures and a reluctance to begin the transition to a more flexible regime, even in the face of deteriorating fundamentals.
2. An over-reliance on short-term foreign currency-denominated debt. The short maturity of debt means that servicing this debt when investors suddenly become risk averse can prove extremely problematic.
3. Inadequate foreign exchange reserves in relation to short-term debt. In the crisis-hit countries short-term debt exceeded foreign reserves by over 100%. Therefore, once the financial panic began it became impossible to stop because each creditor knew that there was insufficient liquidity to pay back each and every loan on demand.

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[9] Wade, R. How to stop New Zealand from becoming the second Argentina. 2001. p.1.

4. Extensively liberalised capital account. An open capital account and a fixed exchange rate have tended to lead to an over-reliance on foreign capital by the private sector in Asia and the public sector in both Latin America and Russia.
5. Imprudent macroeconomic objectives. Poor monetary policy in Asia was reflected in large current account deficits and the Russian economy possessed an unsustainable fiscal deficit prior to the 1998 crisis.
6. The absence of a strong and impartial financial sector has resulted in an inefficient and often corrupt allocation of resources in many developing countries.

It is my intention with this study to illustrate how each of the above vulnerabilities contributed to the onset of the financial crises in the respective countries of Asia and Russia. I will then consider the case of the Chinese economy, which was crucially yet to liberalise its capital account.

Indeed, the Chinese currency controls and the ample pool of foreign reserves that the country possesses enabled China to weather the Asian storm admirably. I feel that other developing countries should follow China's cautious approach to capital account liberalisation and I examine other issues related to deterring de-stabilising speculative transactions to promote global financial stability in Chapter Four.

The failure of the nominally pegged exchange rates in the Asian region, Russia, and Brazil has reopened the debate regarding the most appropriate exchange rate for developing countries and at what stage of their development. To avoid vulnerability to real exchange rate appreciation and an over-reliance on foreign currency-denominated debt I favour a more flexible exchange rate regime. Yet there is no perfect regime and each country must closely analyse their country's characteristics and choose a regime that compliments them the best.

Chapter Six seeks to examine the role of the IMF prior to the Asian and Russian crises and the austere conditions imposed by the Fund as a precondition for financial assistance, which aggravated Asia's economic difficulties. It is clear that the IMF has been trying to do too much and to become more effective must streamline its objectives.

Before we begin, it seems clear to me that the sequence in which these devastating economic crashes took place across the Asian region provides a clear insight

into which theory best explains Asia's financial crisis. So if you believe that Asia's crisis was a punishment for the sins of these corrupt economies it seems far too great a coincidence that so many dissimilar economies suffered crises within the period of a few months. For example, South Korea in 1997, as the world's eleventh largest nation, had almost achieved developed nation status, while Indonesia remained a desperately poor nation. Yet the clearest similarity between each of the crisis-hit economies was a vulnerability to a self-fulfilling financial panic.

CHAPTER ONE: THE ASIAN FINANCIAL CRISIS[1]

Introduction

According to Paul Krugman, "anyone who claims to fully understand the economic disaster that has overtaken Asia proves, by that very certainty, that he doesn't know what he is talking about"[2]. Whilst this does illustrate the complexity of the debate, I intend to examine the main factors that I believe explain the Asian debacle and which have received general backing.

I will primarily consider the case of Thailand because it seems to me that Thailand provides the best example of the dangers of operating an open capital account together with a deficient regulatory regime and a fixed exchange rate. In addition, it was Thailand's devaluation that triggered the withdrawal of foreign funds from its Asian neighbours and raised the cost of borrowing in emerging markets throughout the world.

However, the precise mechanisms that initiated financial crisis varied from country to country and it would be short sighted to consider the region as one when explaining the crisis. The effects of the crisis on each country were dissimilar, making it "difficult to ascribe the [Asian] crisis to a single root cause"[3].

1.i. The remarkable story of Asian growth in context

Economic growth in Asia began with the pre-war Japanese economy, but later spread to the newly industrialised economies of Singapore, Hong Kong, Taiwan and South Korea. Each of these economies benefited from foreign guardianship in opposition to hostility from communist or nationalist elements that were evident in much of the rest of East Asia. In the wake of the Vietnam War (which ended in 1975), economic development and globalisation began to benefit Malaysia, Indonesia, Thailand and the Philippines, four members of the Association of South-east Asian Nations (ASEAN-4). China also began to benefit from foreign capital and international markets when they embarked on their gradualist transition to a market economy in 1978. (See Table 1, which illustrates East Asia's annual GDP growth from 1970-1996, p.30.)

Britain took approximately sixty years after 1780 to double its national output. The United States achieved a doubling of output from 1840 to 1890. After 1880 it took Japan

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[1]Under the pre-1914 gold standard, a financial crisis occurred when a shortage of liquidity afflicted the monetary or fiscal authorities. The problem could arise because of a deficit in the balance of payments, and be complicated by a domestic banking panic. This meant that the fixed exchange rate of the national currency was endangered.
Definition taken from Bordo & Schwartz. 1998. p.5.

[2]Krugman, P. 1998a.

[3]Kotler & Kartajaya. 2000. p.7.

thirty-three years. But Indonesia accomplished the same feat in seventeen years after 1965, South Korea in eleven years after 1970 and China, just ten years after they began their reforms in 1978.[4]

Asia's rapid growth is even more striking when compared to sub-Saharan Africa. In the 1950's "several African countries had more or less the same income level as Asian countries like South Korea and ... [were often] far richer than East Asia in natural resources. Before its 1997 troubles South Korea had a per capita income almost seventy times the $150 of the Congo"[5].

The governments in the high performing Asian economies have concentrated expenditures in sectors essential to enhancing economic performance. Education levels have risen dramatically, for example, and many industries have received government support.

Asian values?

To explain Asia's rapid growth many analysts identified 'Asian values' as one of the main reasons for this growth. Indeed, the Malaysian Prime Minister, Mahathir Mohamad, asked Malaysians "not to accept Western-style democracy as it could result in negative effects. The Prime-Minister said such an extreme principle had caused moral decay ... single parents and economic slowdown because of poor work ethics"[6]. One Asian commentator claimed that Asian growth had been achieved through the "interlocking co-operation of free enterprise, government financial intervention, and a guidance-minded technocratic bureaucracy ... It is a trick that the managers of developed Western economies have yet to learn"[7].

East Asia's route to rapid growth

The ASEAN-4 began their economic growth by focusing on producing exports for much of the Western world. Foreign companies built large factories geared to exports and the native businessmen built small businesses in the Asian cities. Before the 1990s the majority of the smaller scale investment within these economies was financed by the Asians' high rate of savings. Apartment and office blocks began to emerge in the larger cities predominantly financed by bank deposits belonging to Asian households. This encouraged urbanisation as agricultural workers met the new demand for labour in these cities. The success of the initial wave of foreign investors encouraged others to follow and Asia was soon enjoying rapid rates of GDP growth.

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[4]Patten, C. 1999. p.127.
[5]Ibid. pp.126-7.
[6]Ibid. p.150.
[7]P. Krugman. 2000a. pp.36-7.

As a result of the government's export-orientated industrialisation policy, East Asia's exports rose rapidly. In the 1960s, on average, they grew at 11.6% a year, followed by 24.6% in the 1970's, 9.5% in the 1980s, and 11.8% from 1990-'95. Exports from East Asia to the rest of the world rose from $143 billion in 1980 to approximately $855 billion in 1995.[8]

From 1990 onwards, globalisation and financial liberalisation began to alter the composition of foreign funds entering developing countries. Long-term foreign investment abated as speculative short-term capital inflows replaced its longer-term counterpart. The South-east Asian economies accumulated huge inflows of foreign capital, which fuelled the expansion of their bubble economies. There was no shortage of foreign loans for a number of reasons. First, the central banks of many advanced economies were attempting to stimulate demand as a result of the global recession experienced in 1990. The consequent low rate of interest encouraged investors to seek higher returns in new markets and these financiers began calling developing countries 'emerging markets'. Second, the Latin debt crisis that occurred in 1982 was finally resolved in the late 1980s, which improved the novelty and conceivable potential that these markets possessed. Third, the collapse of communism in 1989 improved the world as a market place by reducing the probability of communist invasions. Fourth, the developing countries that had chosen to operate fixed exchange rate regimes became particularly attractive to short-term investors, given that much of the risk of exchange rate volatility losses had seemingly been removed. Finally, the IMF encouraged the Asian countries to extend their financial liberalisation, thus integrating their economies within the global financial system.

Initially, most capital flows to emerging markets were destined for Latin America and, in particular, Mexico. However, the 'Tequila crisis' in 1994-95 encouraged funds to flow eastwards to South-east Asia. The net private capital flows of $190 billion in 1996 were four times larger than in 1990.[9] The emerging markets had little or no experience in the regulation of capital inflows. This fact became increasingly evident as the quality of investment that these inflows financed steadily deteriorated. Yet the regional crisis was predicted by very few analysts.

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[8]Patten, C. 1999. p.126.
[9]Lopez-Mejia, A. 1999. p.29.

1.ii. Factors contributing to financial vulnerability in Asia: poor financial regulation and an absence of corporate transparency

Much has been said about certain negative features of the countries that suffered from the crisis. 'Crony capitalism' and a general lack of transparency within corporate governance were essentially the consequences of state-managed, fast track capitalism. Whilst these factors justify acknowledgement they were not a new element of these economies that would jeopardise growth or even initiate such a crisis. Indeed, they had been evident for many years and were manifested within the economies long before foreign investors arrived on Asian shores. The investors in Asia were aware of the deficiencies of these economies: "It was a faustian bargain: ignore the shortcomings to get a piece of the Asian miracle"[10].

Following the crisis in Thailand international creditors were highly critical of the lack of information that they actually possessed on their investments. The lack of transparency resulted in a mis-allocation of resources and was therefore cited as an indirect cause of the crisis; yet few investors protested when profits were soaring. The lack of corporate transparency meant that investors were unable to access information on companies' foreign currency denominated debts.

According to Timothy Lane of the IMF, the Asian economies became particularly vulnerable to a financial panic as a result of "ineffective financial supervision and regulation in the context of countries' financial sector liberalisations. Capital account liberalisation was poorly sequenced, encouraging short-term borrowing, while limited exchange rate flexibility led borrowers to underestimate exchange rate risk. Monetary policies allowed domestic credit to expand at a breakneck pace. But if banks and corporations in these countries borrowed imprudently, foreign lenders also lent imprudently, possibly reflecting sloppy risk management, perceptions of implicit government guarantees, and the incomplete information available"[11].

A key lesson for the Asian economies is that capital must be efficiently allocated. When developing countries open their capital accounts and receive large inflows of foreign capital they should already possess a sound financial infrastructure. Callum Henderson argues that: "[Emerging markets] need deep and liquid domestic bond markets in order to provide an efficient funding market with which equities must compete - thus making the

[10]Asia Review Book 1998. p.7.
[11]Lane, T. 1999. p.44.

domestic equity market more efficient - to channel inward investment appropriately and to tap the domestic savings base."[12]

The inexperience of the Asian economies in dealing with vast amounts of capital inflows resulted in financial fragility, which was personified by excessive borrowing throughout the microeconomy and the absence of sufficient hedging to protect against currency depreciation. Additionally, a large portion of the short-term flows were invested in long-term projects, increasing the potential for a liquidity attack.

When currencies depreciated corporations endured exchange rate losses, culminating in the insolvency of many companies and increasing the potential for a default on debt. This, in turn, exacerbated the financial panic, increasing capital flight and depreciating the currency further.

The region's excessive over-reliance on short-term foreign financing dramatically increased Asia's vulnerability to financial panic. Once the panic began it became difficult to stop given the countries' meagre foreign exchange reserves relative to short-term foreign currency-denominated debt. The panic was accelerated by the absence of corporate transparency. However, in normal times loans would simply have been re-newed and business would have continued as usual. But Asia had been facing an increasingly hostile external environment since 1995.

Factors precipitating the Asian financial crisis

The Asian economies had become heavily dependent on exports to the United States and the countries of the European Union. (Exports to the U.S. contribute between 10 and 25% of Asian economies' GDP[13].) Thus, the deterioration of the external environment from 1995 onwards slowed exports and worsened the region's current account balances. Thailand's exporting sectors grew by just 0.1% in 1996 as opposed to 24.7% in 1995 and Korea's exports grew by just 4.1% from 31.5% in 1996.[14]

The Asian economies were operating fixed exchange rates, pegging their currencies predominantly to the U.S. dollar. Between 1995 and 1997 the Japanese yen and many European currencies depreciated vis-á-vis the dollar. Inevitably, this made East Asian exports more expensive both in the Japanese and European markets and also in competition with Japanese and European exports in world markets. The consequence of the U.S. dollar's

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[12]Henderson, C. 1999. p.177.
[13]The Economist. 31 March 2001. p.15.
[14]Henderson, C. 1999. p.3.

appreciation was clearly detrimental to the export industries within East Asia. (Table 2 shows Asia's real effective exchange rate[15] appreciations, p.30.)

Furthermore, 65% of East Asian exports were semi-conductors and related capital goods.[16] Thus when the demand for electronics and particularly semi-conductors fell dramatically it damaged the region's trade accounts. In accordance with the fall in demand for semi-conductors, the market was heavily saturated. Over-supply resulted in a substantial fall in the price of semi-conductors, by as much as 95% in a year.

Some analysts have argued that China's currency was in fact the first Asian one to fall when, in 1994, the renminbi was devalued. This devaluation is argued to have greatly improved the country's export competitiveness, which was detrimental to South-east Asian exporting sectors given that China's exports were said to be similar to those of its ASEAN neighbours. China's devaluation was therefore believed to have contributed to Asia's deteriorating economic fundamentals, including a worsening of current account balances. However, as noted by Prakash Lougani (an economist at the IMF), a closer examination of China's export bundles in relation to the East Asian region reveals that "the composition of China's exports ... is quite different from that of the other East Asian economies"[17]. Nevertheless, it can be argued that China's cheap labour encouraged greater quantities of foreign direct investment (FDI) to enter China rather than the rest of East Asia.

Despite these untimely exogenous shocks, Asia had experienced similar disturbances before, such as the developed world's recession in 1990, which reduced demand for Asian exports. Yet their economies continued to grow. But the fundamental difference between 1990 and 1997 was that the Asian economies had become freer, allowing capital to flow in and out of their countries at will, making these over-extended countries vulnerable to a high-tech, high-speed financial panic.

Thailand's prelude to crisis

In 1993 Thailand established the Bangkok International Banking Facility (BIBF). The BIBF was possibly the most significant measure taken by the Thais in the path of financial liberalisation, enabling local and foreign banks to engage in both onshore and offshore lending activities. Thai investors could then borrow cheaply in offshore markets and foreign investors could also access loans from this facility. BIBF licensees were permitted to accept

[15]The real effective exchange rate is the trade weighted exchange rate adjusted for inflation. The real exchange rate is only adjusted for inflation. The nominal exchange rate simply gives the price of a currency in regard to another.
[16]Loungani, P. 2000. p.36.
[17]Ibid. p.35.

deposits in foreign currencies, from both residents and non-residents, for domestic and foreign investments. Financial intermediaries demanded ever more loans and creditors and borrowers did not concern themselves with the possibility of exchange rate losses.

By 1996 Thailand's foreign debt had increased to 50.14% of GDP.[18] External debt above 40% of GDP is generally considered to be highly vulnerable. As greater sums of capital flowed into the country the number of profitable places to invest in diminished. Returns on equity of non-financial shares which were traded on Thailand's stock exchange declined from 26.6% to 7.7% in 1996.[19]

Thailand's rapid liberalisation of the capital account was poorly sequenced, occurring at a time when the regulatory regime remained weak and underdeveloped. This mistake lay at the very heart of Thailand's financial crash. The good times led to bad policy, increasing Thailand's vulnerability to panic.

Failure to introduce flexibility in the exchange rate regime

Since 1984 the Thai baht had been pegged to the U.S. dollar. Despite the dollar's dramatic appreciation from 1995 onwards, the Thai authorities insisted on maintaining the value of the exchange rate. In March 1997, an IMF official concluded that: "[The] introduction of a more flexible exchange rate arrangement is a policy priority, both to increase monetary policy autonomy and to improve the composition of the capital account by reducing incentives for short-term inflows ... In addition, the present system can hinder adjustment to external shocks; in particular the heavy weight of the U.S. dollar in the basket has been unhelpful in present circumstances"[20]. Yet the Thai authorities chose to ignore this and other warnings. Thailand could largely have avoided such a crisis if the Thai authorities had chosen to devalue the baht moderately and adjusted to an exchange rate with greater flexibility. Unfortunately, the Bank of Thailand was reluctant to do so fearing that political repercussions would follow any such move.

Short-term capital flows.

Thailand and its Asian counterparts had a number of key characteristics, which encouraged the flow of destabilising short-term inflows, rather than the more desirable (and more stable) long-term FDI:

1. The most obvious characteristic included the exchange rate peg, which allowed Thailand, South Korea, Malaysia and the Philippines to allow only limited exchange rate

[18]Laird, J. 2000. p.90.
[19]In Biers, D. 1998. p.37.
[20]Laird, J. 2000. p.93.

volatility. Indonesia operated a 'crawling peg', an exchange rate that would gradually depreciate vis-á-vis the U.S. dollar and was therefore highly predictable. For investors, the potential for exchange rate losses was minimised by these rigid regimes, encouraging short-term speculative investments.

2. The regions' liberalisation of capital accounts allowed domestic banks to access offshore markets in order to borrow cheaply in foreign currencies. The offshore markets charged a rate of interest of 6-7% as opposed to the higher domestic borrowing rate of 13-14%.[21] Domestic banks seized this opportunity to borrow cheaply in foreign currencies, converting it into local currencies, which were then available for domestic loans. Hence the banks would reap the rewards of the interest rate differentials. The initial wave of investment that was required as the country developed proved immensely profitable. This encouraged further investment that was, however, subject to declining returns as ever more money was available. Financial intermediaries were lulled into a false sense of security by the exchange rate peg.

3. The liberalisation of the capital account was not complemented by an adequate regulatory regime to supervise the vast quantities of capital inflows. The absence of such regulation produced an environment that abetted excessive risk-taking.

4. Excessive optimism regarding the Asian region encouraged ever more capital inflows. Until the crisis struck, Thailand had "enjoyed a decade of world-wide acclaim as the world's fastest-growing economy"[22]. Nayan Chanda of the *Far Eastern Economic Review* stated that: "Foreign banks frequently lent blindly, with little or no due diligence ... If the market is attractive you go with the herd. Even if you have doubts you don't stop lending."[23]

5. Incentives were offered by governments to borrow in foreign currencies, despite concerns about 'hot money' flows. For example, banks that borrowed and loaned foreign currencies through the BIBF "received special tax breaks"[24].

6. Finally, an empirical study by Shang-Jin Wei of Harvard University found that Asian corruption has greatly discouraged FDI inflows, equivalent to a tax on multinational firms of 20% or more.[25] (Table 3 shows that a number of East Asian economies perform poorly in a number of aspects of their economies and civil institutions, p.30.) This

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[21]Laird, J. 2000. p.95.
[22]Kotler & Kartajaya. 2000. p.14.
[23]In Biers, D. 1998. p.10.
[24]Radelet & Sachs. 1998. p.15.
[25]Wei, S. 1997.

'corruption tax' meant that short-term flows were therefore the cheaper and less risky alternative.

Asian moral hazard

"The Asian miracle was particularly attacked for its reliance on 'statist' industrial policy and cronyism (incestuous relationships between big businesses and the government), both of which contributed to moral hazards in the inefficient financial sector and the resultant over-investment in a classic asset bubble"[26].

These implicit government guarantees were conducive to financial intermediaries becoming excessively over-extended through external borrowing. This was evident in South Korean Chaebol-controlled banks, Thai finance companies and members of Indonesia's ex-President Suharto's family. Coupled with the lack of financial supervision and inexperience in dealing with capital flows, these factors fostered an environment that endorsed excessive domestic lending and over-investment within the Asian economies. For example, the intermediaries would lend capital to speculative real estate ventures that could be either highly profitable or unequivocal failures. If the venture was unsuccessful and large losses were incurred, Krugman argues that the government would step in to salvage their friends at the bank or finance company. "Heads the [finance company] wins: tails the taxpayer loses"[27].

Following the years of high economic growth, Asian governments were insistent that their economies should continue to maintain such economic growth. Together with 'old boy' cronyism, this belief instituted an environment that was unwilling to see private projects fail. As a result, such projects enjoyed a safety net of public guarantees. Corsetti *et al.* argue that: "With financial and industrial policy enmeshed within a widespread business network of personal and political favouritism, and with the governments that appeared willing to intervene in favour of troubled firms, markets operated under the impression that the return on investment was somewhat 'insured' against adverse shocks. Such pressures and beliefs represented the underpinnings of a sustained process of capital accumulation, resulting in persistent and large current account deficits."[28]

Indeed, the consensus among foreign creditors was that their investments within the financial intermediaries, with which they were depositing their capital, were implicitly insured against insolvency by the Asian governments. As Asian investment quality

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[26]Kotler & Kartajaya. 2000. p.24.
[27]Krugman, P. 2000a. p.89.
[28]Corsetti et al. 1998a. pp.2-3.

deteriorated, the domestic creditors did not reduce their exposures to speculative ventures or consolidate their losses. On the contrary, when a business is already experiencing adverse circumstances, the anticipation of a future bail-out will actually provide a stronger incentive to take on even greater risks.

Devaluation

The exchange rate pegs operated within the Asian economies were established in order to achieve monetary stability, which was largely achieved. As confidence in the system grew, capital flows to the Asian region also began to grow and Asian banks and finance companies increasingly borrowed in offshore markets, converting dollars or yen into local currency, which was then made available for loans to the private sector.

The rates of return in Asia were far greater than those that were available in the developed economies. The higher premium demanded by investors reflected the market's belief that emerging Asian markets represented a greater risk than their Western counterparts. Thus the Asian economies offered highly profitable opportunities, allowing easy foreign access to the markets on a short-term basis. The currencies were stable, but, if the environment began to deteriorate, investors could soon get their money out.

Foreign short-term loans to Thailand between 1994 and 1996 amounted to, on average, 7%-10% of GDP, while foreign direct investment remained ludicrously small at 1% of GDP. The country's total external debt (public and private) increased to 50.9% of GDP in 1996 from 38.3% in 1990.[29] "One of the few economic laws ... necessitates that significant capital account surpluses lead to significant current account deficits. The larger the inflows, usually the larger the current account deficit. By 1996, Thailand was running a current account deficit of some of 8% of GDP"[30].

Another result of large capital inflows was the appreciation of real exchange rates. In order to maintain the stable value of the exchange rate the Thai central bank (the Bank of Thailand) attempted to offset any increase in the demand for the Thai currency by sterilising the capital inflows. For example, if a European bank lent a Thai bank U.S. dollars the Thai bank would need to convert the foreign currency into local currency in order to finance investment in Thailand. This raised the demand for baht, so the Bank of Thailand would increase the supply of the domestic currency and buy dollars or yen in the foreign exchange market. Therefore, the initial dollar loan's indirect consequence was to increase the Bank of Thailand's foreign exchange reserves and the domestic money supply.

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[29]In: Biers, D. 1998. p.31.

With the increase in the domestic money supply aggregate demand began to rise. These inflows of foreign capital were used to finance building and infrastructure projects, which, in turn, increased Asian demand for foreign goods and services. The increased consumption then intensified inflationary pressures and induced a further appreciation of the real exchange rate. This led to a deterioration in the trade account thanks to the higher prices of the country's exports.

Although a current account deficit can suggest that an economy is overheating, on its own it is by no means an evil that should require amelioration by means of a devaluation. Indeed, the United States currently possesses the largest current account deficit the world has ever seen and the volume and composition of foreign capital inflows enables the U.S. deficit to grow.[31] Today, trade is dwarfed by the size of international capital flows, so many of the Asian current account deficits could have been sustained if the capital flows to the region had not abruptly stopped and, indeed, gone into reverse.

1.iii. Trigger mechanisms

What initiated the reversal of flows was the identification of Thailand's weakening export sectors (Table 4 outlines Asia's slowing export sectors from 1995-96, p.31.) and the subsequent belief that the country was unable to sustain such a large current account deficit. (See Tables 5 and 6 on p.31.) Additionally, in late 1996, Thailand had recorded its first fiscal deficit for many years. The financial markets then recognised the twin fiscal and current account deficits that were important characteristics of the Mexican 'Tequila' crisis.

Additional trigger mechanisms for the reversal of foreign funds included the Thai government's failed rescue attempt of a prominent finance company, Finance One, which subsequently announced that both foreign and domestic investors would incur losses. This corporate failure together with the collapse of some of Korea's famed conglomerates (or chaebols) encouraged a renewed risk appraisal of the Asian markets and Thai interest rates began to rise in an effort to attract new capital. Thailand's housing glut was also exposed, which had resulted in $20 billion worth of property being unsold at the end of 1996. Thus, when loans began to be called in from the foreign creditors Thailand was drastically short of liquidity. By May of 1997, the net capital account was negative, showing that more capital was flowing out of the country than into it. This news, coupled with the fiscal and current account deficits, strengthened the belief that devaluation was imminent.

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[30]Henderson, C. 2000. p.5.
[31]See Mann, C. 2000. p.43.

Fearing a devaluation, the Thai companies which were at risk from exchange rate losses began converting baht into dollars, thus further contributing to the weakness of the currency in the foreign exchange market. Currency speculators joined in, advocating a devaluation of the baht. The Bank of Thailand responded by buying baht with its foreign exchange reserves. However, the Bank finally gave up its defence of the beleaguered baht, precipitating the collapse of the exchange rate peg on July 2nd 1997. By this time, the Bank of Thailand's had spent $23.4 billion of its foreign exchange reserves in an unsuccessful attempt to defend the value of the baht, which plunged from 25 baht to the U.S. dollar to 56.

Had the banks' and the finance companies' debts been denominated in a local currency the Bank of Thailand could have stepped in and fulfilled its role as 'lender of last resort'. But, these loans were denominated in foreign currencies, which left the government and the Bank of Thailand helpless. The Asian region endured a severe credit crunch as foreign capital went into reverse. The withdrawal of foreign bank loans from the Asian region between 1996 and the second half of 1997 was an astonishing 9.5% of Asian GDP. "It is very difficult to attribute a reversal of this magnitude in such a short period of time to changes in underlying economic fundamentals"[32].

Thailand's economy has for many years exhibited certain defects. These shortcomings were eventually highlighted by the rapid liberalisation of Thai capital markets. The dependency on foreign loans to stimulate growth made the Thai economy vulnerable to an adverse change in investor sentiment. Thus, when the economic climate became less favourable, investors became reluctant to renew their loans believing that Thailand was about to endure a financial crisis.

This prophecy soon became self-fulfilling as Thailand suffered a financial panic comparable to a bank run. When investors began to believe a crisis was ensuing they called in their loans. In turn, this initiated a further withdrawal of capital as remaining investors realised that they must also get their money out to avoid losses when the crisis hits. The upshot is that creditors caused the very crisis they were predicting, proving themselves correct in the process. As a result of the inadequate level of foreign exchange reserves in relation to short-term debt and the poor quality of investment projects, Thailand was unable to raise sufficient liquidity to pay back the loans that were being called in and the crisis ensued.

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[32]Radelet & Sachs. 1998. p.10.

One source stated that: "The Asian financial crisis erupted as globalisation and financial liberalisation accelerated and unrest on financial markets intensified. It was triggered by international speculation. The fundamental and deep-rooted causes were, however, the pervasive defects in the economic foundations and financial systems of the East Asian countries."[33]

1.iv. Asian contagion

The hostile environment following the Asian financial crisis intensified the contagion as investors began to analyse the weaknesses they had previously considered to be manageable given time. But the markets had become less forgiving.

In the aftermath of Thailand's devaluation on July 2nd 1997, there followed a series of depreciations throughout the Asian region. The Philippine peso, the Malaysian ringgit, the Indonesian rupiah, the South Korean won, the Taiwanese dollar and the Singaporean dollar all endured depreciations. Even the Hong Kong dollar was targeted by speculators in October, forcing the Hong Kong Monetary Authority (HKMA) to raise overnight interest rates to 300% to defend the fixed exchange rate.

Although the worst-hit crisis countries were those of Thailand, Indonesia and South Korea, Indonesia's rupiah lost 106% of its value relative to the U.S. dollar between July 4th and December the 19th 1997![34]

The depreciations of the currencies throughout the region was due to the sudden withdrawal of external financing, a repercussion of Thailand's devaluation. The consequence was a severe liquidity crunch in the worst hit economies. Foreign investors appeared to treat the region as one or, at the very least, a homogeneous group of countries in close proximity to one another, with both similar growth rates and moral values.

The dramatic withdrawal of foreign capital was a result of herd psychology. According to Kim and Wei: "Herding is the tendency that investors of a particular group mimic each other's trading. Portfolio investors may herd rationally or irrationally. Informational asymmetry may cause uninformed but rational speculators to chose to trade in the same way as informed traders. Since informational problems may be more serious when it comes to investing in a foreign market than a domestic one, herding may be more severe correspondingly."[35] Those investors who do not follow the 'herd' are liable to bear significant losses, thus encouraging investors to follow the herd.

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[33]Transition. June 1998.
[34]Kloker, D. 1998.
[35]Kim & Wei. 1999. p.9.

In addition to herding, there are a number of other means by which contagion can adversely affect the fundamentals of neighbouring nations or countries who share comparable fundamental weaknesses with the crisis-hit country. Alejandro Lopez-Mejia of the IMF has identified five reasons for the transmission of contagion: "First, trade arrangements and exchange rate pressures contribute to volatility and contagion. Second, there is the 'wake-up call' phenomenon, whereby the collapse of one country's currency alters investors' perceptions about other countries' economic fundamentals. Third, institutional investors' herding behaviour induces common outcomes in countries with very heterogeneous fundamentals. Fourth, there are financial links between countries. For example, the pattern of financial holdings can lead to shocks spilling over into other countries, regardless of those countries' fundamentals. Fifth, liquidity-management practices of open-end mutual funds* can create contagion effects as leveraged investors facing margin calls** need to sell their asset holdings, which, because of information asymmetries, they may do at below-market prices"[36].

The Asian region was highly integrated financially, although this was not through inter-regional investment flows; it was through externally financed 'emerging market funds'. These funds acted as conduits for foreign capital, which were then distributed throughout the region. Consequently, when the troubles in Thailand began to emerge, investors began to call in their loans, which effectively withdrew capital from several Asian economies.

Trade linkages also posed problems because intra-regional trade amounted to a half of Asia's total trade. "It seemed inevitable that if one of the economies collapsed in South-east Asia, the rest would follow"[37].

In the aftermath of Thailand's devaluation, each exchange rate peg in the region looked vulnerable and those possessing the fundamental weaknesses that were inherent characteristics of Thailand were worst struck.

South Korea

The plunge in the value of the Korean won from 800 to the dollar to a low of 1,985 meant that the amount of won needed to repay dollar-denominated debt had more than doubled. (Table 7 shows cumulative depreciation rates following the crisis, p.31.) Furthermore, in March 1998, U.S. $30 billion in short-term debt was due meaning that Korea was facing

[36]Lopez-Mejia, A. 1999. p.30. *An open-end mutual fund is where the fund managers may alter the investments held without notifying the unit holders. These funds are used in the USA. **Margin calls are calls to a client from his commodity or stock broker to increase his margin and usually occurs when the client has an open position in a market that is moving adversely for this position.

[37]Kloker, D. 1998.

potential bankruptcy without foreign aid. The foreign currency-denominated debt of the top thirty chaebols and their numerous affiliates totalled approximately U.S. $60 billion.[38]

Many of the factors that contributed to Thailand's debacle were evident in the world's 11th largest economy, that of South Korea. Korea suffered from weak banking standards and deficient regulation, resulting in over-investment in many sectors. Nevertheless, Korea's crisis had certain elements that differentiated it from that of the rest of the region.

South Korean growth had been helped by conglomerate mergers, the chaebols enjoying deep-rooted affiliations with the government. Since the 1960s the government had administered loans, through the banking system, to priority industries. After the initial success of this procedure, it later gave rise to a growing problem of bad loans. This bred corruption and retarded the banks' ability to make profitable loans. This policy therefore stymied microeconomic growth because the vast majority of banks' resources were directed largely to the chaebols. Nayan Chanda commented that: "Bureaucrats chose to finance giant petrochemical plants and build millions of cars, even when markets clearly couldn't absorb the additional production. By the end of 1997, this orgy of expansion without any concern for the bottomline or shareholder interest had created a staggering amount of debt - 135% to 140% of nominal GNP ... About $153 billion came from offshore borrowing and two-thirds of that was short-term."[39] Moreover, in late 1997 Korea's usable foreign exchange reserves, which are essential for repaying short-term debt as it becomes due, dwindled to just $10 billion.[40]

Korea had experienced deteriorating trade accounts with two of the country's main trading partners since the 1990s. The first was Japan. Korea had failed to undertake significant investment in research and development. The chaebols, therefore, had to rely upon Japan for much of their machinery, which generated a large trade deficit with Japan, amounting to $15 billion in 1996. The second was the trade offensive launched on Korea by the United States. The U.S. wished to raise the value of Korea's currency in order to reduce demand for Korean exports in the U.S. market, threatening sanctions if Korea did not comply. Consequently, Korea's trade account with the U.S. fell from $6 billion in 1988 to a deficit of $11 billion in 1996.[41] Additionally, Korea's East Asian neighbours had a far cheaper labour force, thus intensifying pressure on Korea's exporting industries.

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[38]Henderson, C. 2000. p.46.
[39]In: Biers, D. 1998. pp.12-13.
[40]The Economist. 13 December 1997. p.67.
[41]Kloker, D. 1998.

Finally, the accession of Korea into the developed nations club, the Organisation for Economic Co-operation and Development (OECD), had forced Korea to adopt a more liberal stance towards foreign capital and finance. This enabled Korean banks to borrow cheaply in offshore markets, thus contributing to over-investment and financial vulnerability.

Korea's top twenty listed companies were earning only 3% on assets by 1996. At the same time, the average cost of borrowing had increased to 8.2%.[42] When the country applied to the IMF for assistance it received the largest aid package in IMF history, totalling more than $57 billion.

Indonesia

Of the three countries that suffered acute financial crisis Indonesia has been worst hit, "battered by economic and political crises which have become mutually reinforcing, producing a downward spiral of instability, rising poverty and unrest, and government inaction with no end in sight. The social impact of the crisis in Indonesia has been immediate and dramatic, bringing to light underlying social tensions, which had previously been obscured by relative economic stability"[43]. The Indonesian currency, the rupiah, fell from 2,300 to 17,000 to the U.S. dollar and the economy contracted by 13.2% in 1998. The breakdown of the domestic economy resulted in a collapse in imports and consequently a rapid improvement in the trade account.

Indonesia suffered from ailments similar to those which contributed to Thailand's collapse. Banks initially prospered from the opportunity to borrow cheap credit in offshore markets, converting dollars into rupiah. However, lax financial supervision and regulatory measures were unable to manage the vast inflows of capital to ensure they were put to productive use.

Following the Thai devaluation, analysts believed that Thailand had the weakest fundamentals in the region. No one could foresee the devastating human and financial crisis that swept through Indonesia. "Indonesia's strong economic fundamentals, a more liberal exchange rate policy and the extremely attractive interest rate yields offered by rupiah deposits made many Indonesian companies assume the currency was a safe-haven amid the regional currency storm"[44]. As a result, many Indonesian companies continued to borrow in U.S. dollars and convert them into rupiah, despite the fact that neighbouring countries were experiencing destabilising pressures on their currencies. Consequently, less than 20% of

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[42]Bullard et al. 1998. p.14.
[43]Ibid. p.23.
[44]Asia Review Book 1998. p.26.

Indonesian corporations were hedged against foreign exchange exposures when the rupiah began to slide in late July 1997. When the rupiah depreciated the unhedged borrowers rushed to convert rupiah into dollars, applying further pressure to the downward spiral of the rupiah as it achieved one record low after another. The IMF was then called in to provide financial assistance but actually worsened the situation by contributing to the meltdown of the Indonesian banking system. (The response of the IMF to the Asian crisis will be analysed in Chapter 6.)

Indonesia's economic and political catastrophe resulted in a dramatic increase in the number of people living below the poverty line. From a pre-crisis level of 11.2%, those living on less than a dollar a day increased to 60.6%.[45]

Malaysia

The Malaysian ringgit plunged 33% from July to October 1997 and the Kuala Lumpur stock exchange lost approximately half of its value from its March 1997 peak, with the majority of that decline occurring throughout the summer of 1997.

Malaysia's economic difficulties were aggravated by Prime Minister Mahathir Mohamad's intemperance. Nayan Chanda commented that: "Having chalked up rapid growth for nearly a decade, Mahathir was reluctant to accept that some of his policies could be faulty. He blasted foreign speculators and termed currency trading 'immoral.'"[46] Mahathir's behaviour supported the belief among foreign creditors that the Malaysian Prime Minister was unwilling to address the country's fundamental difficulties.

In September 1998, Malaysia imposed currency controls and fixed the ringgit at 3.8 to the U.S. dollar. Interest rates were lowered and this reduced the debt-service burden that Malaysian banks and companies were facing, which was significant given that Malaysia's debt to GDP was about 160% at the time.

Taiwan

In contrast to other East Asian economies, Taiwanese corporate debt relative to the country's foreign exchange reserves (which amounted to over $100 billion), remained low throughout the crisis period. Thus investors knew that demands for their deposits could easily be satisfied. However, in mid-October 1997 Taiwan allowed its currency to float. The Taiwanese authorities believed that there was little point in defending a currency that had appreciated considerably in relation to five of Taiwan's East Asian export competitors.

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[45]Bello, W. 1998b.
[46]In: Biers, D. 1998. p.13.

Once it was floated, the Taiwan dollar depreciated by just 5% and the economy continued to grow throughout 1998 while many of the country's East Asian counterparts were subjected to devastating economic recessions.

Singapore

The Singapore dollar was the least afflicted currency of those that were affected by the Asian financial storm. During the crisis, the Singaporean monetary authorities allowed a greater degree of flexibility between the Singapore dollar and its basket of trading currencies. The currency touched its lowest value against the dollar for three years in October 1997, but even at this weakened level it represented a significant appreciation against its Asian neighbours. Callum Henderson believes that: "The case of Singapore concerns one of fundamentally superior economic management ... The Singapore dollar could not help but be swept along to an extent by the crisis, but the important point was that investor confidence in the handling of the economic and financial fundamentals of the country remained assured."[47]

Hong Kong

Hong Kong has been operating a currency board system since 1983. Ever since the adoption of this stringent regime the Hong Kong dollar has been fixed at a rate of 7.80 to one U.S. dollar. The Hong Kong Monetary Authority (HKMA) also had access to the foreign exchange reserves of China, which, when combined with Hong Kong's reserves, amounted to $220 billion.

Hong Kong has a strong financial and regulatory system and "corporate Hong Kong wasn't massively leveraged: Among the territory's major corporations, debt averages 30% of equity - one-tenth the figure for South Korea"[48]. However, following Taipei's decision to let the Taiwan dollar float, analysts believed that the Hong Kong dollar was exposed and grossly overvalued. The depreciation of both the Taiwan and Singapore dollars had led to additional pressure on Hong Kong, partly due to the similarity between their export sectors and partly as a result of intensifying speculation that Hong Kong would follow the example of its equally developed neighbour states and allow a moderate depreciation.

There were additional explanations to recommend a correction of Hong Kong's exchange rate. Firstly, the Hong Kong dollar had appreciated by 30% during the 1990s, a result of the increased strength of the U.S. currency. Secondly, the dramatic devaluations of Thailand, Malaysia and Indonesia applied additional pressure to the Hong Kong unit, not

[47]Henderson, C. 2000. pp.50-51.
[48]In: Biers, D. 1998. p.81.

through export competition but through a significant change in relative prices. Finally, Hong Kong's return to mainland China in July 1997 had involved a degree of political risk.

On detailed inspection, market commentators believed that Hong Kong shared a property bubble equal to many of its regional neighbours, illustrated by the astronomical price of real estate. It was also argued that Hong Kong's smaller banks, despite a stringent regulatory regime, were not as healthy as they seemed. The bank's property loans amounted to around 40-50% of domestic bank lending, the highest level in the region.

The currency board regime that Hong Kong operates is supposedly immune to straightforward speculative attacks. Yet it was severely tested in October 1997. The currency board's self-correcting nature means that domestic interest rates adjust automatically to pressures on the Hong Kong dollar through changes in the money supply. Therefore, any selling of Hong Kong dollars causes an equal contraction in the domestic money supply, inducing higher interest rates. The theory of the currency board suggests that eventually interest rates will reach such a point that investor interest will be restored as a result of the high returns available.

In many respects, this is what happened with Hong Kong's defence of its currency. Overnight interest rates reached 300% in a successful attempt to maintain the value of the exchange rate and encourage speculators to hold on to their Hong Kong dollars. However, the costs were large as the high interest rates had severely adverse affects on real economic activity generating a harsh recession in 1998, which saw the economy contract by 10.4%.[49] The HKMA responded in two ways. Firstly, by attempting to stabilise the stock exchange through large interventions of stock purchases totalling U.S. $15 billion, which began on August 14, 1998.[50] Secondly, the monetary authorities attempted to counter-act speculation by reaffirming their commitment to an open capital account and the currency board regime. But the HKMA's intervention in the stock market was greeted by much criticism, domestically and internationally. The HKMA's goal was to reduce interest rates and to stabilise asset prices, yet this will only happen when investors observe value. Thus the intervention by the HKMA in the Hang Seng Index only served to distort equity values. Investors searching for value simply waited until the HKMA stepped aside.

On October 23 1997, the Hang Seng stock market lost 1,211.47 points and reached a 1998 low of 6,544.79 from over 16,000 in 1997.[51] The steadfast currency board inflicted

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[49]Henderson, C. 2000. p.53.
[50]Ghosh et al. 2000. p.304.
[51]Henderson, C. 2000. p.53.

serious economic pain on the territory's economy. In comparison, Singapore and Taiwan moderately depreciated their exchange rates and continued to grow throughout 1998. So the question must be asked in relation to the Hong Kong dollar's stability during the crisis. Was it worth it?

Callum Henderson argues that: "[There was] absolutely no benefit to the HKMA in letting the peg go, and every reason to maintain it ... If the currency board system had been seen to be defeated, it would have caused disaster, and not just for Hong Kong. All other currency boards in the world would instantly have been targeted"[52]. Indeed, Ghosh *et al.* believe that: "should a currency board arrangement fail eventually, contagion to other currency board arrangements could be significant."[53] Additionally, Mr Henderson argues that if the currency board had been abandoned "the resulting devaluation of the Hong Kong dollar could not have been limited and would have caused a proportional devaluation of the banking system's capital base. It would have caused the one thing it had not done to any degree up until that point, a loss of confidence in the domestic supervisory institutions and in the domestic banking system ... The banking system would have imploded, domestic interest rates would have skyrocketed rather than fallen as demand for Hong Kong dollars collapsed and the stock market and the economy would have gone into meltdown"[54].

Furthermore, the HKMA was aware of the contagion that would spread to China should the Hong Kong currency be devalued. A devaluation of the Hong Kong dollar would have increased the price of Chinese exports to the territory, further reducing China's competitiveness, given that their currency had already appreciated in real terms by 30-50% in relation to its regional neighbours. This potential loss of export earnings could easily have brought the Chinese current account into deficit. When Hong Kong started to meltdown analysts began to focus on potential direct and indirect effects on China.

Following Hong Kong's considerable losses on the Hang Seng Index, contagion began to spread to other parts of the world for the first time since the crisis began. Substantial losses occurred on the leading Latin American bourses and the Russian stock market. Russia and Brazil were seen as particularly vulnerable owing to their large budget deficits. Their central banks then raised interest rates attempting to ward off currency speculation.

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[52]Ibid. pp.56-57.
[53]Ghosh et al. 2000. p.301.
[54]Henderson, C. 2000. pp.56-57.

China

Paul Krugman acknowledges that: "China's economic growth has been astonishing, but then so was the growth of everyone else in the region until the crisis. On every other dimension China looks worse not better, than its neighbours: more bad banks (there may well be no truly solvent banks in China), more nepotism, more corruption"[55]. Yet, China's economy continued a remarkable rate of growth throughout the crisis period and the currency, the renminbi, even strengthened against the U.S. dollar. China's apparent immunity to both regional and global financial turmoil will be discussed in detail in Chapter 3.

1.v. Why was the Asian crisis not anticipated?

The economies of South-east Asia were the fastest growing economies in the world before they were hit with the "financial equivalent of a nuclear holocaust"[56]. Few people anticipated the financial crisis. The governments had not been profligate and unemployment was not particularly high. Above all, the governments' policies seemed successful, inflation was low, most countries enjoyed budget surpluses, saving rates were high and continued growth seemed a certainty.

Nobody envisaged such a dramatic nose-dive in investor confidence, despite the continued fall in value of many Asian stock markets throughout 1996. The decline in Thailand's and South Korea's stock markets, which had recently achieved record levels, represented one of the few indications of dwindling confidence amongst market participants prior to the crisis

There were few other indications of the impending financial crisis. Radelet and Sachs argued that: "While current account deficits were large, capital inflows were even larger, so foreign exchange reserves were actually growing across the region (except Malaysia) ... Thailand's [fiscal] budget reportedly deteriorated markedly in late 1996 and early 1997, partly in response to the crisis itself, rather than an independent cause."[57]

Paul Krugman was one of the few who did predict a downturn in Asian economic growth. In his article 'The Myth of Asia's Miracle' he argued that Asian economic growth was the result of resource mobilization rather than efficiency. Krugman compared Asia's growth to that of the Soviet Union: "The newly industrialising countries of Asia, like the Soviet Union of the 1950s, have achieved rapid growth in large part through an astonishing mobilisation of resources. Once one accounts for the role of rapidly growing inputs in these

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[55]Krugman, P. 2000a. p.144.
[56]Kloker, D. 1998.
[57]Radelet & Sachs. 1998. pp.22-23.

countries growth, one finds little left to explain. Asian growth like that of the Soviet Union in its high growth era, seems to be driven by extraordinary growth in inputs like labour and capital rather than by gains in efficiency. Singapore grew through a mobilization of resources that would have done Stalin proud"[58]. The author then uses empirical evidence on the countries' technical efficiency change. "The rate at which Asian developing countries were converging on the productivity of advanced countries [was as follows]: Hong Kong 2.0, Taiwan 0.8, Thailand 0.1, Indonesia -1.2, Malaysia -1.8, Singapore -3.5. Therefore, the Asian economies were not closing the productivity gap"[59] and some were actually falling behind! Similarly, the Soviet Union experienced slowing rates of growth. For example, output per unit of combined input declined rapidly: in the period 1928-1966 it was 2.0; in the period 1950-1960 it was 1.7; in the period 1960-1981 it fell to 0.8; and in the period 1983-1987 it was -0.7.[60] Indeed, the global competitiveness report indicates that a number of Asian manufacturing countries are poorly rated in terms of state funding of scientific research and private sector R&D spending. (See Table 3, p.30.)

Although the Asian crisis did not follow Paul Krugman's initial prediction, it did underline certain flaws in Asia's economic growth, prompting Radelet and Sachs to examine the impressive growth record a little closer. They agreed with Krugman's critique, namely that Asia's growth rate was unlikely to continue at such breakneck pace. But they believe that Krugman was "wrong about the solidity of Asia's economic development, and [that] he gave a misleading impression of Asia's economic prospects for the future"[61]. Radelet and Sachs argue that Asia's rapid growth had been achieved through both productivity growth and capital investments. And more importantly, that investment spending has achieved rates of return that exceed the cost of capital. Thus the authors believe that Asian resources were allocated according to market forces and that rates of return had only fallen gradually over time. In contrast, Soviet resources were allocated via bureaucratic fiat and rates of return were low and began to fall as early as the late 1950s.

1.vi. East Asia in the new millennium

Following their recessions of 1998, the crisis-hit East Asian economies enjoyed a spectacular economic recovery. In 1999 and 2000 these countries experienced average GDP growth of

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[58]Krugman, P. 1994. p.70.
[59]Krugman, P. 2000a. pp.30-33.
[60]Gregory & Stuart. 1994. pp.238-9.
[61]Radelet & Sachs. 1997. p.48.

7%.[62] South Korea grew by 10% in 1999 after contracting by nearly 6% in 1998, an economic rebound of almost 16%.[63] (See Table 8, p.32.) However, good times often make for bad policy and the reforms that these countries began, in the aftermath of the regional crisis, have been jeopardised by Asia's fast recovery. "If 100 reforms are necessary, at most five are being introduced. Once cyclical rebound set in, reform slowed and in some cases stopped"[64].

Ajai Chopra of the IMF's Asia and Pacific department outlined failures on Korea's restructuring front: "'The need for concrete restructuring progress and tangible results - principally the exit of non-viable firms and asset sales - has now become imperative to ensure that the remaining problems do not jeopardise what has already been achieved'. [John Thornhill subsequently argues that:] The same could be said of Indonesia, Thailand and Malaysia."[65] It has been widely agreed by the IMF and the World Bank that the greatest obstacle to progress has been the legal systems that cannot cope with corporate debt resolution. By value almost 60% of Malaysia's debt cases had been resolved in July (2000). The figure was 43% in Thailand while in Indonesia 50% of distressed corporate debt was estimated "to be subject to some form of resolution"[66].

The East Asian economies were fortunate when in 1997 they slumped but the United States boomed. During 1997-98 the United States grew at 4% annually.[67] Morgan Stanley believes that around two-fifths of Asia's total GDP growth in 2000 was fuelled by I.T exports to America.[68] To its credit, the U.S. did not make a political issue over the reduced cost of Asia's exports. But now that the U.S. economy is slowing, American firms have been slashing their investment and consequently their imports from Asia. Merrill Lynch expect Asian exports to increase by only 7% in 2001, following 20% growth in 2000.[69] Asia's slowing exports are compounded by the Japanese yen's continued weakness (on average, exports account for approximately 50% of GDP in the smaller East Asian economies).[70]

But Asia's macroeconomies are far less vulnerable to a financial crisis than they were in 1997. All of the countries, with the exception of Malaysia, have abandoned their pegged

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[62]The Economist. 31 March 2001. p.15.
[63]Henderson, C. 2000. p.xvi.
[64]Chan, R. 2001.
[65]Thornhill *et al.* 5 December 2000.
[66]Fidler, S. 2000b.
[67]The Economist. 31 March 2001. p.101.
[68]The Economist. 7 July 2001. p.12.
[69]The Economist. 16 December 2000. p.111.
[70]The Economist. 7 July 2001. p.12.

exchange rates, current accounts are presently in surplus rather than deficit as in 1997, foreign exchange reserves are healthy and foreign currency-denominated short-term debt has been reduced. However, to become more resilient to global slumps, East Asia must diversify its export destinations and increase regional trade.

Asia's reformers appear to have learnt an important lesson from the financial crisis of 1997 - that of improved monetary policy. Central bankers now stress price stability, and are no longer trying to simultaneously target the exchange rate and inflation. Therefore, East Asian countries have allowed their exchange rates to depreciate vis-á-vis the U.S. dollar, e.g. The Korean won depreciated by 15% from April 2000 to March 2001.[71] This will help the Asian economies to maintain export competitiveness. Although Asia's external debt is primarily denominated in dollars, this is far less a problem than for other developing countries. According to J.P. Morgan, this is because Asia's trade quantities are proportionally so high, hence, the strong dollar will enable them to obtain more in new trade than it will cost them in higher debt-service costs. "As a share of exports, for example, Latin America's external debt is more than twice as high as Asia's. To most central bankers in Asia, therefore, rising debt-service costs have not been a major concern"[72].

America last experienced a recession in 1990-91, which Asia weathered admirably, but, at that time, domestic demand was strong. Presently, domestic demand is weak and governments have little ability to improve it through additional expenditures, for Asian economies, excluding China, possessed an average budget deficit of nearly 4% in 2000.[73] Monetary policy will not be particularly effective because the region's financial sectors remain weak. Banks still harbour many NPLs and are reluctant to lend.

The *Economist* estimates that if America's economy slows sharply, East Asia's growth will be reduced from 7% in 2000 to 5% 2001. But if America has zero GDP growth in 2001, Asian growth would slow to only 3.9%. Goldman Sachs predicts that growth in Hong Kong, Singapore, South Korea and Taiwan would fall from a combined 8.5% to 2.3%, and growth in the less-developed ASEAN economies from 4.8% to 1.3%.[74]

One of the main causes of Asia's financial crisis was the region's external over-reliance on both foreign capital and exports to the West. Asia's recovery, thus far, has been overly dependent on exports to America. This strategy has delayed reform of banks and

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[71]The Economist. 31 March 2001. p.101.
[72]The Economist. 16 December 2000. p.111.
[73]The Economist. 31 March 2001. p.101.
[74]Ibid.

companies, and some insolvent enterprises have been provided with imprudent subsidies enabling them to keep operating. These structural defects should have been addressed over the course of the last two years while external demand was strong. The economies would then have been in a healthier condition to cope with America's downturn because monetary policies would have been more effective. The *Economist* has pointed out that as Japan's experience shows, low interest rates will not drive domestic demand when banks are harbouring large quantities of bad loans, and remain unwilling to lend, while companies saddled with debts are reluctant to borrow.

Additionally, there are demographic threats to Asia's future growth. Firstly, Asia possesses an ageing workforce. According to Chris Patten, one of the main reasons for Asia's high savings and investments from the 1970s onwards was due to the high proportion of economically active residents who were born in the 1950s or 60s. Hence, there will be just as fast a rise in the number of the retired in the early years of this century, e.g. the share of the population over 60 in Singapore will double in just seventeen years.[75] Care of the elderly will place great pressure on families and the state. But most importantly, the financial impact of paying pensions and health care for an increasing number of retired Asians will be significant. The second demographic concern is Asia's rapid urbanisation. This urbanisation occurs because of the huge disparity between urban and rural incomes. At present agricultural productivity is improving, in turn reducing the need for rural workers who then migrate to the cities where industries demand more labour. The Asian Development Bank estimates that by 2025 55% of Asia's population will live in cities, compared with just 35% in 1995. In 2000, twelve of the world's twenty-five largest cities were Asian.[76] Asia's rapid urbanisation will require large investment on urban infrastructure, such as transportation, sewage treatment and clean water supplies. The World Bank has calculated that Asian urban infrastructure investment will amount to $1.5 trillion until 2008, and $10 trillion until 2030. "Managing investment on this scale will test government competence"[77].

At the time of the Asian crisis the Asian economies were fortunate that the region's stability was not additionally jeopardised by an economic crisis in China. China with over $40 billion currently receives four-fifths of all FDI to the Asian region, excluding Japan, while the ASEAN countries share the remainder[78]. This foreign investment has contributed

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[75]Patten, C. 1999. p.137.
[76]Ibid.
[77]Ibid.
[78]The Economist. 17 March 2001. p.103.

to making China an enormous exporter, and this trend is set to continue due to China's near-limitless pool of exceptionally cheap labour, including a growing supply of well-educated graduates. However, China's ability to attract such large volumes of FDI, deprives South-east Asia's economies of desperately-needed foreign skills and technology inputs. Moreover, the *Economist* believes that: "Without China's cost structures - that is, its economies of scale and its low standard of living - other exporters in the region, from Indonesia to South Korea, will have trouble staying in business: China can just about out export them all. This realisation comes as a profound shock to China's neighbours, most of whom have built a development strategy over the past few decades around export-led growth."[79]

But China's rise and predicted accession to the WTO should bring some benefits to the South-east Asian economies. In particular, China's imports grew by $55 billion in 2000 suggesting that the country may become a regional source of growth.[80] Moreover, according to the *Economist*, China will not suffer from a slowing world economy because it is not yet deeply integrated into the world trading system. Instead, China relies on domestic trade, which will increase as railway and road networks become more extensive. South-east Asia's markets must improve if the economies are to enjoy sustainable development. The *Economist* has identified three key areas for urgent reform: "The first is far greater emphasis on clean governance, transparency and legal predictability ... Second, the region must resume its earlier efforts to lower trade barriers ... [Third,] China's growth also highlights the need to upgrade Southeast Asia's domestic capital markets ... Better regulation and financial reporting would also help investment capital to find the best opportunities, boosting productivity growth."[81]

However, DBS Bank in Singapore believe that: "South-east Asia squandered its 'golden decade', which began in the mid-1980s, by failing to invest in better skills and sturdier capital markets. Every investor, businessman and columnist in Asia has his list of things that the region should have done sooner. Since it patently failed to do any of them, the implication seems that South-east Asia is headed for the scrap-heap."[82] But Radelet and Sachs disagree: "The Southeast Asian currency crises of 1997 are not a sign of the end of Asian growth but rather a recurring - if difficult to predict - pattern of financial instability that often accompanies rapid economic growth ... In the long-term, growth will continue because

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[79]The Economist. 10 March 2001. p.26.
[80]Ibid. p.28.
[81]The Economist. 17 March 2001. pp.103-4.
[82]Ibid. p.103.

most of Asia has adopted capitalism as the organizing basis of economic life and become deeply integrated into the global economy."[83] Presently the West enjoys a disproportionate share of world income, but, according to Radelet and Sachs, this share will decline as Asian incomes increase. They estimate that Asia will account for between 55 and 60% of world income by 2025, while the share of income in the West will fall from 45% in 1997 (despite only having 13% of the world's population) to between 20 and 30%. (Table 9 shows East Asia's GDP per capita relative to the U.S. from 1965 to projected estimates in 2025, p.32.) But living standards in the West will remain higher.[84] Moreover, the former prime-minister of Singapore, Lee Kuan Yew believes that the world's economic centre of gravity will move from the Atlantic to the Pacific, arguing that: "East Asia will dominate the world economy within 40 years provided conflicts can be avoided ... By 2040 China and Japan's combined GDP would exceed that of the United States ... China's entry into the WTO [will] make it a 'driving force' of regional growth ... [But] ASEAN countries have to overcome the crux of the problem, that is to restore international interest and confidence in ASEAN's potential."[85]

1.vii. Conclusion

The Asian financial debacle of 1997 was a result of Asia's growing vulnerability to a financial panic. The panic was contrived by the region's excessive dependence on short-term capital inflows to stimulate economic growth. The flow of short-term capital was encouraged by a number of policy steps including the pegging of exchange rates and a dramatic liberalisation of the capital account that was not accompanied by an improvement in regulatory procedures. Authorities were, therefore, unable to effectively supervise the composition of funds in the capital account and Asia received capital inflows in excess of the countries ability to absorb them productively.

A further characteristic of the countries that were worst hit by the crisis, and a general indication of vulnerability to a financial panic was that short-term debt exceeded foreign exchange reserves by well over 100% in Thailand, Indonesia and South Korea. Therefore, as noted by Radelet and Sachs: "Once a crisis starts, each creditor knows that there are not enough liquid foreign exchange reserves for each short-term creditor to be fully paid, so each rushes to be the first in line to demand full repayment."[86] Callum Henderson believes that:

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[83]Radelet & Sachs. 1997. p.45.
[84]Ibid. pp.46-58.
[85]Bangkok Post. 17 August 2000.
[86]Radelet & Sachs. 1998. p.30.

"The most obvious lesson from the Asian crisis is - yet again - that sizeable current account deficits if left unchecked will inevitably come home to roost."[87]

'Crony capitalism', outright corruption and nepotism undoubtedly played a significant role in the build up of NPLs. This was because they provided incentives for excessive risk taking throughout Asia. "Banks had little incentive for ensuring that their loans were creditworthy, while corporations had little incentive to ensure that their loans were needed in the first place since they would get them anyway"[88].

Following the crisis, the Asian 'miracle' economies were heavily castigated for their reliance on statist industrial policies and for pervasive cronyism, which contributed to the rise of moral hazard-induced lending. However, Asia's crisis did not reflect the success of the Western school or the failure of the Eastern one. Linda Lim considered ten Asian nations and divided them into two groups - those who were largely unaffected by the crisis and those who were. The former included several countries whose governments belonged to the Asian values group and were staunchly undemocratic. While the latter included some countries that had already begun to democratise.[89]

At the centre of Asia's crisis lay an inefficient and imprudent micro-economy. Thailand subsequently closed fifty-six finance companies, Korea closed over half of the country's merchant banks (not to mention the failure of many chaebols) and Indonesia endured many bank runs. Moreover, the region's currency crisis became a debt crisis. "It had become a credit crunch where the level of nominal interest rates was no longer so important and where perceived credit risk ruled supreme, the benchmark of whether a company or a finance house would get a loan or not. In this world, both the sick and the healthy found getting credit extremely difficult if not impossible"[90].

No other region of the world has been rewarded by the globalisation of trade and capital markets as East Asia. But although the global economy is quick to reward open markets, it is just as quick to punish those who are ill-prepared. Poorly sequenced liberalisation and inadequate supervision, which is the legacy of imprudent political leadership lie at the heart of Asia's crisis.

In the short-term Asia is clearly at risk to America's downturn. But Radelet and Sachs anticipate a more prosperous future for the Asian region as a whole: "The system of

[87]Henderson, C. 1999. p.3.
[88]Henderson, C. 2000. p.59.
[89]Lim, L. 1998.
[90]Henderson, C. 1999. p.8.

market capitalism, which first appeared in Western Europe, has finally become a global - and, in particular, Asian - instrument of economic development. Asia has demonstrated that it can mould capitalist institutions into a vehicle for rapid economic catch-up."[91]

[91]Radelet & Sachs. 1997. p.59.

Table 1. GDP growth annual average % 1970-1996

	1970-79	1980-89	1990-96
Hong Kong	9.2	7.5	5
Singapore	9.4	7.2	8.3
Taiwan	10.2	8.1	6.3
South Korea	9.3	8	7.7
Malaysia	8	5.7	8.8
Thailand	7.3	7.2	8.6
Indonesia	7.8	5.7	7.2
China	7.5	9.3	10.1
Philippines	6.1	1.8	2.8
Rich industrial countries	3.4	2.6	2

Source: Kotler & Kartajaya. 2000. p.17.

Table 2. Real effective foreign exchange rates. 1990-1997. 1990=100.

	Indonesia	Korea	Malaysia	Philippines	Thailand
'90	97.4	96.1	97.1	92.4	102.2
'91	99.6	91.5	96.9	103.1	99
'92	100.8	87.7	109.7	107.1	99.7
'93	103.8	85.2	111	97.4	101.9
'94	101	84.7	107.1	111.7	98.3
'95	100.5	87.7	106.9	109.5	101.7
'96	105.4	87.1	112.1	116.3	107.6
'97	62.3	59.2	84.8	90.8	72.3

Source: Chang & Velasco. 1998c. p.56.

Table 3.

Several Asian manufacturing nations are rated poorly in key aspects of their economies and civil institutions.

Ranking out of fifty-three industrialised and major developing nations worldwide

	State Funding of Scientific Research	Private-sector R&D Expenditure	Judicial Independence	Corruption
China	22	47	29	45
Indonesia	53	53	51	52
Malaysia	42	31	30	28
Philippines	52	48	47	51
S. Korea	25	44	15	33
Taiwan	24	38	16	23
Thailand	48	36	43	41

Source: Sachs, J. 1999c. p.12.

Table 4. Exports % change over the previous year 1995-96

	'95	'96
Thailand	22	-1
China	21.5	3
Taiwan	20	4
Singapore	13	4
South Korea	30	4.5
Hong Kong	15	5
Malaysia	20	6
Indonesia	13	11
Philippines	29	17

Source: Kotler & Kartajaya. 2000. p.20.

Table 5. Current account $ billion 1993-2000

	'93	'94	'95	'96	'97	'98	'99	'00
Korea	1	-5	-9	-23.5	-14	15	31.6*	11.7**
Thail	-6.5	-8	-13.5	-14.8	-4	7	12.5	9.9#
Malay	-3	-4.8	-7.2	-5	-5.5	-2	12.6	13.6#
Indon	2.5	-3.6	-6.8	-7.8	-7	4.5	5.8	11.1#
Phili	-3	-3.2	-3.6	-4	-5	-2	7.8	13.6#
Taiw	7.2	6.4	5.2	11	7	5.5	5.1 Q1	9.6 Q4
Singap	4.4	12	14	13.8	13.4	7.8	18.8 Q1	21.8 Q4
H.K	8	2.3	-5.5	-2.3	-3	-2.3	7.2	5.9#

*June 1999. **November 2000. # Figures for 2000 are OECD projections.
Sources: Far Eastern Economic Review. 'Rebuilding Asia'. N. Chanda. 12 February 1998. The Economist. Emerging market indicators. 4 April 1998. p.148, 28 August 1999. p.90 and 17 March 2001. p.154. OECD Economic Outlook. December 2000. p.126.

Table 6. Current accounts, % GDP 1992-1996.

	Indonesia	Korea	Malaysia	Philippines	Thailand
'92	-2.2	-1.5	-3.4	-1.9	-5.9
'93	-1.2	0.1	-4.2	-5.5	-5.3
'94	-1.4	-1.2	-5.7	-4.8	-8.1
'95	-3.2	-2	-7.7	-2.6	-7.6
'96	-3.3	-4.8	-6.5	-3.5	-7.5

Source: Chang & Velasco. 1998c. p.55.

Table 7. Cumulative depreciation rates (July 1998).

Indo	Malay	Thail	Korea	Phili	H.K	Singap	Taiwan
81%*	39%*	36%*	34%**	37%*	0%*	12%***	13%**

*From July 1997. **From October 1997- May 1998. ***From August 1997- May 1998.
Sources: Radelet & Sachs. 1998. Malleret et al. 1999. p.114.
The depreciations of the crisis-hit economies were quite different to the depreciations of Singapore and Taiwan.

Table 8. Annual GDP growth % 1998-2002

	'98	'99	'00	'01*	'02*
China	7.8	7.1	8	7.6	7.8
Hong Kong	-5.1	3.1	9	7.1	5.5
Indonesia	-13.2	0	3.7	5	6.1
Korea	-5.8	10.5	8.9	6.2	-
Malaysia	-7.5	5.4	8.5	7	6.5
Philippines	-0.5	3.2	3.5	3	3.5
Singapore	0.3	5.2	6	5.6	-
Taiwan	4.7	5.3	6.2	5.8	-
Thailand	-9.4	4.2	5.6	5.8	7

*2001 and 2002 are OECD estimates.
Sources: Henderson, C. 2000. p.200. OECD Economic Outlook. 68. December 2000. p.126.

Table 9. GDP per capita relative to the U.S. 1965-2025

	'65	'95	Projected '25	Projected per capita GDP Growth Rate 1996-2025
Four Tigers	*17.3%*	*72.2%*	*98.5%*	*2.8%*
Hong Kong	30.1	98.4	116.5	2.1
Singapore	15.9	85.2	107	2.5
South Korea	9	48.8	82.6	3.5
Taiwan	14.2	56.2	88	3.1
China	3.2	10.8	38.2	6
Southeast Asia	*10*	*21.2*	*45.7*	*4.5*
Indonesia	5.2	13.1	35.8	5
Malaysia	14.3	36.8	71.2	3.9
Philippines	10.7	9.4	28.5	5.3
Thailand	9.7	25.6	47.4	3.8

Source: Radelet and Sachs. 1997. p.51.

CHAPTER TWO: THE RUSSIAN FINANCIAL CRISIS OF 1998

Introduction

Since 1991 Russia has attempted to transform a command economy into a market-orientated system, but from 1991 to 1999 GDP contracted by almost 50%. (See Table 1, p.65.) Boris Yeltsin (then president) aptly described the situation in a speech given on 30 March 1999: "We are bogged down halfway between a planned, command economy and a workable market one. We have created a freakish model, a hybrid of the two systems."[1] Looking at many socio-economic indicators, such as health care, life expectancy and levels of investment within the economy, Russia has deteriorated significantly since 1990. Russia is a democracy, but also a kleptocracy. Corruption and crime is pandemic. Political connections are the most important 'currency' in the market place. Many of the economic reforms Russia has undertaken have failed. In turn, this has led to financial vulnerability. I will examine the effects of these partial reforms and how they caused such instability within Russia and then consider the untimely exogenous shocks that were also at the heart of the Russian financial crisis.

2.i. Failures in Russian economic reforms

According to the consultancy firm McKinsey, "one of the highest priority problems in the world today is the failure of the reforms undertaken in Russia in the early 1990's to improve the well being of its population ... The drive towards establishing a market economy based on equal opportunities for all competitors has essentially stopped in Russia since 1995"[2].

Under the leadership of Mikhail Gorbachev, the Soviet Union became more receptive to reform and consulted various Western economic agencies. Attention then began to focus on the experiences of economic transition in Central European countries such as Poland and Hungary. Economic liberalisation was becoming increasingly radical and Russia had severe economic troubles that required attention. The primary concerns were over-industrialisation and inefficiencies within the economy, shortages of goods, large federal budget deficits and high levels of inflation.

Communism collapsed in Eastern Europe in late 1989. In 1991, the Soviet Union disintegrated. The Russian Federation became an independent state and President Boris Yeltsin's government attempted a 'shock therapy' stabilisation programme together with a swift adjustment to a market-orientated economy. This recovery strategy was chosen by Russian neo-liberal economists (encouraged by Western advisers such as Jeffrey Sachs and

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[1]CDSP. 1999, Vol. 51, no.13, p.14.

Anders Åslund) who believed a market-orientated system with clearly defined property rights and low inflation was essential to the establishment of an economy driven by entrepreneurial activity. Moreover, it was perceived that if reforms were implemented quickly the cumulative output loss would be far smaller and that the greatest opportunity to implement reforms was at the beginning of the transition process. The reformers not only sought advice on how to establish a thriving market economy but also requested grants and loans from international organisations such as the IMF.

It has often been argued that Russia has performed poorly because its 'shock therapy' approach to transition was too fast and radical. However, Anders Åslund believes that the Russian economy is not very liberalised and that the financial crisis in 1998 was the consequence of reforms that were too slow and partial. "Virtually all the problems in Russia today - excessive state intervention, corruption, high tax rates, lingering inflation, and limited rule of law - are indications of insufficient reform efforts".[3] Corrupt practices have profited from the excessive regulations that were imposed by a vast and pervasive state. Åslund argues that reformers have never had enough power to overcome tenacious vested interests. There only real chance was in 1992, when the West, and particularly the U.S., enjoyed much popularity and influence in Russia. Western countries should have used this influence and its aid to push for the measures required for the complete economic reform of Russia. Since the West's initial lack of action, Western support has primarily been directed through the IMF. But this support has been received by less reformist governments and the results have been mixed.[4]

Background to the financial crisis: the stabilisation of the rouble

One of the key stabilisation programmes carried out by the reformers was monetary stability. In 1992 the large federal budget deficit was financed entirely by money creation. The economic liberal Andrei Illarionov, stated that the money supply was increased by 130% in 1991, 640% in 1992, and 380% in 1993.[5] The hyperinflation of 1992 was a direct result of the monetization of the large budget deficit.

As part of the attempt to conquer hyperinflation Russia introduced the rouble corridor in 1995. The rouble acted as an anchor of stability for the economy. It helped to increase

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[2]McKinsey Global Institute. 1999. Solow et al.

[3]Åslund, A. 2001. p.21.

[4]See: Åslund, A. 1999b. p.71.

[5]CDSP, 1994.

confidence amongst investors who were then prepared to lend to Russian banks, companies and the Russian government. By 1995, the lower (but still sizeable) federal budget deficit was financed entirely by borrowing on the international and domestic markets. Thus the government, with support from Western advisers, introduced a new anti-inflationary method of financing the budget deficit. The Russian government's borrowing involved private sector loans, which usually took the form of government short-term (less than one year) rouble-denominated Treasury bills (GKOs). Initially, GKOs were sold only to Russian investors, but, under Western pressure to liberalise financially, the GKOs were soon purchased by Western banks.

The tightening of monetary emissions brought the annual rate of inflation down to around 15% in 1997. This contractionary decision taken by the finance ministry led to a shortage of cash in circulation, and accordingly, to an increase in the non-payment of wages to public sector workers. Given the exceptionally high returns on the short-term GKO investments (which often exceeded 100% per annum), there was little point in financiers exposing themselves to even greater risks by investing over a longer period of time. The substantial rate of return offered on the GKOs attracted the majority of investors in the Russian market. This largely stifled private real investment throughout the rest of the economy, further tightening domestic liquidity.

Initially, the procedure of borrowing to finance the deficit was successful because domestic and foreign investors believed that the Russian government could finance their debt. The investors would then 'roll-over' these loans to the government. If investor confidence began to dwindle, higher rates of interest would be offered in order to maintain the rouble's semi-fixed exchange rate. However, the non-payment of wages led to a vicious circle of decline; diminished purchasing power due to non-payment of wages caused a deteriorating internal market this, in turn, led to capital flight owing to the lack of investment opportunities within the Russian market. According to Dooley and Kletzer, "capital flight arises when residents avoid anticipated taxation of domestic deposits (for example, through inflation) and of the gross earnings on reported foreign assets ... The types of policies that can lead to capital flight include a large variety of taxes on and subsidies to domestic asset earnings, including outright confiscation, that vary by residence of the investor in practice"[6].

The Russian experience from 1995 to 1998 shows that inflation can be controlled through widespread non-payments, but as noted by *Transition*, "the economic costs of such a

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[6]Dooley & Kletzer. 1994. pp.8-10.

policy are staggering in terms of misallocation of resources and postponed enterprise restructuring, facilitation of corruption, bad investment climate, and stifled growth prospects. Furthermore, under these circumstances, low inflation, which places public debt on an unsustainable course, is not likely to last, so it indicates neither success nor credibility"[7].

Nevertheless, this budget deficit financing strategy bought the government time to improve its tax collection and at the time, it was believed, that the lower level of inflation would encourage investment. In an attempt to reduce the deficit, the government cut expenditures and raised taxes, thus further contracting entrepreneurial activity.

The rise of the oligarchic state

The partial liberalisation of the Russian economy has resulted in the rise of oligarchic capitalists ('oligarchs') who exercise considerable economic and political control in Russia. Their wealth is largely based on, in effect, 'stealing' from the Russian state. The group of oligarchs, according to Graeme Herd of the University of Aberdeen, share five fundamental characteristics, the most obvious being their deep-rooted economic power base. They monopolise Russia's print and broadcast media, which provides them with 'information power'. The oligarchs' have strong influence at both the highest levels of government and of Russian power structures, illustrated by their capability of organising strategic partnerships with multinational corporations. Finally, all of the oligarchs enjoy close relationships with regional governors and influence policy decisions concerning the strategic development of former Soviet economic assets.[8]

The oligarchs govern the cash-generating sectors of the economy and are influential in federal and local government conduct. McKinsey Global Institute argues that: "The combination of arcane laws ... low salaries of state employees and weak enforcement and control mechanisms provides the means and incentives for corrupt practices."[9] In 1996, the oligarchs and their media power played a crucial role in Boris Yeltsin's re-election campaign. Having formed strong contacts with the government elite, the oligarchs plundered the state and helped Yeltsin win the 1996 election, in return for guarantees that government handouts would persist. Russia's economic reforms have been stalled by powerful vested interests who have the most to gain if reforms continue to stagnate.

It was these oligarchs, together with the State Duma (Russia's lower house of parliament), that rejected the anti-crisis package in 1998 that the Russian administration, the

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[7]Pinto et al. 1999. pp.2-3.
[8]Herd, G. 1998a. p.93.
[9]McKinsey Global Institute. 1999. Solow et al.

West and the IMF were striving for. They were aware of the consequences for the Russian Federation and its people, but having made the vast proportion of their wealth from stealing from the state this was not a concern. Moreover, following the huge inflow of foreign money into Russia in 1997, the oligarchs seemed to conclude that they should take the money while it was still available to them.

The oligarchs have emerged due to various methods of rent-seeking behaviour. These rent-seeking opportunities have offered exceptional profits in comparison with opting for the uncertainty that genuine wealth-creating activity provides. As a result of Gorbachev's partial liberalisation and encouragement to promote foreign trade, commodities such as oil and various metals could be exported by state enterprise managers. These managers obtained licences allowing them to export commodities at much higher world market prices. Oil and metal prices within Russia were constrained by state-controlled prices. As late as 1992, the Russian price of oil was 1% of the world level! Anders Åslund argues that the reformers attempted to end this embezzlement by releasing Russia's commodity prices and exports. But, the state energy lobby, led by Viktor Chernomyrdin opposed this notion, arguing that Russian industries would fold if they were exposed to world market prices. Chernomyrdin and his allies won, enabling a few state enterprise managers, government officials, commodity traders and politicians to accumulate, according to Åslund, 30% of Russia's GDP in 1992.[10] It was only after the extraction of billions of dollars from the state enterprises did the reformers finally achieve the deregulation of commodity prices.

The Russian Central Bank played a pivotal role in the financial crisis and the rise of crony capitalists. Boris Kagarlitsky believes that: "The leaders of the Russian central Bank ... are personally responsible for the financial catastrophe in today's Russia."[11] During the early years of transition, reformists failed to establish a prominent position within the central bank. Consequently, cheap credits were readily available to influential businessmen. Despite an annual inflation level of 2,500%, the bank was willing to provide loans at an interest rate of 10-25% per annum. In 1992, net credits issued by the Central Bank of Russia amounted to 32% of GDP.[12] The Chairman of the Bank was elected by his allies for the third time in September 1998.

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[10] Åslund, A. 1999b. p.66.

[11] Kagarlitsky, B. 1998a.

[12] Åslund, A. 1999b. p.66.

Food import subsidies, which represented 17.5% of Russia's 1992 GDP, also provided abundant opportunities for personal enrichment. In 1992 food importers paid only 1% of the prevailing exchange rate when they purchased essential foods from abroad, but they could re-sell them on the domestic market and hoard the subsidy. The imports were actually paid for with Western 'humanitarian' export credits, which were added to Russia's state debt[13]. The potential fear of famine in the winter of 1991-1992 ensured that reformers could not oppose these subsidies.

The bounty that was gathered from these three rent-seeking business enterprises was acquired by just a small number of robber barons who, according to Åslund, accumulated 79% of GDP in 1992.[14] These enormous incomes were obtained via direct government subsidies or indirectly through government regulations.

By 1995 oligarchs controlled many Russian banks. Tight monetary policy was implemented at this time to maintain the rouble exchange rate and stabilise the level of inflation. The oligarchs favoured this stabilisation, given that their bank loans to the Russian government proved increasingly profitable due to the high level of interest rates.

The oligarchs were also beneficiaries of the country's privatisation reforms. According to Paul Krugman: "[They] high-jacked the economy's 'privatisation' programme to their own-enrichment. One might at least have hoped that, having stolen the country, the oligarchs would then try to run it as a paying business; but instead they have acted as short-term looters, extracting whatever they could and shipping the money out of the country ... The oligarchs - the only Russians who really could pay considerably more in taxes - have chosen not to, leaving the government in a permanent fiscal crisis."[15]

Privatisation

The IMF emphasised the importance of privatisation to the Russian reformers, claiming that it would both improve managerial expertise and reduce government expenditure.

The rapid, first stage of privatisation between 1992 and 1994 was a huge undertaking given that almost all of the industrial sector had been state-owned during the Soviet era. Many of these heavily industrialised and inefficient enterprises ended up in the hands of 'insiders' (existing managers and workers). As a consequence of this 'insider' method of privatisation, managers were seldom replaced by market-orientated entrepreneurs and managerial quality either stagnated or frequently deteriorated. Little cash was actually

[13]Ibid. p.67.
[14]Ibid. p.68.

obtained because of the use of vouchers and the needed restructuring of many enterprises did not take place to any great extent because the new owners typically did not have the capital, skills or incentives. No larger company showed any significant improvement in production.[16] Meanwhile, the government lost revenues from profitable state companies, which had previously been its primary source of income. The old Soviet bureaucracy remained in charge of many companies, but, at the same time, the former Soviet system of external control expired. Yegor Gaidar believes that the 'insider' method of privatisation ensured that enterprise managers remained "part of the social infrastructure of the totalitarian society; they were in no way different from other officials in the state administration. They had gone to university together, they worked together, they socialised with one another. They could also collude together"[17]. The privatisation process was supposed to transform Russian industrial enterprises into internationally competitive institutions. With the benefit of hindsight, it was recognised that privatisation would not prosper in an environment that lacked a strong judicial system and non-state corporate governance mechanisms, based either on banks or equity markets. Russia had neither. Consequently, the investment environment remained poor and little headway was made in industrial restructuring. During Soviet times, companies' efficiency at producing goods was low in comparison with the rest of the world, but, according to McKinsey, it has further deteriorated since the reform process started assets put in place since 1992 employ less than 10% of Russia's workforce and, surprisingly, produce an average of only 30% of the U.S. productivity level.[18]

A consortium of commercial banks proposed that they lend the Russian government capital and, in return, obtain a large block of shares in Russia's big companies as collateral. In August 1995, in an effort to increase revenues from privatisation, President Yeltsin accepted a version of the plan, which later became known as the 'loans-for-shares' scheme, where twenty-nine blue-chip companies were to be auctioned separately to banks. The auctions were supposed to be open to all bidders, including foreigners, and the bank that put forward the biggest loan to the government would obtain each block of shares. The banks were not allowed to sell the shares until September 1996. However, the loans-for-shares scheme had numerous problems and damaged the reputation of large-scale privatisation. The number of companies participating was continually reduced due to political opposition and

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[15]Krugman, P. 2000a. p.130.
[16]McKinsey Global Institute. 1999. Solow et al.
[17]Gaidar, Y. 1998. pp.7-8.
[18]McKinsey Global Institute. 1999. Solow et al.

lawsuits by managers of influential companies who resisted the sale of their shares to outsiders or banks. Eventually, only twelve companies were auctioned in auctions that only a few of Russia's strongest banks controlled. The banks that conducted the auctions excluded foreigners, colluded, frequently disqualified their competitors and won the bids themselves at very low levels. The government eventually obtained just over $1 billion.[19] But the new majority owners simply continued the management theft, generally by selling products at below market prices to their own enterprises, allowing the former state companies to deteriorate.

Privatisation has often been cited as a primary cause of Russia's decline. This is largely due to the fact that it was largely the only open transfer of wealth that was evident within Russia. It was, therefore, easy to blame. Furthermore, people believed that the state-owned industries were of far more value than they actually were. This caused disappointment and anger at the cheap sales of factories.

Whilst privatisation has not been an unqualified success it has realised significant achievements given that 80% of Russian enterprises are now privately owned and, since 1997, Russia's private sector has created at least 70% of the country's GDP.[20] However, the main problem of the Russian reforms was the abundant opportunities it provided for the oligarchs to become incredibly rich and maintain such extensive control over government conduct.

Summary: a comparison.

The market reforms undertaken in Russia failed to stimulate economic growth and worse, instituted decline as businesses languished. The economies of Hungary and Poland were far more resilient to global financial turmoil in 1997 and 1998. According to Nicholas Stern, Russia did not "balance privatisation and liberalisation with deep institutional reforms" and were therefore far less resilient to global financial turmoil. "The striking contrasts in the region show that stability and growth require markets with competition and financial discipline private ownership with effective corporate governance and the rule of law"[21].

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[19]Blasi et al. 1997. p.75.

[20] Åslund, A. 2001. p.21.

[21]N. Stern. Financial Times. 24 November, 1998. p.3.

2.ii. Internal causes of the Russian crisis

The federal budget deficit

One of Russia's key fundamental weaknesses was the size of the federal budget deficit, which was 6.8% of GDP in 1997. This was a primary reason for the country's macroeconomic instability. Yegor Gaidar argued that: "During 1995-1998 the problem of tax collection was not a problem of tax administration in the usual sense. It was more a political struggle about what constituted the essence of the emerging economic system, whether it was to be a system in which the relationship between the state and the enterprises was to be regulated by law or whether it would be business as usual, based on political influence and personal contacts. The result of this struggle was ... A semi-equilibrium in which the budget deficit was stabilised at around 6-7% of GDP, but there was not enough political support to reduce this figure ... Deficits of this magnitude are unsustainable in the long run."[22] The reason for the budget deficit is not due to irrational or excessive state expenditure. On the contrary, public services have been cut. The problem simply results from an inability to obtain taxes. Tax revenues for the federal government in 1997 were equivalent to roughly 8% of GDP, a third or less of revenues collected in most Western countries and desperately inadequate to finance the government's expenditures.[23]

The virtual economy

Public sector workers, including soldiers and taxmen, have often gone months without receiving wages. Many workers in the private sector receive payment in kind. The problem of payment arrears is essentially due to companies failing to pay their suppliers, employees and taxes. Payment in kind formed just over 50% of industrial employees wages, and this figure was greater amongst large companies that would administer 73% of their organisation in non-monetary ways. These same large companies would actually pay 80% of the taxes owed to the federal government, although only 8% of the 80% of the taxes paid would be in the form of cash. Rather than writing-off these debts and receiving nothing at all, the government began accepting payment in kind. The non-monetary payment of wages implies virtual earnings, which then become virtual fiscal commitments to the government. An economy based on virtual earnings, virtual commitments and virtual prices is essentially a virtual economy.[24] Since the years of market reform the virtual economy has increased in size due to its popularity and resilience. This has had the effect of changing the dynamics of

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[22]Y. Gaidar. 1999. pp.7-8.
[23]The Economist. 22 November 1997. p.28.
[24] See: Gaddy & Ickes. 1998. pp.53-56.

the federal budget. With little revenue being obtained in the form of cash, the options of public expenditure have been severely restricted and taxing payment in kind is very difficult.

According to McKinsey Global Institute, barter transactions are commonplace in approximately a half of Russia's economy.[25] Tax evasion, energy subsidies and government procurements are generally carried out via complicated barter deals. Both the government and government-related enterprises disguise these subsidies under generous barter deals that provides further personal enrichment opportunities. Large companies with good political connections would often hand over goods and services to the government and other budget-financed organisations in an attempt to be excused from paying cash. This represented a weak control over spending commitments by the government, which often tried to clear these mutual debts only to see yet more tax and spending arrears appear.

Many Russian citizens, who would usually be prepared to pay taxes, had doubts that their hard-earned cash would be used appropriately to benefit the country or the economy. They believed their taxes would be far more likely to benefit corrupt officials, who would 'skim-off' the top of taxes received.

Within the Russian economy there is a large reliance on the oil and gas producing sectors. Some 40% of government federal revenues depend on the volatility of the relative prices of oil and gas.[26]

Inadequate tax enforcement

Russia's weak tax system has as many as 200 different levies, the majority of which derive little, if any, revenue. Anders Åslund argued that: "Russia needs a new tax system with lower, not higher, rates which should defend the rights of honest tax payers so that it is meaningful to pay taxes. The present system is so arbitrary that you are more likely to be forced to pay a penalty if you pay your taxes than if you ignore them altogether. Moreover, excessive rates make it impossible to collect taxes"[27]. In addition, the profit tax system, which if paid, would almost eradicate all profits, has forced firms to hide their profits in the shadow economy. The former Finance Minister, Boris Fyodorov, stated that: "The authorities have not made it clear to people that they have to pay [taxes]."[28] The Russian judicial and law enforcement system is ineffectual and penalties are rarely dealt out to managers who ignore their tax obligations.

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[25]McKinsey Global Institute. 1999. Solow et al.
[26]Ibid.
[27] Åslund, A. 1998b. pp.185.

Fundamental reform of the tax system has often been blocked by politically influential businessmen. For example, the former Prime Minister and ex-head of Gazprom, Viktor Chernomyrdin, teamed up with Boris Berezovsky, a crony capitalist and media tycoon. This partnership helped stall reforms during the autumn of 1997.[29] Leyla Boulton of the *Financial Times* stated that: "Rarely have solutions to a problem been so clearly recognised yet so tough to apply successfully in practice."[30]

Soft budget constraints

In a market economy a manager's performance is judged largely on the profits that the company makes. To achieve profits he or she must conduct business efficiently or pay the price. In the command planning system the manager was usually responsible for producing quantities. Consequently, profits were of little or no concern, given that the state would ensure the market survival of insolvent companies. These 'soft budget constraints' have persisted after the collapse of the Soviet Union. By way of contrast, Poland had enterprise budget constraints hardened early on in its transition process, which made bankruptcy a real threat to inefficient enterprises. This was an important step in Poland's far more successful transition.

The government's unwillingness to impose hard budget constraints on companies is due to factors such as its fears of unemployment and its consequences. This process has restricted restructuring and tax collection, whilst also reducing the level of domestic savings. Furthermore, it has distorted the market place and led to unequal competition. During the privatisation of state property from 1993 to 1995, over 125,000 companies became privately owned. However, sub-national governments have maintained influential affinities with the enterprise owners of important companies, irrespective of whether they are publicly or privately owned. Regional governments have handed out subsidies and behaved in a discriminatory manner, often alleviating tax arrears between the government and firms with governmental connections leaving small enterprises with no connections, to make up the difference. (McKinsey Global Institute makes much of this point: see below.)

Existing labour regulations in Russia encourage managers to react to changes in demand via prices as opposed to quantities. Therefore, the employer will either cut wages or pay them sporadically, if at all. Consequently, few are made redundant and workers would

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[28]Treisman, D. 1998. p.58.
[29] Åslund, A. 1998a.
[30]Boulton, L. Financial Times. Russia Survey. 15 April 1998. p.8.

rather hold on to their job for the hope of one day being paid, than receive the dole, which is at a humiliatingly low level.

The continuance of soft budget constraints has ensured a distinct lack of incentives for these enterprises to perform efficiently. Moreover, it means that market mechanisms will not redistribute resources efficiently, from poorly functioning enterprises to efficient companies that deserve to prosper. Soft budget constraints are also incompatible with an impartial and efficient tax system. This is because enterprise tax obligations will be determined, not by law but by a negotiation between the company and state authorities. This provides ample opportunities for corruption. Soft budget constraints and soft administrative control facilitates an environment that encourages inefficiency for companies, society, and the whole economy.

Unequal competitive conditions

Anders Åslund argued that: "Taxation has become a free negotiation between the ubiquitous tax inspectors and tax payers, meaning that the strong win and small entrepreneurs are chased out of business ... Poland and Hungary ... have six times more enterprises in relation to their population than Russia. This means feeble competition, leading to substandard products and service, high prices and little economic growth."[31] Unequal rules of competition were cited by McKinsey as one of the fundamental causes of the persistent budget deficit. These distortions have been implemented by the government to achieve social objectives, most notably, to minimise unemployment. However, the distortions impede Russia's economic performance and, therefore, impair the social objectives they were intended to enhance.

McKinsey Global Institute found that: "Despite high competitive intensity, the competition is unequal and it causes low productivity. Price decontrol and privatisation did successfully stimulate competition. Paradoxically, however, in Russia the more productive companies are often the least profitable. Thus, more productive companies are not gaining market share and not pushing less productive firms out."[32] Moreover, the regulatory environment prevents productive enterprises from crowding out or taking over their less productive competitors. As a consequence of the unequal competition, efficient companies often struggle financially, while their less productive competitors prosper. The market distortions take a variety of forms including; differential effective tax rates; preferential access to land and government procurements; differing energy prices paid by different

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[31] Åslund, A. 1998a.

[32] McKinsey Global Institute. 1999. Solow et al.

institutions in the same industry; differing methods of law enforcement; and differing degrees of red tape imposed on enterprises. All of these measures put potentially efficient enterprises at a cost disadvantage, in turn, reducing their investments and growth. Indeed, a further consequence of no real credible threats of bankruptcy is that these insolvent enterprises rarely pay their suppliers on time, if at all.

In June 1998, total arrears amounted to approximately $144 billion, almost one-third of GDP. Tax arrears to the federal budget totalled $17 billion; at the same time, arrears to the consolidated budget (federal and regional) were twice as large. Inter-enterprise arrears represent the largest proportion of total arrears at $63 billion in June 1998.[33] The result is that few suppliers can pay their workers, let alone their taxes. Moreover, in Russia company directors often fail to report to outside shareholders so they have ignored requests for improved productivity. Many company directors have become very wealthy through various corrupt practices, including amassing wage arrears, asset stripping and complicated arbitrage schemes leaving their companies to languish. The implicit subsidies that these inefficient enterprises enjoy guarantee high levels of government expenditure, whilst ensuring that the economy stagnates at a low level. Experience from Poland has shown that bankruptcies must be enforced if restructuring is to be successful.

The unequal competitive environment presents extensive obstacles to the growth of the Russian market and subsequently creates macroeconomic instability. James Gwartney of the *Financial Times* argues that: "The central problem of the Russian economy is simple. The country has a large number of enterprises that are continuing to operate even though they are producing obsolete products ... These must be closed and the resources shifted into genuinely productive activities ... Russia needs to deregulate business activity ... It is impossible to operate a business and comply with existing regulations. The regulatory maze strengthens corrupt politicians and criminal elements that use it to extort wealth ... All regulations that restrain business entry and operation should be abolished."[34]

Increasing risk premiums

In late 1997 and throughout 1998 there was a dramatic increase in the price of borrowing. This was partly due to the Asian financial crisis and the subsequent fear and uncertainty felt towards emerging markets. However, foreign and domestic investors became increasingly concerned with Russia's federal deficit. Tax revenues were not increasing and the precarious

[33]Malleret et al. 1999. p.118.
[34]Gwartney, J. 2000. p.27.

situation was becoming untenable as investors perceived the Russian state was unable to finance its increasing amount of short-term debt.

Further doubt spread when Boris Yeltsin decided to sack the government in March 1998. Anders Åslund subsequently wrote: "There are many in the West who think that Boris Yeltsin has gone mad. First, he fired several top ministers, including his Prime Minister ... Then he pressured the parliament to accept Sergei Kiriyenko, a young official largely unknown abroad, as his replacement."[35]

An excessive build-up of short-term debt

"The seeds of the ... crisis were laid three years ago [1995] with the creation of a market for domestic government debt. Theoretically, this would allow the government to finance its deficits in a non-inflationary way, that is, without printing money. But ... the government rapidly began accumulating an unsustainable pyramid of debt"[36]. Russia, in a similar vein to the Asian crisis-hit economies, had become overly dependent on short-term foreign capital leaving the economy vulnerable to an adverse change in investor sentiment.

Continuous disagreement between a reformist government and the conservative parliament stalled reforms and perpetuated the budget deficit. Financing this deficit by borrowing became increasingly difficult when the cost of borrowing began to rise in October 1997, reflecting perceptions of growing risk. By mid-1998, the fiscal situation had become unsustainable. The servicing of debt was crowding-out other spending plans, and nearly one in every three roubles (31% to be exact) of public expenditures were spent on servicing the debt. Furthermore, taxes, which represented 80% of total budget revenues, could pay for just over a half of Treasury bills that became due each month.[37]

The loans to the Russian government were largely in the form of short-term bonds (GKOs), comprising 70% of the market in early 1998.[38] The short-term GKOs have to be refinanced frequently, which is rarely a problem for longer-term borrowing. The continual refinancing of debt means that lenders must always be found to provide the government with further loans. During the first half of 1998 $1 million of Treasury bills had to be rolled over each week,[39] but throughout the spring and summer of the same year, it was becoming increasingly difficult to find new buyers. This meant that the state had to increase interest

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[35] Åslund, A. 1998a. p.10.
[36]Financial Times. World Economy & Finance survey. 2 October, 1998. p.26.
[37]Malleret et al. 1999. p.129.
[38]Ibid. p.116.
[39]EBRD Transition Report: A 1:1. 1998. pp.12-15.

rates to continue attracting investors. However, each interest rate rise only served to increase the government's debt service payments. Boris Kagarlitsky argued that: "The government was hooked on short term debt. The only way it could meet the payments on its bonds was to borrow ever more money ... Inevitably, the point finally came where there was simply no money left in the budget to continue servicing the debt."[40] An additional fundamental weakness was that Russia's short-term foreign debt exceeded its foreign exchange reserves by over 100%. Foreign exchange reserves totalled a meagre $14 billion and $20 billion of GKOs were held by less-than-confident foreign investors. Therefore, the state needed an international rescue loan, from the IMF if it was to pay off maturing bonds and avoid a devaluation of the rouble. Russia was pledged $22 billion, the majority of which would come from the IMF. But investors decided that $22 billion was not sufficient to resolve Russia's fragile fiscal position. The upshot was that capital flight from Russia and other developing economies produced a $2-3 trillion reduction in the value of global stock market capitalisation.[41] The communist-dominated Duma refused to pass procedures essential for reform, such as tax increases and the IMF loan fell through. The point where the government could no longer 'roll-over' its maturing debt led to Russia defaulting on its domestic debt and floating the rouble on August 17th 1998.

Warning ignored: collapse of the Moscow stock exchange

During the first eight months of 1997, the Moscow stock exchange was the best-performing market in the world. The value of Russian shares doubled during 1996 and 1997. The capital inflows led to a vast speculative asset bubble, which saw the stock market rise by 142% in 1996, and a further 184% in the first eight months of 1997.[42] The increased value of the Russian capital markets represented expectations of Russia's potential growth given its conceivably large consumer market, its abundant natural resources and Moscow's location between the East and the West. However, the reality soon became apparent. Investors became increasingly apprehensive after the Asian collapse, Russia's tax collection was stagnating and crony capitalists continued to stifle economic growth by stealing from the state and investing abroad. Russia's financial collapse first began when the stock market fell by 20% in one day in October 1997.[43] But this did not provoke sufficient policy reforms despite the Russian administration, the IMF, and the West all urging for a package of prudent

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[40]Kagarlitsky, B. 1998a.
[41]Hale, D. 1998. p.9.
[42]EBRD Transition Report A1:1 1998. p.12.
[43] Åslund, A. 1999a. p.72.

policies, which was submitted to the Duma in 1998. Yet the Duma, with the backing of the business elites, rejected it and the financial collapse ensued.

The Russian Trading System (RTS) reached a peak of 571.6 on 6th October 1997. By 17th September 1998 it had fallen to 51.7.[44]

An untrustworthy and inadequate banking sector

A fundamental weakness shared by all of the developing countries that have experienced severe financial crises in the 1990s has been a weak financial sector. In 1992 Russia's citizens endured hyperinflation. As a result of this traumatic experience many Russians were apprehensive of holding roubles. Furthermore, the banks were generally not trusted by Russian citizens and, consequently, held few household deposits and financed little private investment. The exception was the proclivity to direct public funds to politically favoured firms. The largest contributing factor to the banking system collapse was the stubbornness of the Russian government to do away with its economic nationalism. The *Financial Times* stated that: "The banking system is a hybrid built from the wreckage of communism with neither the capital nor the credit skills to provide long term investment for the economy."[45] Various Russian banks have also received large indirect subsidies from the government. These indirect subsidies in 1997 took the form of $5.9 billion entered by the Kremlin into funds of the largest fifteen banks, in order to increase their liquidity.[46]

Prior to the financial crisis, the Russian banking sector had little involvement with industrial investments. Instead, the banks had become over-burdened with forward contract liabilities, and by June 1998, the banking sector was greatly exposed to a rouble devaluation. By August 1998, Russian entities possessed $200 billion of foreign contracts, approximately twice the total of the banks' total assets.[47]

An unfavourable environment for foreign direct investment (FDI)

McKinsey stated that: "The absence of bank lending in Poland did not prevent it from achieving a strong economic growth due to FDI and retained earnings ... FDI [has] been the secret of Poland's economic miracle." In stark contrast, Russia has attracted negligible quantities of FDI. In 1997, FDI totalled just 0.5% of GDP. But the former Soviet states of Azerbaijan and Kazakhstan obtained much higher levels of FDI (19.2% and 5.3% of GDP

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[44]International Herald Tribune. 3 June 1998. p.1.
[45]Financial Times. 15 April 1998. Russia Survey. p.4.
[46]Financial Times. 9 April 1997. Russia Survey. p.9.
[47]Malleret et al. 1999. p.116.

respectively) and even the dictatorship in Belarus has attracted more gross FDI than half of Russia's regions.[48]

Unequal competitive conditions are often identified as a major reason for the lack of FDI within Russia. Foreign companies know that they will be exposed to an unfavourable working climate and soon find themselves subject to disproportionate taxation and intrusive inspections by officious inspectors.

Further deterrents against FDI are also evident. For example, companies categorised under the United Energy System (UES) were limited to a maximum of 25% foreign ownership.[49] But crime, corruption and the low quality of infrastructure have also deterred potential investors.

Russia demonstrates immense potential for economic growth. Numerous regions possess vast quantities of natural resources, together with a relatively cheap and well-educated workforce. However, market distortions must be removed, destitute companies must be taken over or forced to cease production.

Crime and corruption

According to Paul Krugman, seven men control approximately one half of Russia's marketable wealth. Therefore, the Russian government only needed those seven men, and a few smaller scale oligarchs, to have paid their taxes, in order, to have resolved the fiscal deficit.[50] Yet the business elite not only own marketable wealth, they also own politicians and they refuse to pay. The lack of an effective judicial and law enforcement system together with deficient public sector salaries and state control of crucial assets has intensified the scope for corruption within Russia. Companies without government connections are subjected to excessive taxes, officious inspectors, arbitrary fines and farcical regulations. This has resulted in an economy which has failed to reward entrepreneurship. When criteria was selected by the Russian public as a means of becoming wealthy, 88% chose connections, 76% dishonesty and just 39% believed that hard work would be rewarded by wealth.[51]

Commentators have often perceived international loans to Russia as profligate. Many within the IMF opposed the July 1998 package believing that these funds would only benefit the oligarchs, who would then siphon the money into foreign bank accounts. The World Bank once provided $5 billion to assist the restructuring of the coal industry, but the money,

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[48]Brock, G. 1998, p.351.
[49] Åslund, A.. 1998b. p.187.
[50]Krugman, P. 1998b.
[51]Yavlinsky, G. 1998. p.71.

according to Boris Kagarlitsky, simply disappeared.[52] Russia's prevailing economic conditions and liberal regulations on international financial transactions have provided ample opportunities for both capital flight and the Russian mafia. Russia's financial markets have become an international centre for money laundering. The majority of international banks have regulations to detect and report money laundering. But because crime and corruption are at the heart of Russia's society it is almost impossible to determine whether money is earned legitimately. In 1999, the Russian Interior Ministry estimated that organised crime controlled 40% of the economy, and that approximately half of Russia's banks were managed by criminal organisations.[53]

The *Economist* stated that: "The unusual thing [within Russia] is not that crime has flourished since 1989. It is that there has been at least an attempt to run Russia as a law governed state. And the worrying thing, for both Russians and the rest of the world, is that this attempt has largely failed."[54]

Anders Åslund argues that Russia's key problem has been the four dominant circles, which have defended corruption and rent seeking, whilst also opposing equitable tax and regulatory reform. The first is the business elite. The second is the state administration, which expanded by 1.2 million bureaucrats from 1992 to 1998, nearly 2% of the labour force. Most of the new employees were inspectors who impede the work of businesses and effectively reduce competition and create monopoly rents for the big companies. The third bracket is the regional governments, which thrive on subsidies. Lastly, the conduct of deputies of the State Duma preserves the profits of the rent-seekers.[55]

Lack of political credibility when challenging the oligarchs

The former Prime Minister, Sergei Kiriyenko (regarded as one of the very few competent and honest Russian politicians of the post-communist period), attempted to "sever the incestuous link between business and politics ... Kiriyenko went straight for the jugular of the economic and political juggernaught, Gazprom, one of the most powerful Russian institutions and a bastion of oligarchy ... The Prime Minister had gone too far in challenging the vested interests at the core of Russia's crony capitalism. He might still have been saved by presidential support, but this was not forthcoming. Following the collapse of the rouble and

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[52]Kagarlitsky, B. 1998a.
[53]The Economist. 28 August 1999. p.18.
[54]Ibid.
[55] Åslund, A. 1999a. p.85.

the decision to default on August 21st, 1998, Yeltsin sacked the entire cabinet for the second time in five months"[56].

Russia's current president Vladimir Putin is generally perceived as a positive impetus for Russia's economic growth, and has promised a 'dictatorship of the law'. Mr Putin has selectively attacked some of the country's most prominent oligarchs including Boris Berezovsky and Vladimir Gusinsky. Mr Gusinsky, and his media company, have experienced a barrage of intimidation from the authorities, and in the civil courts he has been sued by Gazprom regarding a $300 million loan. Having spent four days in prison he was released, in a government-brokered deal, which saw Mr Gusinsky surrender a majority stake in his media empire to Gazprom.

An increasing outflow of federal funds to sub-national governments

In an attempt to reduce the burden on the federal budget and to meet the differing demands of Russia's republics, the federal government allowed the lower regional governments to have greater autonomy over expenditure. In 1992 the regional budget revenue was 11.8% of GDP. In 1997 this figure was at 13.5% of GDP.[57] As the regional budget revenues increased, so did the wastefulness of the sub-national governments expenditure. According to Anders Åslund, about a third of expenditure at regional level goes to communal support and housing. Unfortunately, the regional governments tend to concentrate this area of expenditure on the wealthier members of society, rather than poorer members of the population. Another third of expenditure provides subsidies and in effect, soft budget constraints to many companies. Enterprises should face a credible threat of bankruptcy to promote efficiency. The final third of regional expenditure goes to socially beneficial projects.[58]

2.iii. Exogenous factors

Asian contagion

"The Russian default was the third stage of the global financial contagion that began with the devaluation of the Thai baht in July 1997 ... The devaluations contributed to a slide in world commodity prices, leading currencies of other commodity producers, such as Australia, Canada, Chile and Mexico, to plummet as well. During these two stages, Russia avoided a rouble devaluation thanks to previously pledged IMF support"[59].

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[56]Malleret et al. 1999. p.120.
[57]EBRD. Transition report 1998. A1:1. p.15.
[58] Åslund, A. 1998b. p.186.
[59]Hale, D. 1998. p.9.

Average GDP growth in Asia between 1990 and 1995 was 8% per annum. In stark contrast, Russia had experienced its first year of GDP growth since transition began in 1997, of just 0.8%. However, Russia did bear certain similarities to its emerging market comrades.

Following the East Asian financial crisis of 1997, the international financial operators began to reassess their exposures to other 'emerging markets' bearing similar fundamental weaknesses that underlay the Asian debacle. These characteristics included a dependency on short-term 'hot money' foreign deposits, a fixed exchange rate, inadequate foreign exchange reserves, a weak financial sector and governments, which were feeble in the implementation of macroeconomic objectives. Furthermore, Malleret *et al.* believe that: "It was feared that the long-term implications for such markets might be secular not cyclical."[60] Russia was clearly vulnerable to a self-fulfilling financial panic.

From October 1997 onwards, investor sentiment became increasingly bearish. Loans to the Russian government began to be called in as the potential for a financial crisis was realised. During January 1998 $600 million of foreign money left the rouble-denominated bond market.[61] The dramatic outflow of foreign capital meant that the government had to opt for one of two unfavourable choices facing it. To devalue its exchange rate or to raise interest rates. Initially, they chose the latter and raised interest rates to exceedingly high levels (which touched 150%) in order to defend its exchange rate. However, each interest rate rise only served to worsen public finances, in turn this further deteriorated investor confidence. Arguably, the Asian crisis precipitated a looming Russian financial crisis.

Fear of competitive devaluations

In late July 1998, the Japanese yen resumed its decline vis-á-vis the U.S. dollar. Primary commodity prices continued falling, further reducing export earnings of mining and agricultural sectors within the Asian region. Finally, economic growth within the U.S. was forecast to slow. These factors seem to suggest an imminent devaluation of the Chinese renminbi, which would then prompt further devaluations within the region. The potential for a new round of devaluations throughout many emerging markets led to a renewed 'flight to safety' as investors continued to head for safer climes.

Weaker commodity prices

The Asian financial crisis together, with the strong U.S. dollar, depressed the prices of primary commodity goods. Primary commodities account for 80% of merchandise exports in

[60]Malleret et al. 1999. pp.113-114.
[61]Financial Times. 5 February 1998. p.18.

Russia. This huge reliance upon the relative price of these commodities was partly the result of deindustrialization that had taken place since 1992.

Export incomes fell by 11% year-on-year in the first half of 1998.[62] Contracts for primary commodities in Russia were largely short-term. This meant that export earnings would fluctuate in accordance with the short-term prices. Consequently, the external and fiscal balances of the country deteriorated. In the first six months of 1998, Russia's trade balance fell by $7.5 billion in comparison with the same period in 1997; at the same time, the country experienced its first post-communist current account deficit (-3% of GDP).[63]

In 1998 the price of a barrel of oil had fallen, from the previous year, by $10 to just $14 a barrel. Although, it was only the export price that declined, the domestic price remained at roughly $11 a barrel.[64] The decline in commodity prices occurred at a precarious time for the Russian economy and only served to exacerbate risk aversion amongst investors.

Moral hazard

In addition to the untimely exogenous shocks Russia was experiencing, moral hazard had manifested itself within the international financial community. When a large international rescue loan is forthcoming, in an attempt to alleviate financial speculation and restore market confidence, it can actually encourage governments and investors to behave recklessly. This phenomenon is known as moral hazard.

Many of the investors that remained in the Russian market following the Asian debacle and subsequent international rescue loans, believed that the IMF and other such organisations would continually intervene and 'bail them out'. Jeffrey Sachs of Harvard University argued that: "U.S. investors wanted to get their money out of Russia ... without devaluation losses, [so the IMF stepped in believing it could] outsmart the market."[65] Moreover, Malleret *et al.* argue that: "By [July 1998] the U.S. government had clearly thrown caution to the winds of the moral hazard issue and decided to go ahead with the bail-out."[66] Bordo and Schwartz believe that: "The IMF has repeatedly suspended loans to Moscow because of its failure to live up to its promises, but has then resumed lending for fear of contagion."[67] (Moral hazard will be discussed at length in Chapter 6.)

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[62]United Nations, Economic Survey of Europe, 1998, no.3, p.31.
[63]Malleret et al. 1999. p.111.
[64] Åslund, A. 1998b. p.186.
[65]Sachs, J. 1999a.
[66]Malleret et al. 1999. p.125.
[67]Bordo & Schwartz. 1998. pp.42-43.

2.iv. The effects of Russia's financial crash

Domestic effects

The August 17th 1998 devaluation saw the rouble plummet from 6.3 roubles per dollar to 20.8 per dollar on September 8th 1998.[68] Russia's economy contracted by at least 4.6% in 1998. In 1998, the Russian central bank spent $10 billion in a failed attempt to maintain the rouble's exchange rate anchor.[69] The government was left with even fewer means to fund its expenditures. Defaulting on its domestic debt did immense damage to Russia's already poor reputation within the world investor fraternity. The expected reaction to the crisis by the weak Russian government was that the money supply would be increased to finance their budget deficit, whilst the consequent rise in inflation would reduce wage arrears in real terms. But expenditures have only been evident on the most essential of projects.

The devaluation increased the price of imported goods significantly as the purchasing power of Russian consumers deteriorated. The consumer price index (CPI) rose to 60% from July to September 1998. In 1996 only 18% of Russians lived below the poverty line. This figure rose to 30% after the financial crisis.[70]

The devaluation of the rouble led to a collapse in the volume of imports entering Russia, falling by 65% from August to September 1998.[71] Conversely, the depreciation of the rouble has made domestic producers much more competitive and Russia's trade account achieved a surplus of $2 billion in November 1998.[72]

The oligarchs have been plundering the state for many years and have been incredibly successful in so doing. However, they were adversely affected by the 1998 financial collapse. "August's financial crisis was a logical outcome of the oligarch's war, as they tried to maintain their high and dubious incomes by any means. In the end, the Russian state could no longer deliver enough cash to satisfy their ravenous appetites. The crash radically reduced the amount of money that could be made on the state - and thus the power of the corrupt businessmen"[73].

External Effects

The August 1998 financial crisis and its aftermath inevitably harmed the export industries of Russia's trading partners. The balance of payments of the CIS countries was dramatically

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[68]RET. October 1998. p.1.
[69]Pinera, J. 2000. p.70.
[70]International Herald Tribune. 17 February 1999. p.1.
[71]RET. October 1998. p.1.
[72]RET. February 1999. p.9.

weakened by the events in Russia and the Russian crisis reduced output of many of the CIS countries by as much as 5%.[74]

Financial contagion continued to proliferate following Russia's crisis. The *Financial Times* wrote: "Investors watching Russia stumble to the brink of financial collapse in the past few days did what they always do in a crisis - bought German government bonds in search of the safest haven for their money."[75] Inevitably, this led to a continued tightening of liquidity across other emerging markets, particularly Latin America. The Russian crisis exposed Brazil's twin deficits on the current account and public finances. In January 1999, Brazil abandoned its exchange rate peg.

Russia in the new millennium

In 1999, GDP grew by 3.2%. This represented the first significant growth since the transition to a market economy began.[76] (See Table 1, p.65.) Economic growth was a record 8.3% in 2000[77] and industrial production rose by 10%.[78] Inflation has fallen from around 90% in 1999 to an estimated 20% for the whole of 2000 and the rouble has stabilised, having fallen in nominal terms by 75% in 1998 and 31% in 1999. Furthermore, the central bank's foreign exchange reserves have increased to U.S. $25.9 billion in March 2001 and Russia is enjoying a large current account surplus, which rose from U.S. $2.4 billion in the fourth quarter of 1998 to $46.4 billion in the fourth quarter of 2000.[79] Moreover, Russia's federal budget has been turned from a chronic and unsustainable deficit to a surplus amounting to 4% of GDP in the first half of 2000. The surplus has been achieved through increased tax collection, primarily through higher export and excise tax receipts.[80] There has also been a significant decline in barter transactions because cash has been more available. Hence, the costs of conducting barter transactions have grown in relation to using more readily available cash.

Unfortunately, these favourable statistics do not indicate that Russia has left behind the years of decline and stagnation to begin a course of sustainable long-term growth. Major problems still afflict the Russian economy. A Moscow investment bank, Renaissance Capital, estimates that one-third of the recovery in GDP since 1998 is the result of the

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[73] Åslund, A. 1999b. p.73.
[74]Raiser & Sanfey. 1998. pp.537-538.
[75]Financial Times. 1 September 1998. p.2.
[76]RET. October 2000. p.3.
[77]The Economist. 12 May 2001. p.52.
[78]OECD. Economic Outlook. December 2000. pp.128-129. No. 68.
[79]The Economist. 12 May 2001. p.146. 28 August 1999. p.90 and 19 May 2001. p.136.
[80]OECD. Economic Outlook. December 2000. pp.129. No. 68.

trebling of world energy prices, and the remainder is due to the 75% devaluation of the rouble.[81] The U.S. dollar has risen against most currencies, which has enabled Russia to obtain more for its exports of raw materials because they are mainly priced in dollars.

But Vladimir Putin's chief economic adviser, Andrei Illarionov, argues that these favourable factors should have increased GDP by over 14% in 2000 alone, rather than just 8.3%. "So the net impact of economic policy, at a time when the government claims to have launched serious economic reforms, has been to produce a drag on the economy [worth almost six percentage points]"[82]. Mr Illarionov reckons that almost half of the competitive benefits of the devaluation have been eroded by inflation and hence the appreciation of the real exchange rate. But owing to continued capital flight (which amounted to a conservative estimate of $100 billion from 1990-2000[83]) some upward pressure is being removed. Mr Illarionov is highly critical of the government's fiscal policy, "both for failing to control spending (non-interest expenditure is up 28%) and for not raising taxes. Only 15% of the 'windfall' has been captured by the state. Much more has gone on imports and in capital flight"[84].

Gaddy and Ickes argue that the decline in barter transactions is the result of the real depreciation of the rouble, which has shifted behaviour towards the greater use of money. "This is a behavioural change, but it does not represent restructuring"[85]. A further mitigating factor slowing Russia's economic growth has been the deterioration in household incomes, which in 1999 were approximately 75% of the 1995 level. Inevitably, this has reduced domestic consumption and Gaddy and Ickes believe that the rise in company profits has come largely at the expense of a decrease in real wages, which fell from an average hourly rate of $1.10 in July 1998 to $0.45 in May 2000. Owing to the increased real cost of imported inputs in sectors such as machinery manufacturing, Russian producers are actually exporting less than they did before the financial crisis, despite their greatly improved trade competitiveness.[86]

Furthermore, some oil importers are already reducing demand due to the high oil prices. Inevitably, this puts pressure on the price of oil and a lower price would slow

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[81]The Economist. 25 November 2000. p.148.
[82]The Economist. 27 January 2001. p.105.
[83]The Economist. 9 December 2000. p.126.
[84]The Economist. 27 January 2001. p.105.
[85]Gaddy and Ickes. 2001. p.16.
[86]Gaddy and Ickes. 2001. pp.15/19.

Russia's current growth. Thus to achieve sustainable growth economic reforms must be undertaken in earnest.

The need for essential reforms

Russia's prerequisite for sustainable growth is the implementation of structural reforms, the most influential of which will be microeconomic. These are the toughest reforms to implement, but they would reap the greatest rewards. The fortuitous current environment should be taken advantage of to install crucial reforms. Hard budget constraints should be enforced, insolvent companies must be shut down and the government must continue to reduce arrears. These additional resources can then be employed more efficiently in other areas of the economy. However, given the absence of an adequate social safety net the consequent unemployment could possibly increase poverty. New jobs must therefore be created. According to Andrei Nesterenko of the Russian Academy of Sciences, unemployment as a result of bankruptcies may not necessarily lead to substantial reductions in living standards for lower income groups if the available social capital is spent in a more intelligent manner. Mr Nesterenko believes that competitive private companies and governments should become involved in the provision of social and public services.[87] To enable this to happen the following vital reforms must be undertaken:

1. The deregulation of business activity.

Enterprises in Russia are subjected to problematic laws, weak legal enforcement, high taxes and corruption, all of which inhibit entrepreneurial activity. To encourage the involvement of private enterprises the business environment must be improved and business activity deregulated. In turn, this would induce entrepreneurial activity and FDI, which is of vital importance for Russia because Mr Nesterenko believes that: "Russia's economic revival must rely almost exclusively on private investment."[88]

It is crucial that earnings are retained for reinvestment and restructuring of property because both the Russian stock market and the country's banks are failing to direct sufficient capital to producers. Presently, investment opportunities are reduced by Russia's persistent capital flight, which exceeds $20 billion a year. Companies and affluent individuals prefer to deposit their money in foreign banks where the legal systems are stronger. But, as noted by

[87]Nesterenko, A. 2000. p.21.
[88]Ibid. p.22.

Anders Åslund, Russia's capital flight also "reflects the country's high level of savings ... a resource for the future[89].

FDI is often regarded as the most productive form of external assistance available from the international community. FDI would be accompanied with the import of efficient foreign machinery and the finest managerial expertise essential for efficient production and much needed restructuring of Russian assets. Poland has attracted considerable amounts of FDI, which have been a vital part of the country's success. Poland's experience with FDI shows that foreign companies will, with the correct incentives, retain profits and invest elsewhere in the economy. Russia should do all it can to attract foreign capital and strive to become a member of the World Trade Organisation. FDI might also help to further weaken the position of vested interests, namely the oligarchs.[90]

2. The establishment of clearly defined property rights.

If private investment is to stimulate a revival within Russia, clearly defined property rights and a system of land entitlement must be introduced. This will provide an incentive for entrepreneurs to develop their land and allow them, where possible, to use it to mortgage further investments.

3. Reform of the tax system.

According to Mr Nesterenko, "what hampers business in Russia most of all are taxes. If entrepreneurs paid all the taxes they owed, they would pay more than they earned"[91]. The tax system must be simplified and reduced. Presently, it forces entrepreneurs to conceal their profits in the shadow economy and punishes honesty. Those who can afford to pay taxes, namely the business elite, must be forced to do so. Little has been achieved in making the tax system more transparent. Despite many proposals only one significant change has taken place - a flat-rate 13% income tax, and a simplified fiscal regime for businesses, which took effect in January 2001. Following the introduction of the 13% flat rate tax income tax revenues increased by 70% because people abandoned expensive tax-avoidance schemes.[92]

Encouragingly, there are now even proposals, which advocate the eradication of tax preferences. The government must insist on cash tax payment and enforce hard budget constraints, whilst discontinuing hidden subsidies to languishing enterprises. Pinto *et al.*

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[89] Åslund, A. 2001. p.23.
[90]Havrylyshyn & Odling-Smee. 2000a. p.10.
[91]Nesterenko, A. 2000. p.22.
[92] Åslund, A. 2001. p.22.

argue that: "Once net creditors realise that the government will no longer provide hidden subsidies through tax breaks and other concessions, the practice of non-payments will end spontaneously"[93]. In addition, law enforcement and an effective judicial system must be established to confirm that the era of non-compliance is over and taxes must be paid.

Further developments and recommendations

A further impediment to Russian economic growth is the country's level of foreign indebtedness. Currently, Russia's foreign debt is equal to about $160 billion and annual repayments are expected to be between $12 billion and $17 billion, during 2001-05. This amounts to over half of the federal budget.[94] This is a considerable burden on the economic development of Russia, given that money continues to leave the country and so ensures a weak domestic economic environment with few investment opportunities. (Table 2, p.65, shows Russia's expected debt repayments 2001-05.) Andrei Nesterneko believes that: "Major debt repayments must be re-scheduled beyond 2005, giving the economy several years to restructure and take off."[95] However, Andrei Illarionov argues that Russia should be taking advantage of the current favourable economic environment and repay the country's debt. He reckons that in doing so Russia would improve the country's image abroad, and also absorb the inflationary effects of the country's extra cash from the $60 billion trade surplus.[96] But Gorban *et al.* believe that: "Despite a significant trade surplus, factors such as capital flight, low tax collection rates and weak government control over expenditure patterns severely limit the amount of funds that could be paid to the external creditors."[97]

In 2000, only ten of Russia's eighty-nine regions provide more funds to the federal government budget than they received from it and they provided the government with over half of the total tax revenues it obtains.[98] President Putin has responded by issuing a decree to have Russia's eighty-nine regions overseen by seven federal administrators. It is hoped that this will help to alleviate the excessive expenditures that result from the misuse of resources in various regions.

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[93]Pinto et al. 1999. p.4.
[94]Nesterenko, A. 2000. p.21.
[95]Ibid.
[96]The Economist. 27 January 2001. p.105.
[97]Gorban et al. 1999. p.1.
[98]Nesterenko, A. 2000. p.22.

*Controls on foreign exchange restrict the availability of foreign currencies by a country's central bank. Controls may be implemented to discourage destabilising short-term capital flows or to rectify a balance of payments deficit.

The Russian government has used currency controls*. For example, Russian exporters were forced to sell 50% of repatriated export revenues in October 1998; this was increased to 75% in mid-January 1999. In March 2000, amendments were made which allowed exporters who were using 25% of revenues to service foreign debts to repatriate just 50%, while other exporters continued to repatriate 75%.[99] Additionally, the foreign exchange licences of some of Russia's most prominent banks were suspended. The Russian government has submitted two bills to parliament. The first will establish state control over foreign exchange transactions, and the second, requires registration of foreign trade transactions, which, if implemented, will enable officials to suspend a transaction if there is evidence to suggest it is disguising capital flight or money laundering.

Russia's banks urgently require restructuring. Jacques Sapir believes that the most effective method of restructuring will be the partial nationalisation of Russia's largest banks. According to Mr Sapir, the initial phase of such a strategy "would comprise deposit or savings banks and would be partly state-owned. These would concentrate on managing the private payments system, in close collaboration with the central bank ... The second part of the banking sector would comprise investment banks, mostly private, that would raise money through the internal financial or stock markets to finance long-term high risk operations"[100]. Mr Sapir believes that the combination of nationalisation and specialisation could greatly enhance the credibility of Russia's banks and he also points out that this is a similar approach as was used by France in 1945 with spectacular results.

Russia should learn from the consequences that were the result of the government's non-payments policy to artificially control inflation. The reduction of inflation must be based on fiscal reform and the government must refrain from inducing an additional build-up of arrears. Stoneman *et al.* argue that: "The pervasiveness and institutionalisation of non-payments is one of the most important impediments to the emergence of an operable market economy. Payment arrears, barter and offsets are, in essence, a highly effective obstruction to the imposition of hard budget constraints"[101]. However, arrears have fallen markedly. (See Table 3, p.65.)

[99]Westin, P. 2000. p.5.
[100]Sapir, J. 1999. pp.15-16.
[101]Stoneman et al. 2000. p.5.

Another measure that would considerably improve federal budget revenues would be the imposition of a 10% tax on exports. Mr Sapir believes that this would provide additional receipts of 4.7% of GDP, "enough to manage the current deficit problem"[102].

Currently, the fortuitous environment provides little incentive for Russian enterprises to restructure and become more efficient. But, as identified by Gaddy and Ickes, there is an ironic paradox regarding those enterprises, which invested, in an attempt to improve their competitiveness, prior to the August 1998 devaluation. These enterprises may have incurred dollar-denominated debt to enable them to purchase foreign machinery. Consequently, these enterprises endured significant exchange rate losses following the August 1998 devaluation.

Jose Pinera, who was responsible for the privatisation of the Chilean pension system from 1978 to 1980, believes that the privatisation of Russia's pensions will drive economic growth. According to Mr Pinera, if Russia does this properly and runs pension reform in parallel with other reforms, "pension reform can stimulate a virtuous cycle in which workers invest their savings in capital markets, and markets increasingly invest in Russia as both the financial and the corporate sectors develop"[103].

Mr Pinera also believes that Russia should replace the rouble with the euro (but this does not mean joining the European Union or adhering to E.U. policy standards). He argues that the majority of Russian citizens have little faith in either the Russian central bank or the rouble and many citizens actually prefer to use the dollar and other foreign currencies whenever they can. The euro should be chosen rather than the dollar because Russia appears to identify more closely with Europe than America. Moreover, the euro is not associated with one particular country and, most importantly, the E.U. is not Russia's superpower rival. This 'dollarization' would greatly increase investor confidence in Russia, which would be reflected in lower interest rates. (Dollarization is discussed in Chapter 6.) Adopting the euro would also provide greater security for long-term loans, such as mortgages, which, according to Mr Pinera, are practically non-existent today. "Use of the euro, a liberalised banking sector integrated into the international financial system, and greater domestic competition will finally enable Russians to use the world's and their own savings for productive purposes"[104].

According to Andrei Nesterenko, "[Vladimir Putin's] economic achievements will depend on progress being made in four areas: bringing down foreign debt, creating a market

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[102]Sapir, J. 1999. p.17.
[103]Pinera, J. 2000. p.68.
[104]Ibid. p.71.

friendly environment, restructuring the real sector, and bringing order to economic federalism"[105].

Stoneman *et al.* believe that: "[Russia is] going through a revolution as profound as 1789 in France or the English Civil War."[106] McKinsey found that there are no natural or economic obstacles in Russia that would impede high economic growth. Russia has a relatively cheap and skilled workforce, substantial energy reserves and considerable spare capacity in potentially profitable industrial resources.[107] Over the long term, it is conceivable that Russia can realise its potential and achieve advanced economy status.

Market distortions must be removed and the industrial sectors with the greatest growth potential, such as oil and light manufacturing (consumer goods and food processing), could flourish to replace imports that are likely to increase with any appreciation of the exchange rate. Pinto *et al.* estimate that the absence of market distortions would lead to large inflows of FDI and that annual growth of 8% would be attainable. If this growth is sustained over 15 years Russia could reach the GDP level of Spain or Portugal.[108]

However, a strong argument can also be made in favour of Russia's continued stagnation. Nobody doubts the country's potential but, as noted by Stoneman *et al.*, "the task of managing Russia's inherited industrial infrastructure would challenge the most advanced economic, political, civil, and management institutions. Unfortunately, all these institutions are weak in post-Soviet Russia"[109]. Furthermore, Russia's development will be a costly process, with experts estimating that $2 trillion will be required to modernise the country's infrastructure, labour force and production facilities.[110]

2.vi. Conclusion

The Asian financial crisis adversely affected Russia, owing to the country's large federal budget deficit and its means of financing this deficit by relying excessively on short-term borrowing. Investors began to demand greater risk premiums, but each interest rate rise only increased the government's debt-service payments. The upshot was, that yet more funds had to be borrowed to cover the additional cost of borrowing. However, throughout 1998 investors became increasingly unwilling to 'roll-over' their loans to the Russian government,

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[105]Nesterenko, A. September 2000. p.21.
[106]Stoneman et al. 2000. p.6.
[107]McKinsey Global Institute. Solow et al. 1999.
[108]Pinto et al. 1999. p.4.
[109]Stoneman et al. 2000. p.6.
[110]Nesterenko, A. 2000. p.20.

despite interest rates being offered in excess of 150%. The situation was unsustainable, the rouble was devalued and the government defaulted on its domestic debt. Russia should have devalued its currency in response to the growing pressures from the Asian crisis, and adopted a more flexible regime, which would have provided a far smoother adjustment to exogenous disturbances. Pegged exchange rates appear inconsistent with international capital mobility and massive private capital flows.

The government's inability to obtain tax revenues was the consequence of various market distortions, which, in turn, were the result of too many partial reforms when Russia first embarked on transition to a market. From 1992 to 1998 Russia performed far worse than was expected. Archie Brown of Oxford University has argued that: "Both Russian marketeers and their Western advisers were from the outset of the post-Soviet period far more interested in building a market economy than in building a democracy. As a result of these misplaced priorities they built neither the one nor the other."[111] The Russian transition began with great endeavour; privatisation and monetary stabilisation was essentially achieved by the mid-1990s. However, economic reform after 1995 was disappointing. Anders Åslund argued that: "Consecutive Russian parliaments have continuously voted against serious market liberalisation; real reformers were in power only from November 1991 to June 1992."[112]

Russia's experience is in many ways incomparable with any other economy in transition. Radical reforms have achieved notable successes elsewhere so why not Russia? The fastest reformers have been those countries closest to Western Europe, such as Poland and Hungary. These countries were generally more economically developed at the start of transition and they had also had less time under socialist rule. Furthermore, these countries enjoy the incentive of prospective accession to the European Union, which has encouraged radical reform. Stoneman *et al.* conclude that: "The battle for Russia's future remains undecided. The revolution will only be over when effective reforms take hold and when sustained economic recovery is clearly underway. By the same token, continued economic stagnation will suggest that the struggles of competing interest groups remain unresolved and the revolution has yet to run its course."[113] But a lot will depend on the performance of Vladimir Putin. James Gwartney believes that: "If Mr Putin moves slowly and timidly,

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[111]Brown, A. 1999. p.57.
[112] Åslund, A. 1999. p.75.
[113]Stoneman et al. 1999. p.6.

Russia will continue to stagnate. But if he implements the necessary reforms, Russia's economic rebound will be the story of the decade."[114]

[114]Gwartney, J. 2000. p.27.

Table 1. Russia's GDP % change on a year earlier 1990-2002

'90	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02
-4	-13	-19	-12	-15	-3	-3.5	0.8	-5	3.2	8.3	4	4

Figures for 2001 and 2002 are OECD estimates.
Sources: Economies in Transition: comparing Asia and Europe. 1997. p.163. The Economist. 25 November 1999. p.148 and 12 May 2001. p.52. OECD Economic Outlook. December 2000. p.129.

Table 2. Russia's expected debt repayments 2001-2005, $ billions.

	'01	'02	'03	'04	'05
IMF	2	3.3	3.1	1.5	1.3
Eurobonds*	3.5	2.7	4.3	3.7	6.1
Official Creditors	2.3	2	1.4	0.7	0.5
Paris	3.2	3.4	1.5	1.5	3.5
Other	2.8	3	8.4	5.1	3.1
Total	13.8	14.4	18.7	12.5	14.5

* includes payments on restructured debt to the London Club.
Source: The Economist. 13 January 2000. p.94.

Table 3. Total wage arrears 1998-2001. Roubles billion.

	Total Wage Arrears, rbs billion.
'98	77
'99	43.7
'00	31.7
'01*	32.3

*2001 is an estimate.
Source: Russian Economic Trends, monthly update. March 2001. p.7.

CHAPTER THREE: THE ASIAN FINANCIAL CRISIS AND CHINA

Background

China is the largest country in the world and home to over a fifth of mankind. "It presently has a government struggling to make the transition from impoverishing communist economics to market capitalism. That is a formidably difficult task given China's size and the former backwardness of its economy. So far, the Chinese leadership has managed the transition quite adroitly"[1].

In 1978, China began a programme of economic reform to gradually transform the country into a market economy. The majority of productive assets were owned by the state, so in an effort to ignite economic development the Chinese authorities attempted to deregulate the economy, opening up markets and enabling entrepreneurs to establish private businesses. Foreign trade and investment were liberalised, enabling China to enjoy huge inflows of foreign direct investment (FDI) and rapid increases in income, primarily through the highly efficient export sectors. Additionally, state controlled prices have been gradually relaxed, education standards have improved, and China has achieved remarkable growth since commencing their gradualist transition. (See Table 1 and 2, p.92.)

The former Governor of Hong Kong, Chris Patten, argues that: "Chinese communists embarked on capitalism because communism had so manifestly failed, and its failures threatened to topple the party from power. With their governmental competence questioned and their moral authority in tatters, Deng and his supporters argued through the late 1970s and 1980s that, in order to retain its control of China, the Communist Party would have to show that it could after all make people better off. The only way it could accomplish that was by modernising China, introducing capitalism, and throwing the country's doors and windows open to the outside world ... Improvements in the living standards of parts of China, and parts of Chinese society, have bought time. To many Chinese 'shut up and I'll let you get rich' seemed about as good an offer as the Chinese were likely to get from their government. They preferred the freedom to make money to the absence of any freedom whatsoever."[2]

Some argue that China could become the world's number one economy in terms of total national output in as little twenty years. (See p.88.) But in terms of GDP per capita, it will not rank alongside the advanced countries of the world, such as France, Britain, Germany, Japan and the U.S., for many decades. Gerald Segal believes that: "[China] is

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[1]Patten, C. 1999. p.282.

overrated as a market, a power and a source of ideas. At best, China is a second-rank middle power that has mastered the art of diplomatic theatre ... In 1997 China accounted for 3.5% of world GNP ... The U.S. was 25.6%. China ranked seventh in the world, ahead of Brazil and behind Italy. Its per capita GDP ranking was eighty-first, just ahead of Georgia and behind Papua New Guinea ... Using the U.N. Human Development Index, China is one hundred and seventh, bracketed by Albania and Namibia - not an impressive story."[3]

Yet the Asian financial crisis threw China into the international limelight, and played to the country's ambitions of becoming a world economic power. This is because a devaluation of the Chinese renminbi would have triggered a further bout of currency depreciations throughout the Asian region and ignited fears of catch-up devaluations in the emerging markets of Latin America and Eastern Europe.

Throughout the crisis period the Chinese authorities managed to avoid devaluing the renminbi. In so doing, China received lavish praise from the U.S. for not introducing an additional deflationary impulse to the world economy.

Introduction

China, like the Asian and Russian economies prior to their crises, operates a nominally pegged exchange rate, which allows the renminbi to fluctuate within a strictly defined range. In 1997, the renminbi strengthened slightly against the U.S. dollar and appreciated in the range of 30-80% in relation to its crisis-hit regional neighbours. In 1998, the Chinese economy maintained its impressive rate of growth despite growing by its lowest annual level, of 7.8%, since the early 1990s. China's relentless growth is even more impressive when one considers the harsh recessions that Asia's 'miracle' economies were enduring at this time. (See Table 3, p.92.) The fiscal austerity measures that were introduced in China in 1994 succeeded in controlling inflation and foreign exchange reserves have reached record levels. Moreover, China has consistently generated substantial current account surpluses, amounting to $24 billion in 1997, nearly 3% of GDP.[4]

However, on a closer inspection it would appear that all is not quite as well as the impressive figures above would suggest. Few analysts trust Chinese economic data. Chinese statistics have long been exaggerated for numerous reasons, which primarily include local officials doctoring their statistics to make them and their regions look good. Additionally, China produces some useless goods, which are never sold but are still added to GDP.

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[2]Ibid. p.142.
[3]Segal, G. 1999. p.24.
[4]Fernald & Babson. 1999.

Possibly the most significant difference between China and the crisis-hit Asian economies is that China possesses a current account surplus. (See Table 4, p.92.) However, China's seemingly impressive current account surplus of $24 billion in 1997, is actually offset by Hong Kong's current account deficit of $19 billion, "reducing the total to a fairly unimpressive $4.6 billion. China's trade surpluses, in other words, are largely a statistical illusion"[5].

The primary recipient of China's bank credits has been the state-owned enterprises (SOEs), 45% of which are insolvent. It is therefore no surprise that even "by conservative estimates, at least a quarter of Chinese loans are non-performing - a rate that South-east Asians would have found frightening before the crash"[6].

Few market participants questioned China's vulnerability to Asian contagion until Hong Kong's currency and stock market were subjected to fierce speculative attacks, forcing a collapse in asset markets, which, in turn, struck the stock exchanges of Shanghai and Shenzhen. Analysts then began to focus on China's slowing export sectors, which had lost a considerable degree of price competitiveness following the East Asian currency devaluations. These devaluations prompted concerns that China's inflows of FDI would subside, given that the vast majority of inflows are received from the East Asian region.

Clearly, China had many of the same ailments that were inherent failures within both the fallen Asian economies and Russia. In fact, China exhibits pervasive corruption and considerable nepotism, but crucially, less vulnerability to a financial panic.

3.ii. Evidence of China's vulnerability to financial crisis

A weak banking sector

The Chinese banking system provides a clear example of the similarities between China and the crisis-afflicted economies of East Asia and Russia. China's banks are weak and suffer from deficient regulation and supervision. They provide easy credit to inefficient, over-leveraged state enterprises and their cronies. Speculative property development is rife within many Chinese cities, one of the aspects that were central to the rise in non-performing loans (NPLs) in Malaysia, Thailand and Indonesia. Shanghai has built more office space in one decade than Hong Kong built in four. Moreover, Nicholas Lardy believes that: "At least 20% of outstanding loans are bad by Western standards (roughly 18% of GDP), indicating that Chinese banks possessed approximately $145 billion in bad loans at the end of 1996. At the beginning of 1998, China's state banks had a declared capital base of $54 billion meaning

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[5]Krugman, P. 1997.

that the banks are bankrupt three times over. However, Mr Lardy considers that a more realistic estimate of the extent of Chinese bad loans is 70% of GDP!"[7] Mr Lardy claims that an additional "vulnerability China shares with the Asian countries in crisis is an enormous build up of NPLs ... The ratio of NPLs in China is substantially higher than it was in South Korea, or Thailand before the crisis"[8].

A further Chinese vulnerability to Asian contagion was identified by Fernald and Babson: "Weak banking systems are a particularly important problem if the banking system is large relative to the economy ... The size of China's banking system is similar to that in the rest of Asia. In particular, the median ratio of bank loans relative to GDP was 93% in Malaysia, almost identical to the ratio in China."[9] The absence of clear bankruptcy laws enables insolvent banks and companies to continue operating, whilst managers lack the necessary incentives to ensure that their companies perform efficiently. These insolvent enterprises are able to persist with their money-losing activities thanks to government subsidies and the absence of market mechanisms that would otherwise enforce bankruptcy.

Chinese banks continue to lend blindly and support money-bleeding state enterprises. This is because they are aware that the authorities will guarantee bank deposits, which are primarily held in state-owned banks. Therefore, household depositors still have confidence in the banking system, and the deposit base remains sound. However, the longer that the banks persist in financing the insolvent state-owned enterprises, the greater the likelihood depositors will lose confidence in the Chinese banking system, requiring an intervention by the Peoples Bank of China (PBOC) to act as 'lender of last resort'. But, this may only succeed in exchanging a banking crisis for a fiscal and, in turn, current account crisis.

The competitive threat to China's export sectors

China's trade has been one of the primary ingredients that have promoted economic growth since 1978. In 1997, China's net exports contributed 19.2% to economic growth, 10% higher than the average level since the start of the reforms.[10] International trade played only a limited role in China's growth at the start of economic reforms in 1978, when the Chinese authorities concentrated production on import substitution. However, by 1994 the annual value of China's exports was U.S. $102.6 billion from approximately $7.3 billion in 1978.[11]

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[6]Segal, G. 1999. p.26.
[7]The Economist. 14 February 1998. p.69.
[8]Lardy, N. 1998. pp.82-85.
[9]Fernald & Babson. 1999.
[10]Economics blue book of the Peoples Republic of China, 1999. p.295.
[11]Henderson, C. 1999. p.11.

Despite the Asian crisis the renminbi remained relatively stable, and the Chinese currency consequently appreciated by around 30-80% relative to the ASEAN currencies, reducing Chinese export competitiveness in these markets. China's 1998 current account surplus weakened and year-on-year export growth fell from 20.9% throughout 1997 to 8.6% for the first five months of 1998.[12] This was a result of the collapse in domestic demand and increased competitiveness of East Asia. The contagion effects on trade occur as a result of the reduced income level of the crisis-hit countries. Hence, China's exports to East Asia slowed markedly given the renminbi's real appreciation vis-à-vis China's regional neighbours. This has illustrated the importance of diversifying export destinations as an aid against contagion. Moreover, 20% of China's exports are destined for the Japanese economy, which was (and still is) enduring a prolonged economic recession. This was compounded by a depreciation of the Japanese yen vis-à-vis the U.S. dollar, which worsened Chinese export weakness in this market. Some 40% of Chinese exports were destined for Asian markets (including Hong Kong), where growth slowed markedly and the Asian devaluations improved much of East Asia's wage costs in relation to China. Although China was not hit by an adverse turn in investor sentiment, the belief that China was completely insulated from the Asian crisis is incorrect. China's exports contributed approximately 2% to the country's 1997 growth of 8.8%.[13] Consequently, the slowdown in export growth threatened GDP growth and, more importantly, the slower export growth jeopardised the reform programme of SOEs. This was because the Chinese government had been relying upon strong export growth to provide employment for the millions of SOE workers that are being made redundant each year from SOE reform.

Despite the depreciation of ASEAN currencies, China still possesses a number of advantages in producing low-end manufacturing products, which the country specialises in. Average monthly wages of $60 are a third of those that would be demanded in Thailand. The *Economist* argued that: "ASEAN's manufacturers offer little threat to China's - quite the contrary. China has a near bottomless pool of cheap labour, useful economies of scale, and growing domestic demand to supplement the market for exports. In almost any manufacturing process China gets into ... It soon becomes unbeatable."[14]

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[12]Kynge and Ridding. 1998.
[13]Ibid.
[14]The Economist. 2 December 2000. p.94.

However, China experienced deflation after October 1997. This was partly a result of domestic oversupply, but deflationary pressures were also being imported thanks to cheap foreign imports, which suggests that the renminbi is overvalued. Indeed, the East Asian devaluations provided further deflationary impulses to the Chinese economy. This is because cheaper East Asian products flowed into the Chinese market, further weakening prices in already saturated Chinese goods markets. Overcapacity in the Chinese economy indicates that additional inflows of FDI will achieve lower profit margins. Thus, a prolonged slowdown of the Chinese economy would result in a decline or even a reversal of FDI. Consequently, there were fears that the government would provide an inflationary impulse to the Chinese economy by allowing a devaluation of the renminbi, which would have raised the real price of imports into the Chinese market.

However, if the Chinese authorities had chosen to devalue the renminbi they would have triggered an additional round of 'beggar-my-neighbour' currency devaluations throughout the Asian region, or at the very least expectations of such depreciations. This in turn, would have caused a further rise in the price of emerging market borrowing throughout the world as investors re-appraise their exposures to similar economies. Moreover, a Chinese devaluation would have widened "China's trade surplus with the U.S., which is likely to exceed $30 billion this year [1997]. American politicians already complain that their country's bilateral trade deficit with China is intolerable, and China's leaders know that a trade war with America would be sure to destroy any economic benefit from devaluation"[15].

China's state-owned enterprises (SOEs)

"The state sector sucks in four-fifths of investment clogging the banks with bad debts and starving private firms of cash"[16]. In 1997, over 6,000 SOEs were bankrupted and that number continues to rise, increasing unemployment and the need for adequate welfare benefits. Many insolvent SOEs, which continue their money losing activities, are unable to pay wages to employees, igniting further social tensions. China has approximately 110,000 medium and large sized SOEs, nearly 50% of which are insolvent. These SOEs employ around 120 million workers, of whom approximately 50 million are believed to have no useful work to do.[17] Chris Patten has stated that: "Lending from the state banks to these firms is hollowing out China's banking system, which it would probably cost about 25-30% of China's GDP to recapitalise ... China's high savings are in effect, drained away each year

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[15]The Economist. 13 December 1997. p.97.
[16]The Economist. 14 February 1998. p.20.
[17]Patten, C. 1999. pp.143-144.

to bail out the money losing state enterprises, which swallow three quarters of the country's investment but deliver well under half its industrial production. This is why China is so crucially dependent on attracting foreign investment."[18]

The growth of the Chinese exporting sectors was supposed to provide employment for the millions of workers made redundant through government SOE reform, but the reduction in export demand from the East Asian region slowed Chinese export industry growth and threatened the reform process. The SOEs operate with inadequate incentives to perform efficiently and have little reason to be productive. Callum Henderson believes that: "If the SOEs are allowed to any major extent to carry on with the old unproductive practices ... One of two things could occur: a Soviet-style collapse of the state sector or a rising and intolerable burden on the state budget if the government seeks to avoid the former ... The SOE problem has to be dealt with now, however much pain it causes, for the alternative will surely be even more painful."[19]

China's outstanding credit has grown from 53% in 1997 to 100% in 1998; a ratio reminiscent of South Korea prior to Korea's financial crisis. The SOEs are the primary recipients of bank credit and their balance sheets have deteriorated markedly as the debt they owe has increased dramatically. In 1978, when the gradualist economic reforms began "[SOE] balance sheets were quite strong, reflected in a debt-to-equity ratio of about 10%- about a fourth or a fifth of what one would expect among firms in a market economy. Because of a rapid increase in their borrowing, by the end of 1995 the debt-to-equity ratio of all state-owned firms ... exceeded a striking 500%. This change implies that many of China's state-owned firms are insolvent- some cannot even cover their operating costs with their income. Because of their highly leveraged position, more and more firms will be unable to service the debts if the economy slows down, further undermining the weak financial position of banks"[20].

The reduction of the number of SOEs in the Chinese economy will require a vast reallocation of labour and capital. SOE reform will cause widespread redundancies, a politically difficult step, which can only be made easier if new jobs are created for the laid-off workers. Thus investment within the non-state sector must continue. Any reduction in FDI flows to China would make this transition more difficult and jeopardise SOE reform.

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[18]Ibid.
[19]Henderson, C. 1999. pp.212-213.
[20]Lardy, N. 1998. pp.80-81.

Some 80% of China's FDI is courtesy of ethnic Chinese living in East Asia. Utilised (as opposed to contracted) FDI inflows to China have risen at an annual rate of 28% from 1983 to 1997 and amounted to approximately $45 billion in 1997 and 1998, followed by $41 billion in 1999. The Chinese mainland now accounts for approximately one third of the total stock of FDI destined for emerging markets and China's stock of FDI ($350 billion) is the world's third largest, behind the U.S. ($1.1 trillion) and Britain ($394 billion).[21] However, 1997 was a "year of record capital flight from China by some reckonings, an outflow of $35 billion. Much so-called investment from East Asia makes a round-trip from China via some places like Hong Kong and then comes back in as FDI to attract tax concessions"[22].

China's current account surplus indicates that the country is a net exporter of capital. The Chinese Central Bank often purchases U.S. treasury bonds and other foreign exchange assets. However, it is "hard to understand how China can attract so much foreign investment without running a large current account deficit. Where does the money go? ... [Russia runs the biggest trade surplus of all] ... obviously this isn't because the Russian economy is super competitive. What that trade surplus actually reflects is Russia's sorry state, in which nervous businessmen and corrupt officials siphon off a large fraction of the country's foreign exchange earnings, parking it in safe havens abroad rather than making it available to pay for imports. China ... suffers from a milder form of the same ailment. The reason those inflows of foreign capital don't finance a trade deficit is that they are offset by outflows of domestic capital ... In other words, that [trade] surplus is a sign of weakness rather than strength"[23].

A further similarity between China and Russia, in 1997, was the running of budget deficits, which indicate poor government discipline over the collection and spending of public revenues. Indeed, Russia and China's budget deficits are primarily the result of soft budget constraints - government support for insolvent enterprises. Although China's budget deficit was only 0.2% of GDP in 1996, this figure does not include SOE deficits financed by the central bank (the PBOC). When these deficits are included, the budget deficit amounts to 6% of GDP[24] similar in size to Russia's budget deficit in 1997 of 6.5% of GDP.[25] This is why the Chinese government is attempting to reform the SOEs and therefore greatly reduce the burden of supporting them through the PBOC. However, in the short-term this restructuring process only aggravates the economic slowdown.

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[21]The Economist. March 10 2001. p.26.
[22]Segal, G. 1999. pp.27-28.
[23]Krugman, P. 1997.
[24]Henderson, C. 1999. pp.32-33.

The absence of efficient capital markets

A misallocation of capital contributed to the onset of the Asian crisis. This misallocation was essentially due to the absence of efficient and transparent asset markets. Capital inflows were consequently directed towards inefficient and often corrupt activities. China's capital markets are currently rampant with speculative activities as a result of ambiguous regulations and weak supervision. China's 'A' share market capitalisation amounts to approximately 50% of China's GDP, representing Asia's third largest stock market behind Tokyo and Hong Kong. China's 'A' share market was the world's best performer in 2000, yet this was partly achieved by "market-ramping carried out by a handful of powerful insiders ... The managers of ten big investment trusts took regular trips to the sauna. There ... they rigged the market"[26].

Foreign investors are still unable to purchase renminbi-denominated 'A' shares. Instead, they must purchase independently priced, and foreign currency-denominated, 'B' shares. However, the majority of foreign investors invest only in the mainland companies that have issued 'H' shares, which are listed in Hong Kong. This is because these shares enjoy the security of Hong Kong's common law system. But according to the *Economist*, "the fragmentation of China's equity markets negates much of its purpose. A company with 'A', 'B' and 'H' shares today has three wholly different valuations, none with much connection to fundamentals ... [In February 2001] 'A' shares traded at four times the price earnings ratio of the corresponding 'B' shares in Shenzhen, and three times the ratio in Shanghai. The gap between 'A' and 'H' shares is not much smaller. Distortions such as these were bound to persist as long as domestic savings remained locked in Chinese currency shares, and overseas savings remained locked out of them"[27].

3.iii. China's evasion of the Asian currency meltdown

Despite China's apparent similarities to the crisis-hit East Asian economies, the renminbi did not endure the sort of speculative attacks that East Asia were subjected to in 1997. This was because the Chinese capital account remains essentially closed. Only the current account has been liberalised for international transactions. Beijing would claim that this is proof of the wisdom of adopting a slow and gradual process of economic reform, as opposed to 'big bang' liberalisation, which has resulted in only a partially liberalised Russian economy that was

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[25]RET. March 1998. p1.
[26]The Economist. 3 March 2001. p.100.
[27]Ibid. p99.

vulnerable to a financial panic. In the Asian economies the sequencing of capital account liberalisation was headlong and, consequently, lacked competent regulatory measures.

In addition to China's inconvertible currency, the country has a vast pool of foreign exchange reserves relative to short-term debt. In 1997, China's foreign exchange reserves amounted to $140 billion.[28] Such liquidity provides a crucial defence against financial market volatility, particularly when reserves are in excess of short-term debt.

China's guiding principles on capital controls

Commentators have often stated that China's favourable external fundamentals, most notably a healthy current account surplus and foreign exchange reserves in excess of short-term debt, would themselves preclude a self-fulfilling financial panic on the Chinese renminbi. But, more importantly, China's closed capital account prevents domestic residents or foreign speculators from exchanging the renminbi for speculative purposes. "The key elements of China's capital controls are a universal requirement for registration, strict criteria of approval, tight control over using foreign exchanges and severe penalties for breaching regulations"[29]. The main objectives of China's capital controls are as follows:

1. Restrictions on levels of borrowing.

The authorities have emphasised the importance of increasing domestic savings rates; foreign capital inflows have been considered as supplementary. This has enabled China to maintain current account surpluses over the last twenty years, despite being one of the world's largest foreign capital-absorbing nations. At the same time these restrictions have inhibited financial intermediaries from borrowing excessively in foreign currency-denominated loans, which has prevented an expansion of balance sheets that was seen elsewhere in Asia.

2. FDI is the more desirable form of capital inflows, whilst short-term speculative flows must be discouraged.

FDI avoids the potentially destabilising effects of short-term foreign capital, which must be serviced in good times and bad. Consequently, around 80% of China's debts are long-term.

3. A gradual approach to capital account liberalisation.

The restrictions on capital flows have helped the Chinese authorities to preserve a stable exchange rate. Without the capital controls, Chinese banks may have borrowed

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[28]Feldstein, M. 1999a. p.104.
[29]Yongding, Y. in 'Global Finance: new thinking on regulating speculative capital markets'. p.294. 2000.

excessively in foreign currencies. Thus the capital controls insulated the economy from exogenous shocks that may otherwise have exposed China's weaknesses.

Because foreigners are not permitted to buy and sell local currency-denominated 'A' shares, an adverse turn of foreign investor sentiment has no implications for the value of the renminbi. Would-be-sellers are unable to sell their shares until they find a foreign buyer who will pay dollars for their shares. Because the Chinese capital account has not been liberalised, only residents with a need related to trade, tourism, a repatriation of profits derived from a direct investment or the repayment of an approved foreign currency-denominated loan can purchase foreign exchange.

Due to the renminbi's lack of convertibility foreign investors own only a very small share of renminbi-denominated financial assets such as bank deposits and corporate stock. The difficulty of converting such assets back into dollars means that the type of high speed financial panic that occurred in Asia, where foreign investors and local borrowers rushed to convert local currency into dollars cannot happen in China.

The Chinese futures market for foreign exchange is also restricted to those who have a trade-related need, preventing currency speculators from taking short positions in reniminbi. Moreover, domestic enterprises with foreign currency-denominated loans are unable to purchase foreign exchange to make payments until these loans come due.

However, capital controls do come at a price since any attempt to restrict the movement of capital will involve costs. If the rules are too strict they may discourage the good transactions. Conversely, if they are too loose, they will be evaded with ease. Additionally, controls provide ample opportunities for corrupt practices because officials are in a position to grant or refuse profitable entitlements. However, following the Asian crisis, market participants, and the IMF, were thankful that China had not liberalised the country's capital account.

Despite the controls on capital, some capital is illegally converted into foreign currencies and deposited in offshore bank accounts. As identified by Paul Krugman, this capital flight helps to explain China's trade surplus. The substantial quantity of capital fleeing China reflects problems with the country's investment environment. It also indicates that should the Chinese authorities relax the foreign exchange controls, many other investors would flee the Chinese market to seek more profitable opportunities abroad.

In 1998, China's trade surplus amounted to approximately $43.6 billion and utilised FDI to $45 billion. However, foreign exchange reserves rose by only $5.1 billion from 1997 to year-end 1998. The combination of FDI inflows and the trade surplus should have

increased foreign exchange reserves by a substantial proportion of the $88.6 billion, which should only have been reduced by a number of offsetting factors given that the capital account is closed. So what has happened to the rest of the money? Callum Henderson has identified two possible explanations. Firstly, there is the 1997 PBOC rule that allows specific Chinese trading enterprises to retain up to 15% of their export receivables in foreign exchange as opposed to immediately converting the currencies into renminbi. The State Development Planning Commission, believes that the slackening foreign reserves are the result of exporters amassing dollar revenues up to the limit permitted by the PBOC instead of converting them into renminbi. But Mr Henderson disputes this because in 1998 exports amounted to around $182 billion. Thus if every exporter in China held 15% of its foreign currency receivables (which is against PBOC rules considering only certain exporters are allowed to retain these earnings) it would amount to only $27.3 billion. Secondly, the existence of the Chinese black market, which enables Chinese residents to convert renminbi into U.S. dollars, indicates capital leakage through illegal foreign exchange transactions. Mr Henderson argues that: "The very fact that the authorities have cracked down on such activities in Guangdong and Xiamen, and that the PBOC governor himself, Dai Xianglong, spoke in terms of 'crushing' the black market for foreign exchange appears to confirm this ... One hears of up to 40% of annual FDI being leaked back out of the country. Given that this would amount to $18 billion, using 1998 as a benchmark, this would seem exaggerated. There is no question, however, that such leakage is occurring."[30]

Yet there are other explanations of the capital leakage. On the Chinese stock markets we have seen that only foreign investors were allowed to purchase 'B' shares (denominated in U.S. and Hong Kong dollars), but in practice approximately 80% of the 'B' shares listed on the Shanghai exchange and 60% of shares on the Shenzhen exchange are held by Chinese residents who have established illegal offshore accounts.[31] But since the 26th February 2001 the PBOC has permitted Chinese residents to buy 'B' shares. The 'B' share market failed to attract many foreign investors because it was too illiquid and the quality of listed companies was often poor. Instead, most domestic enterprises seeking hard currencies listed their shares on the Hong Kong stock exchange or on foreign markets. Further changes to the stock markets are expected later in 2001 or in 2002. Measures include the merging of the Shenzhen and Shanghai stock exchanges and the development of a second board, similar to

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[30]Henderson, C. 1999. pp.92-96.
[31]The Economist. 3 March 2001. p.99.

the U.S. Nasdaq, that will provide new technology companies with the opportunity of raising capital.

But there are additional explanations of the illicit capital leakage. These include borrowing without government approval, forging documents to disguise borrowing as export earnings to receive a tax rebate, unauthorised investment abroad by Chinese enterprises, capital flight under the disguise of payments for patents, commissions and travel expenses. While loopholes in the capital controls enable foreign investors to use residents as agents to buy shares prohibited to non-residents, and importers often receive invoices that are higher than the actual value of goods, the difference is then remitted abroad.[32]

To counteract this capital leakage China's Supreme Court, in October 1998, demanded a major crackdown on illegal foreign exchange activities. However, foreign investors expressed concern and domestic trading enterprises also complained about the inconveniences caused by these stringent measures. The Chinese government subsequently responded by loosening the controls to ensure economic activity was not discouraged. Such action clearly demonstrates the authorities concern and determination to challenge the outflow. Addressing the illegal capital leakage without deterring investment and trade flows poses a significant problem to the Chinese officials, leading Yu Yongding to conclude that: "The greatly weakened effectiveness of capital controls in China is one of the most important threats to China's economic stability."[33]

China's healthy foreign exchange reserves

At the end of 1998, China's foreign exchange reserves amounted to a new high of U.S. $150 billion. At the beginning of 2000 the country's total debt obligations amounted to U.S. $137 billion. But only 20% of China's total debt obligation is short-term.[34] Moreover, China's external debt is modest relative to foreign reserves. Short-term international bank lending amounted to only 24% of foreign reserves in 1997, in comparison with 249% for Indonesia and 145% for Thailand.[35] One of the key fundamental weaknesses of the Russian and East Asian countries was that the country's foreign short-term debt exceeded available foreign exchange reserves. But with China, the knowledge that there is ample liquidity to pay each short-term investor can in itself preclude a financial panic.

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[32]Yongding, Y.
[33]Yongding, Y. In 'Global Finance: new thinking on regulating speculative capital markets'. 2000. p.302.
[34]Ibid.
[35]Henderson, C. 1999. p.104.

Nevertheless, an Asian style high-speed financial meltdown is unlikely to occur in China, irrespective of what level of foreign reserves the PBOC holds. This is due to the restrictions on capital mobility. Despite these controls, capital is fleeing China, but whether this leakage is sufficient to demand an exchange rate realignment is doubtful.

China's capital controls have, therefore, insulated China from destabilising speculative pressures. China also possesses an extremely strong external position, including $150 billion in foreign exchange reserves and a current account surplus. (See Tables 4 and 5, pp.92/93.) And while some analysts argue that these strong fundamentals would preclude a self-fulfilling attack on the renminbi, these favourable factors are primarily a result of the capital controls that the Chinese authorities have employed.

Other crisis prevention measures in China

Market mechanisms do not operate fully in China and bankruptcies are controlled. Insolvent enterprises often receive subsidies enabling them to continue with their money-losing activities. Furthermore, many Chinese financial institutions support moral-hazard- related-lending, on a scale that is reminiscent of East Asia prior to the 1997 crises. These institutions bear little responsibility for bad loans and harbour incompetent, inefficient financial regulation and supervision. Consequently, the Chinese authorities can be rewarded for their gradual approach to capital account liberalisation, which has restricted Chinese financial institutions from borrowing excessively in foreign currencies. The renminbi's inconvertibility has enabled China's external fundamentals to remain strong, in contrast to its East Asian neighbours. Hence, China's bad loans are denominated in its local currency rather than foreign, as was the case in Thailand, Indonesia, South Korea and Malaysia. Therefore, the possibility of a bank run in China is reduced because the PBOC could fulfil its role as 'lender of last resort'.

China's financial markets are at a very early stage of financial development. Therefore, the absence of easily accessible stock futures and foreign exchange forwards, may also have contributed to China's evasion of destabilising speculative attacks. Furthermore, China's capital controls discriminate in favour of long-term foreign investments, rather than short-term speculative flows. Moreover, China receives the largest quantity of FDI inflows of any emerging market in the world. Long-term investment avoids the problem of debt servicing that can prove so difficult with short-term debt, particularly when the economy suffers an adverse turn in investor sentiment. FDI has played a significant role in improving China's economy. The indirect consequences of FDI have introduced new technology and

products, whilst direct investment has also helped to increase the size of the non-state (typically profitable) sector.

Walden Bello believes that China is well respected by foreign investors, unlike the countries of South-east Asia because "Beijing is tough on foreign investors and enjoys the upper hand with the international business community. Yet foreign investors are scrambling to get into China, restrictions and all ... Foreign investors will always scream about investment controls chasing away foreign capital. But the case of China ... shows that where there is money to be made, investors will live with the restrictions. In contrast, foreign investors can blackmail other governments to dilute their investment rules. Investors know they can ratchet up their demands because weaker government's will inevitably give in ... Respect is what the Chinese government gets from investors"[36].

China is believed to possess enormous economic potential because it is the largest country in the world in terms of population and has an enormous market place, with many millions of prospective customers to satisfy. But the respect that both foreign investors and governments grant the Chinese regime seems a little perverse. As Chris Patten argues, "the Chinese government needs our investment. It needs access to our markets. Without our money and our purchases of Chinese goods, the very future of the communist regime would be imperilled. We spin the wheels for it"[37].

3.iv. Why China would not devalue

At the time of the Asian crisis China had a number of reasons to maintain the renminbi - dollar exchange rate. Even the currency speculator George Soros was adamant that China would 'until its dying breath' defend both the Hong Kong dollar and the renminbi exchange rates: "To devalue the [renminbi] would knock a psychological prop from under the Hong Kong dollar, which is pegged via a currency board to the American dollar. Should the peg come into question, Hong Kong's own financial system would suffer horribly, with consequences ... for China, which depends heavily upon capital raised in Hong Kong for much of its development."[38] A devaluation of the renminbi would have triggered expectations of competitive devaluations throughout the Asian region. Such expectations would have become self-fulfilling and would have struck emerging markets throughout the world, severely aggravating the Asian crisis. "Asset prices would fall everywhere and growth would decline. An already far-too-high dollar would be pushed even higher as Asia

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[36]Bello, W. 1999b.
[37]Patten, C. 1999. p.202.
[38]The Economist. 14 February 1998. p.69.

seeks to fix employment problems with ever-larger trade surpluses. Emerging market lending would again get hit"[39].

A renminbi devaluation would not necessarily promote China's exports to Japan and East Asia because Japan has been enduring a prolonged economic recession and Asia's crisis has had a profound effect on income levels in these economies. A related point to China's export competitiveness is the high proportion of foreign raw materials that constitutes many of China's exports. Some Chinese products comprise up to 57% in foreign inputs, thus a renminbi devaluation would be largely offset by the increase in the price of these components.[40] From 1990 to 1997 average Chinese export growth was 17% per year. But in 1998 exports only increased by 0.5% and imports fell by 1.5%.[41] However, Henny Sender believes that China may actually have found that it is more competitive following the Asian crisis. Sender argues that China can increasingly compete on quality as opposed to just lower unit costs and its trade-finance arrangements did not fall apart as they did in the rest of Asia. China's oversupply of commodities and 1998 deflation amounted to an effective devaluation. China's export share of Asian countries to the U.S. market has increased dramatically since 1989, at the expense of its South-east Asian neighbours. (This trend is illustrated in Table 6, p.93.) In addition, Sender argues that the tax rebates to exporters effectively devalue the exchange rate by 3%. Furthermore, Chinese exporters were offering an exchange rate of over 9 renminbi to the U.S. dollar, in comparison with the official rate of approximately 8.3.[42]

Finally, China's capital controls have insulated the economy from market volatility and indirectly contributed to China's strong external fundamentals. Provided China continues to enjoy prolonged inflows of foreign capital, the renminbi will be able to maintain its pegged exchange rate. Yu Yongding stated that: "Due to the current account surplus and continued capital inflows, there was actually an excess supply of the dollar on China's official foreign exchange market. In other words, if there were not devaluation expectations, the renminbi would have to bear revaluation pressure, rather than devaluation pressures. Although on the black market the renminbi was traded at a lower than official rate, the transaction volume on the black market was small owing to the capital controls;

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[39]Dornbusch, R. 1999.
[40]Yongding, Y.
[41]Far Eastern Economic Review. 25 February 1999. p.61.
[42]Sender, H.. Far Eastern Economic Review. 25 February 1999. pp.17-18.

[consequently] the influence of the black market on the determination of the renminbi's official rate was minimal."[43]

Indeed, on the Shanghai foreign exchange market official trading (averaging at around $150-200 million a day) dwarfs the black market, which usually amounts to approximately $200,000 a day. But Callum Henderson argues that: "A black market is ... a symptom of economic failure of some sort, of local scepticism with financial and economic policy and with present valuation of the currency and domestic assets, be they property, stocks or anything else that has a value to it."[44]

3.v. East Asian lessons for China

The intensity and duration of the Asian financial meltdown took everyone by surprise. China was negatively affected in certain areas of its economy, most notably in its slowing exports and inflows of FDI, which pose additional problems to the economy. However, the Asian crisis has served as an invaluable and free lesson to the Chinese authorities, who must take heed of the fundamental weaknesses that were so brutally exposed in the Asian financial crisis. The clearest lesson of the Asian crisis was the dangers and vulnerability posed by an open capital account, and inadequate regulation and supervision. Easy credit gave rise to a growing proportion of NPLs, which were primarily denominated in foreign currencies. Thus, the collapse of the exchange rate peg transformed a currency crisis into a financial and economic crisis.

The financial effects of the Asian crisis occurred because investors became risk averse and wished to avoid economies that possessed similar fundamental weaknesses. The belief that a crisis will ensue becomes self-fulfilling and an investor stampede may take place, precipitating the crisis. The excessive reliance on short-term external financing was at the heart of the Asian and Russian crises.

Since the outset of the Asian crisis, China has adopted a number of policies in order to strengthen the country's insulation from financial market upheaval, whilst also focusing attention on the necessary reforms of the economic system, the financial one in particular.

The authorities have been engineering a comprehensive but gradual reform of the financial system, which has several notable aspects. Firstly, the process of commercialisation must be accelerated and managers increasingly assessed by Western market standards, thereby encouraging banks to become more risk-averse and profit-orientated. Nevertheless, whether the banks will actually consolidate their loans remains questionable. The Chinese

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[43]Yongding, Y.

authorities response to the anticipation of slowing growth, following the Asian crisis, was to significantly increase, in Keynesian fashion, government expenditure on infrastructure projects. State enterprises have also stepped up investment. According to Fernald and Babson, "nominal state investment in 1998 was 22% higher than a year earlier ... The increase in investment by state enterprises appears to have been financed by substantially faster third-quarter lending by the four major banks. Hence, the increase in growth appears to be at the expense of previously announced enterprise and bank reform"[45]. This spending spree on infrastructure was being made in an effort to attain the 8% GDP growth target that Beijing has become so accustomed to meeting and, on occasion, even surpassing. However, the haste of the infrastructure expenditure has caused concerns regarding the quality of the investments undertaken. This response to slowing growth illustrates that, despite moves to make the banks more commercially orientated, the government strongly influences the banks' policy conduct. Fernald and Babson acknowledge that: "China faces the very difficult task of sequencing, that is, of trying to move from having a non-commercial banking system where market mechanisms do not work fully, to have a viable commercial banking system where incentives are appropriate. The transitional stage - where controls have been lifted but incentives remain inappropriate - holds clear dangers as was evident in the Asian crisis economies."[46]

Currently, banks and state enterprises are bound together by government intervention, which only results in soft budget constraints. The lack of incentives results in a high proportion of bad loans because enterprises do not have the motivation to ensure that such loans are either profitably or efficiently used. The government knows that to counteract this, insolvent financial intermediaries must cease operations, meaning that balance sheets are no longer allowed to deteriorate and the concept of the market environment must be introduced, rather than a business environment based on implicit and explicit guarantees. However, China has no formal insurance programme to protect depositors' money, meaning that the closure of banks is a socially (and economically) difficult step.

Second, there is need for an increase in capital adequacy standards. The Ministry of Finance injected 270 billion renminbi ($32.5 billion) of special treasury bonds into China's four state-owned commercial banks in August 1998. The PBOC then stated that it would provide these banks with enough time for them to improve their management personnel and

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[44]Henderson, C. 1999. p.102.
[45]Fernald and Babson. 1999.
[46]Ibid.

reform their operations. In May 2001, the chairman of China's central bank said that the government would recapitalize three of the country's four largest commercial banks to help them to attain the minimum international standards for capital adequacy (currently 8% of assets).[47] However, "throwing money at the banks won't work unless they also start lending on the basis of credit analysis, rather than politics"[48].

Third, there is need for the development of sound supervision and regulatory measures to reduce excessive borrowing and lending by financial institutions, thus fostering an environment that rewards risk-averse, profit-orientated lending. The government has been attempting to constrain the widespread growth in the number of finance companies, whose reckless lending became infamous following Thailand's crisis.

Finally, there is need for a restructuring of assets. In 1999, China transferred approximately 16% of the four largest commercial banks' bad loans, or 1.4 trillion renminbi ($169.1 billion), into asset management companies (AMCs).[49] In 2000, these same banks transferred 400 billion renminbi in bad loans to AMCs. The AMCs' mandate is essentially to recover whatever they can. "[But] the selling of assets through the AMCs is expected to be an uphill struggle, meaning that the finance ministry will eventually have to foot most of the bill"[50]. These bad loans were purchased by the AMCs for bonds issued to the banks, but interest has to be paid on these. The *Economist* argues that: "The cash for this, less what can be raised at auction, can only, eventually, come from the taxpayer."[51] Therefore, the potential for new bad loans must be reduced by prudent lending criteria and, according to the *Economist*, without SOE restructuring the banks will not be successfully reformed.[52]

The fact that many of the Asian crisis-hit countries were operating pegged exchange rates has served as an additional warning to the Chinese authorities. The fixed exchange rates in Asia facilitated the creation of bubble economies where vast amounts of short-term capital flowed into, and subsequently out of, these economies. Furthermore, the exchange rate pegs were predominantly fixed to the U.S. dollar, which had strengthened considerably throughout the late 1990's. Consequently, Asian exports lost price competitiveness, which in turn, resulted in weakened current account balances. Prior to their financial crises Mexico, Thailand and Russia all delayed the transition from a pegged exchange rate regime to a more

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[47]International Herald Tribune. 10 May 2001. p.17.
[48]Barnathan et al. 1998.
[49]International Herald Tribune. 10 May 2001. p.17.
[50]Financial Times. 14 May 2001. p.10.
[51]The Economist. 19 May 2001. p.98.
[52]Ibid. p.97.

flexible arrangement even in the face of deteriorating fundamentals. The government must, therefore, have the courage to act when change is needed. Beijing recognises the need for greater exchange rate flexibility. This is partly because China's predicted accession to the World Trade Organisation (see below) may result in a surge in imports, a deteriorating balance of payments and, consequently, an unsustainable exchange rate peg. A move towards greater exchange rate flexibility will probably involve a widening of the renminbi's daily trading band.

The above are important considerations for China's future policy on exchange rates, because as Tom Holland of the *Far Eastern Economic Review* believes that: "At some point during the opening decades of the 21st century the Chinese currency, the renminbi, will become fully convertible. Immediately, the renminbi will become the world's fourth most heavily traded currency, behind the U.S. dollar, the euro and the yen."[53]

China has recognised the importance of maintaining export competitiveness and diversifying export destinations. Moreover, the authorities realise that devaluation will not promote sustainable export competitiveness. Consequently in 1998, the Chinese government ordered that tax rebates be increased for specific exporters to improve their competitiveness. Chinese exporters, which are sensitive to microeconomic management by Chinese officials, increased production and exports rose by 1.6% year-on-year in June 1998 and 3.5% year-on-year in July 1998, following the above decree.[54] The government is also providing increased funding for enterprise research and development to maintain (and possibly) improve long-term competitiveness.

In addition to the increase in tax rebates, the authorities have also been encouraging exporters on the more prosperous Eastern coast of China to increase the production of high value-added and technology-intensive goods. At the same time the production of labour-intensive, low value-added products is being transferred to less-developed and poorer areas inland, where wages are far lower. Indirectly, this programme is developing China's more rural and backward areas and hence increasing incomes in these areas. The increasingly globalised world economy has intensified competition in the world market and Chinese officials realise they must continually adjust the country's trade structure according to changes in comparative advantages.

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[53]Holland, T. 2000a. p.76.

3.vi. China in the new millennium

China's SOEs currently lack sufficient incentives to perform efficiently. It is often the case that managers do not face hard budget constraints and are thus not encouraged to perform profitably. Failing managers stay in their jobs owing to an asymmetry of information, which makes it difficult for the government to determine whether external factors or managerial failures reflect the enterprises' performance. The absence of effective SOE supervision results in adverse selection and moral hazard. According to Li *et al.*, the performance of SOEs will only be improved if three areas are reformed: firstly, the introduction of effective governmental supervision of the enterprise; secondly, the enterprise manager is a person of high moral principles; and, finally, the Communist Party secretary and the Workers' Council (which presently represents SOE management staff) provide impartial inspections assessing the management of SOEs.[55]

Cautious gradualism has epitomised China's economic reforms to date. But, the Chinese prime minister, Zhu Rongji, promised, in March 2001, more economic pain as SOE reforms are doubled and more loss-making companies are shut down and others merged or sold. China's current leaders are showing much determination in challenging some of the country's most difficult problems. Deflation has been checked, but reforms must continue. Unemployment must be controlled to prevent a social backlash, yet the Chinese SOEs must be made into efficient enterprises (to reduce the burden on the budget deficit) and the banking system must lend strictly according to profit-based criteria, while ensuring that the SOEs do not fall under en masse due to a lack of financing.

These challenges require a tougher and more drastic approach to reform than is offered by China's gradualist approach. This is because the state-controlled banks are currently heavily burdened with NPLs. These NPLs are the consequence of the governments continued support for money-bleeding SOEs. Consequently, the banking system does not encourage or improve the efficiency of corporate governance and actually results in poor corporate discipline. The gradual approach to the reform of the banking system means that, as time goes by, the slow progress may be insufficient to offset the deterioration in asset quality. In turn, this will reduce the banking system's overall liquidity, which will cause a reduction in lending. The lower level of bank lending will reduce investment to the corporate base, thus weakening profits and adversely affecting economic growth. Workers of these companies see the reduction in profits and respond to this increased job insecurity by saving

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[54]Henderson, C. 1999. pp.100-101.

more and spending less, which further adversely affects bank liquidity and lending. This vicious circle was evident in the Asian crisis and has contributed significantly to Japan's economic slump.

Callum Henderson argues that: "As with everything else, China has far too much banking capacity, in terms of both branches and workers. The result is a crippling cost base under which no bank could realistically be profitable. That cost base has to be substantially reduced."[56] The alternative is that the PBOC will print money to maintain economic growth. However, this will ignite inflation, whilst placing an additional strain on the maintenance of the exchange rate value. Therefore, an increasing number of bank employees must be made redundant, but this will only require greater government expenditures to provide subsistence benefits. To encourage the reform of the Chinese banking system and to boost consumer spending, the authorities in 1999 introduced a 20% tax on interest earned on bank savings, which will keep household deposits at an artificially low level. Therefore, the banks should make healthy profits by reducing the overall level of interest they pay on money they borrow. At the same time, these restrictions should promote the banks to lend by profitability criteria.

The authorities are attempting to sort out the stock markets. China's socialist market has two main objectives for the stock market, according to the *Economist*. "The first is to facilitate a 'massive debt-equity swap' for the Chinese economy. China's domestic saving is enormous: it runs at around 40% of GDP. But these funds have traditionally been allocated in the least efficient way, through the state banking system. Most loans go to awful SOEs"[57]. If savings are, therefore, directed to the stock market the Chinese authorities hope that it will result in a more efficient allocation of capital. Furthermore, the government hopes to mollify social tensions by raising money to pay pensions and unemployment benefits to the five million people that are made redundant each year from SOE reform. The second goal is to expose enterprises to the discipline of the market, which rewards efficiency and punishes inefficiency by enforcing bankruptcy. The stock market is, therefore, being used to provide incentives for companies to perform efficiently. "By ensuring that SOEs have minority shareholders, the government hopes to inspire companies to improve their corporate governance, transparency and competitiveness"[58]. The Chinese authorities must realise that enterprise managers should be appointed on the basis of their management talent, rather than

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[55]Li et al. 1999. p.5.
[56]Henderson, C. 1999. p.201.
[57]The Economist. 3 March 2001. p99.
[58]Ibid.

their connections to the state. The 'B' share market has a market capitalisation of just 1% of the 'A' market. The diverse valuations of China's various shares will only converge when the authorities combine the markets' various share classes. Allowing Chinese residents to purchase foreign currency-denominated 'B' shares was therefore perceived as the first step towards the integration of the 'A' and 'H' share markets. If this is achieved China would have the world's fourth biggest stock market. But complete integration will not be possible until the renminbi is made convertible for capital account transactions and no one knows when this will be.

These are difficult tasks but the authorities determination to tackle these issues is illustrated by the measures that are being undertaken to ensure that China joins the World Trade Organisation (WTO) in early 2002, after fifteen years of trying. WTO admission would force China to adhere to WTO rules or to make a clear and strict commitment as to how it will adhere in a shorter period of time than is usually provided to other developing economies. This is due to the fear that China may flout the rules once the country is admitted to the WTO.

Accession to the WTO will require that by 2006 China will have reduced tariff and non-tariff barriers whilst domestic banking, telecoms, agriculture and distribution is also liberalised, enabling foreign companies to compete in these markets. It is estimated that WTO membership would increase China's annual GDP by 2-3%, with each additional percentage point of growth providing five million extra jobs. In addition, a more efficient allocation of Chinese capital and resources would provide a further 4% to annual GDP growth.[59] If China becomes a more market-orientated economy by 2005, it is estimated to grow annually by 7% until then, by 9% from 2006-2015 as the benefits of restructuring emerge before slowing a little thereafter. Thus, by 2020 China's economy would have grown to $10 trillion in 2000 dollars, equalling the size of America's economy today.[60] Javed Burki, a former World Bank official, predicts that if present trends continue, China will become the world's largest economy accounting for 26% of global output by 2025. America will remain constant at around 21 or 22%, while India will become the world's third largest economy followed by Japan, Germany, Brazil and Mexico in that order.[61]

China's entrance to the WTO would increase domestic competition and expose inefficient SOEs to market forces given that, under the WTO, they will no longer enjoy

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[59]Transition. April 2000. p.13.
[60]The Economist. 10 March 2001. p.26.
[61]See: Greenway, H. 2001.

current levels of subsidies or preferential treatment. Recently established consumer durable manufacturers will encounter fiercely competitive pressures, which will force them to undertake corporate restructuring to improve their efficiency. The liberalisation of the domestic market will accelerate technology transfers through the establishment of foreign enterprises. But the main efficiency gains from WTO membership will take place in the non-tradable and in the currently protected sectors, which according to the World Bank, "will feel the impact of import competition or the arrival of new foreign backed competitors"[62]. Moreover, admission to the WTO will contribute to reducing the role of the state in the Chinese economy, which currently suppresses economic growth through trade barriers and local protectionism in many sectors. In June 2001, the United States and China declared that they had agreed on several issues, most significantly farm subsidies that had previously blocked Beijing's entry to the WTO. An agreement with the E.U. followed shortly after. Only a bilateral agreement with Mexico remains to be concluded. China may be able to join the global trade body early in 2002. Pierre-Louis Girard, the chairman of the WTO working party drafting China's accession terms, said that: "We are now very close but we are not there yet. I urge governments to make every effort to conclude these negotiations as quickly as possible."[63]

The *Economist* believes that: "WTO membership is just the first of the reform initiatives. The central government has declared war on most parts of the socialist economy, all the time sticking to 'the socialist road.'"[64] The government is now attempting to provide better access and communication to the disparate areas of Eastern China by improving infrastructure such as roads, railways and fibre optic cables. The U.S.'s development of extensive highways and railway systems was the largest contributing factor to the growth of the country because this infrastructure enabled a more efficient and widespread use of land.[65] Indeed, development of an infrastructure of itself will not provide sustainable development, but a sound infrastructure is conducive to sustainable development by enabling a more efficient use of resources e.g. China's abundance of inland workers and land.

China's GNP is approximately a sixth the size of Japan's, but China's energy consumption, as a percentage of GNP, is eight times higher than Japan and is actually the world's highest. Given China's inefficiencies, which distort the pricing mechanism and thus

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[62]Transition. April 2000. p.13.
[63]Financial Times. 5 July 2001. p.7.
[64]The Economist. 10 March 2001. p.25.
[65]Henderson, C. 1999. p.226.

supply and demand, China would need a substantial multiple of Japan's energy consumption if it is to attain an equal level of GNP. Mr Henderson argues that: "What is needed is a commercially driven pricing mechanism, with minimum government interference and a national power grid. The government aims to develop the latter by 2009. It is an awesome task - one of many such - but it is fundamental not only to the development of efficient energy pricing but to the further development of the economy as a whole."[66]

3.vii. Conclusion

So far, according to the *Economist*, China's growth has been primarily achieved through the removal of restrictions on labour mobility, enabling former agricultural workers to find jobs in cities, where productivity is higher. Globalisation has benefited China's economy hugely. Exports amount to 23% of GDP making the country the world's ninth largest exporter.[67] Yet China's 'catch-up' growth has been slowing over recent years indicating that the speed at which China is catching up with the West is also slowing.

The Asian financial crisis shattered the economic growth that China's regional neighbours had enjoyed for the last two decades. Yet China maintained its resilient growth, despite possessing similar weaknesses that were evident in the Asian and Russian economies prior to these countries financial crises. China has a pegged exchange rate and the country's banks are insolvent three times over by Western standards. Despite China's capital controls vast amounts of capital is fleeing the country. Moreover, the existence of SOEs is placing a huge burden on the budget deficit, capital is poorly allocated and many analysts contend that China actually possesses more corruption and nepotism than the fallen Asian tigers. Additionally, the Asian crisis reduced China's export competitiveness and threatened future inflows of FDI, which, in turn, jeopardised SOE reform and thus the sustainability of the budget deficit.

Despite these weaknesses China was largely insulated from the financial upheavals of 1997 and 1998 for two reasons. Firstly, China's partially inconvertible currency has indirectly strengthened China's external fundamentals (most notably a current account surplus) and minimised short-term debt. Capital controls have prevented weak Chinese banks from borrowing in foreign currencies, whilst also restricting speculative behaviour towards the renminbi. Secondly, in stark contrast to East Asia and Russia prior to their crises, China's foreign exchange reserves greatly exceed the country's outstanding short-term

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[66]Ibid. pp.188-189.
[67]The Economist. 10 March 2001. p.26.

debt. However, the notion that China was unscathed by the regional crisis is untrue. The Asian crisis occurred at a precarious time for the Chinese economy.

Asia's crisis has provided conclusive evidence of the dangers posed by capital account liberalisation, when regulatory and supervisional measures are weak, providing China with an invaluable lesson. China must continue to reform the economy, separating business from government, thus removing the potential for moral hazard, and developing a financial infrastructure that rewards entrepreneurship and efficiency. Successful admission to the WTO would certainly help China's prospects by encouraging reform through a more competitive environment. Moreover, accession to the WTO will provide a sure measure of economic progress. Nobody doubts China's potential but the country continues to exhibit many fundamental weaknesses, which must be addressed.

China's current condition has been summed up by Chris Patten: "China has moved with praiseworthy speed from North Korean economics to something resembling a capitalist economy. It has opened up to the world, and encouraged investment in capitalist development ... The next stage of the economic journey is more difficult. It involves dismantling, slimming down, privatising, making profitable the SOEs that are the legacy of Mao's China. This is the task that proved so difficult in the constituent parts of what was once the Soviet Union and in the countries of its European empire."[68]

[68]C. Patten. East & West. p.143.

Table 1. China's average GDP % growth 1970-1996 in relation to rich industrial countries

	1970-79	1980-89	1990-96
China	7.5	9.3	10.1
Rich Industrial Countries	3.4	2.6	2

Source: Kotler and Kartajaya. 2000. p.17.

Table 2. China's annual GDP % growth rate since the gradualist reforms began in 1978.

'78	'79	'80	'81	'82	'83	'84	'85	'86	'87
11.7	7.6	7.8	5.3	9	10.9	15.2	13.5	8.9	11.6

'88	'89	'90	'91	'92	'93	'94	'95	'96
11.3	4.1	3.8	9.2	14.2	13.5	12.7	10.5	9.6

Source: Economics blue book of the Peoples Republic of China 1998. p.512.

Table 3. China's GDP growth through the Asian crisis period and beyond.

'97	'98	'99	'00	'01	'02	1996-2025
9.5	7.8	7.1	8	7.6	7.8	6*

2001 and 2002 are OECD estimates. * Projected per capita GDP growth rate.
Sources: Economics blue book of the Peoples Republic of China 1999 p.509. OECD Economic Outlook 68. December 2000. p.126. Henderson, C. 2000. p.200. Radelet & Sachs. 1997. p.51.

Table 4. China versus other Asian economies selected indicators 1996 %

	1.Change in real GDP growth 98-99 avg minus 95-96 avg	2. Bank Loans/GDP	3. Current Account/GDP	4. Total Debt/Reserves
Indonesia	-17.5	55.4	-3.4	707
Malaysia	-12.2	93.4	-5.2	147.3
Thailand	-11.5	100.5	-8	240.7
Korea	-11	61.5	-4.7	307.6
Singapore	-7.7	96	15.2	*
Hong Kong	-7.2	162.4	-1.7	*
Philippines	-4.9	49	-4.3	410.9
China	-2.7	92.7	0.9	162
Taiwan	-1.2	143.7	4	25.6

Column 1 compares the growth from two years after the 1997 crisis to the growth recorded two years prior to the crisis. Columns 2, 3 and 4 show statistics for 1996 and are thus

unaffected by the Asian crisis. Debt figures for the banking sectors of Hong Kong and Singapore are not comparable with data from other countries due to the large size of external claims and liabilities.
Source: Fernald and Babson. 1999.

However, only 20% of China's external debt is short-term:

Table 5. Chinese external debt and reserves 1994-1998 U.S.$ billions

	'94	'95	'96	'97	'98#
External Debt*	138	150	175	180	181
Total Reserves**	59	80	110	143	145
Short-term commercial bank debt	19	25	30	36	34

* External debt figures include bank claims on China, from BIS, which exceeded China's reported external bank debt by about $50 billion at end-June 1997. # June 1998 estimate.
** excluding gold.
Source: Fernald and Babson. 1999.

Table 6. Export share of selected Asian countries in the U.S. market, 1989-1996

	'89	'93	'96
Greater China	*24%*	*33%*	*34%*
China	13	25	29
Hong Kong	11	8	5
NIEs	*59*	*44*	*41*
South Korea	22	14	13
Singapore	10	10	11
Taiwan	27	20	17
ASEAN-4	*17*	*23*	*25*
Indonesia	4	4	5
Malaysia	5	8	10
Philippines	3	4	4
Thailand	5	7	6
Total	100%	100%	100%

Source: Henderson, C. 1999. p.16.

CHAPTER FOUR: ISSUES ARISING FROM THE EXPERIENCES OF EAST ASIA, RUSSIA AND CHINA

4.i. The globalisation of finance

The process of economic 'globalisation' is not a new phenomenon; although the term is new the process (which has greatly speeded up of late) has taken place over the course of the last five centuries. Entrepreneurs in the more economically advanced countries have increased trade and production activities in territories and countries throughout the world. Since the 1950s there has been a vast expansion of international capital markets. Initially, this was driven by international investment flows associated with the post-war economic recoveries but it was later influenced by the establishment of offshore currency markets where financial transactions were subject to only limited regulation. The increased prominence of short-term capital flows between major trading currencies eventually overwhelmed the Bretton Woods fixed exchange rate system in 1972-73. Since the collapse of the Bretton Woods system there has been a greater frequency of financial crises that have hit economies throughout the world, such as the Latin American debt crisis in the early 1980s, the ERM crisis in the early 1990s, the 'Tequila' crisis of 1994-95, the Asian crisis in 1997, Russia in 1998 and Brazil in 1999.

The end of the fixed exchange rate era reflected the belief that free international capital mobility is essential if the benefits arising from global trade and investment are to be maximised. Indeed, from the mid-1970s onwards capital controls were increasingly freed, exchange rates were increasingly floated and private capital flows increased dramatically. The quantities traded in the world's foreign exchange market rose from a daily average of $15 billion in 1973 to over $1,000 billion in 1999, larger than all of the world's stock markets put together.[1] More recently, the increase in capital flows has been driven by Western governments and multilateral institutions (such as the IMF) introducing and advocating policies of extensive economic liberalisation. The size and volatility of this market has meant that central banks are no longer able to adequately protect the value of their currency in international markets.

The integration of developing (and more recently transitional) economies into the global financial system has been accompanied by a sharp rise in external financing. Indeed, net capital inflows to emerging markets in 1987-89 amounted to approximately $50 billion a

[1]Khor, M. 2000.

year. But in 1995-97 these flows increased threefold to just over $150 billion, although they decreased substantially following the Asian financial crisis.[2]

Destabilising short-term capital inflows were at the heart of the Russian and East Asian financial crises. These economies, which had become dependent on short-term capital, found that their creditors would 'roll-over' the loans when times were good, but when the market became more pessimistic, creditors were increasingly reluctant to roll-over their loans. China's capital controls, in contrast, have minimised inflows of short-term debt and promoted the role of long-term foreign direct investment (FDI). China's capital controls have also contributed to the strength of the country's external fundamentals, resulting in a typical current account surplus and $145 billion of foreign exchange reserves at the end of 1998.[3] Consequently China, despite some similar weaknesses, was insulated from the financial panic that swept through Asia in mid-1997 and Russia in August 1998.

In light of these findings, the potential role of capital controls in developing economies will be analysed and attempts made to identify the optimal method of sequencing for capital account liberalisation. The capital account liberalisation of the Asian economies was poorly sequenced, which ultimately contributed to the region's vulnerability to a financial panic.

Capital inflows

There are essentially three types of capital flows. Firstly, long-term investment flows such as FDI. Secondly, portfolio investment, that includes transactions via debt and equity securities. Finally, aid or assistance capital flows, which may include short or long-term trade credits or bilateral and multilateral loans. Barbara Peitsch states that: "An investment is considered direct foreign investment when a lasting relationship is established between a legal person or entity resident in one country (the foreign investor) and an entity resident in another country (the foreign investment enterprise) in which the foreign investor obtains a controlling interest. This type of investment can be contrasted with (foreign) portfolio investment, in which the investor is not interested in exerting significance over management decisions."[4]

To recall, net capital inflows to emerging markets in 1987-89 amounted to approximately $50 billion a year. But in 1995-97 these flows increased threefold to just over $150 billion. The volume of short-term capital flows to Asia were maximised by a policy mix, which stored up trouble for the future, including the promotion of short-term rather than

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[2]Eichengreen and Mussa. 1998. p.17.
[3]Fernald and Babson. 1999.
[4]Peitsch, B. The OECD Observer. April-May 1995. p.32.

long-term investments. (Table 1, p.118, shows capital flows to Asia and the Pacific before and after the crisis.) The most prominent aspects of this policy mix included a pegged exchange rate, extensive capital account liberalisation and an inadequate regulatory regime to supervise the capital inflows. Consequently, some Asian countries became over-reliant on external capital to finance economic growth and received capital inflows in excess of the economies ability to absorb them effectively and efficiently.

4.ii. Capital account liberalisation

Capital account liberalisation is defined as the "freedom from prohibitions on transactions in the capital and financial accounts of the balance of payments"[5]. Each of the advanced economies in the world has liberalised its capital account and, in so doing, allowed their currencies to be fully convertible for capital account transactions. In theory capital controls cannot be maintained if domestic politics have been fully liberalised simply because capital controls enforce restrictions on peoples' economic freedoms.

There are numerous reasons to conclude that capital account liberalisation is a positive undertaking for an economy. Studies, including those by Jeffrey Sachs and even the World Bank, have repeatedly shown that economies, which liberalise and welcome foreign capital are those that experience the most rapid increases in GDP growth. For example, the East Asian region had, until 1997, grown rapidly and reduced poverty substantially. In contrast, the closed, statist economies of sub-Saharan Africa have made little economic progress.

Nevertheless, the integration of a country into the international financial system poses enormous economic challenges. With capital account liberalisation comes inherent dangers that will, with an adverse turn in investor sentiment, scourge countries that exhibit fundamental weaknesses. Moreover, the Asian and Russian financial crises indicate that international financial markets do not work perfectly. Worse, the international financial system has inflicted enormous economic losses and caused social dislocation in such developing countries. Nonetheless, markets and the 'invisible hand' certainly appear to be the most efficient way of allocating resources in comparison to a centrally planned system. But capital account liberalisation should reflect the development of a deep, sophisticated and efficient domestic financial system.

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[5]Eichengreen and Mussa. 1998. p.19.

Global perceptions on capital account convertibility

The recent financial crises in East Asia, Russia and Brazil have prompted debates regarding the liberalisation of developing economies' capital accounts. The discussions have primarily focused on three areas. Firstly, the optimal speed and sequencing of capital account liberalisation. Secondly, whether restrictions should be placed upon international capital flows, such as a Tobin tax (which will be discussed later in this chapter). And finally, whether there is an optimal exchange rate regime compatible with the free movement of capital, or alternatively, an exchange rate that is suitable with restrictions on capital mobility.

The ongoing debate on capital account liberalisation has seen broad disagreement between the United States and the IMF on one hand, and Europe and Asia on the other. The U.S. and the IMF essentially believe that the Asian and Russian crises were punishment for the sins of these economies. These misgivings, according to the U.S. and IMF, were the causes of the countries financial meltdowns because 'crony capitalism' resulted in a misallocation of resources. Furthermore, the IMF does not consider that the extensive liberalisation of the Asian region's capital accounts was a central cause of the crises. This is apparent because the IMF demanded additional capital account liberalisation as a precondition for the provision of the 'bail-out' loans to South Korea, Thailand and Indonesia!

The countries of the European Union and the Asian region oppose this notion. Essentially, they believe that the seeds for these crises lay in the comprehensive liberalisation of the region's capital accounts throughout the 1990s. Foreign capital inflows to Asia surged, causing an immense speculative bubble to form in the property market, the stock market and industrial investment. The result was staggering levels of private debt to foreign lenders, who shouldered little or no responsibility for the havoc that ensued on their departure. Thus, Asia and Europe believe that capital account liberalisation precipitated Asia's regional crisis and both responded by proposing restrictions on international financial transactions. The Japanese government has considered implementing capital controls and endorsed the use of such restrictions throughout the Asian region. Indeed, Malaysia, in response to continued speculative attacks on the ringgit, introduced capital controls on the 1st of September 1998. The restrictions on capital mobility allowed the Malaysian government to reduce interest rates, with no adverse affect on the currency. Yet the imposition of such controls in Malaysia received a great deal of criticism from the IMF and U.S.

Many Russian economists have felt aggrieved by policy recommendations made to them by the IMF and, in particular, the creation of a market to enable purchases of short-term government debt to take place. The high returns offered on this short-term debt stifled

investment throughout the rest of the economy and the borrowing was not accompanied by a significant improvement in tax revenues. Hence the government's ability to service its debt did not improve and the debt became unsustainable. Boris Kagarlitsky argued that: "Foreign credits did not save Russia. They did not prevent the crisis. On the contrary, they provoked it. At the same time, the conditions imposed on Russia by the IMF and other international financial institutions prevented Russian decision-makers from seeking realistic solutions to the country's problems using domestic resources, which even now are impressive."[6] Furthermore, the liberalisation of financial transactions in Russia has accelerated capital flight and assisted the Russian mafia and international drug dealers by creating an international centre for money laundering.

In the aftermath of the financial crisis in Asia and Russia, the U.S. responded with the proposal of a 'new global financial architecture'. This new architecture was to be constructed on the principals of increased transparency and accountability, the continuation of free capital movements and a reduction in the scope for moral hazard. Alexander Swoboda stated that: "The goals of the system remain the same: to foster efficiency in trade in goods and assets; to ensure the stability of the system; and to allow for an equitable, socially acceptable distribution of income and wealth."[7]

In response to Asia's financial meltdown, Japan's finance minister proposed an 'Asian Monetary Fund' (AMF). In a similar vein to the IMF, the AMF would have the capability to provide liquidity to a member country suffering from potentially destabilising speculative attacks. The IMF responded unfavourably to such a proposal, which will be discussed in greater detail in Chapter 6. But instead the countries of the European Union cautiously advocated a new international financial architecture, which would divide the world into monetary zones. Each zone would maintain a degree of control on capital mobility and it is a concept, which is widely supported in the Asian region.

However, as noted by Robert Wade, the United States has a strong interest in the preservation and diversification of free global capital mobility. The United States' persistent current account deficit indicates that the country spends more than it earns. To finance this deficit the U.S. borrows heavily in international markets, although, unlike the Asian and Russian economies, approximately 90% of the capital borrowed by the U.S. is denominated in U.S. dollars, which makes the U.S. economy far less vulnerable to a financial crisis than an

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[6]Kagarlitsky, B. 1998a.
[7]Swoboda, A. 1999. p.2.

economy which has borrowed heavily in foreign currency-denominated debt.[8] Moreover, the U.S. has the lowest level of household savings in the world (see below). The U.S. economy must therefore supplement these savings with foreign capital inflows to maintain the economy's high level of consumption.

Analysts, particularly in Asia, have also accused the U.S. of forcing their free trade beliefs upon developing countries through IMF recommendations (which will be discussed in Chapter 6). Proponents of this view believe that the U.S. wants everyone to play by American rules, whether it involves multinational companies or global finance. Finally, over one half of the banks in continental Europe are owned by governments or receive subsidies from their governments. This delicate financial system highlights a further reason for contention between the U.S. and E.U. concerning the free movement of capital. This is because American and European banks obtain the majority of their profits conducting different operations. For instance, American banks obtain a greater proportion of their profits from trading incomes, e.g. trading in swaps and derivatives. In contrast, European banks receive profits largely from interest payments. Therefore, a liberalisation of these financial systems to free capital mobility would result in intense competition in Europe. This would reduce interest rate spreads and, of course, profits in banks that are already thought to be suffering from an increase in non-performing loans (NPLs).[9]

Advantages and disadvantages of capital account liberalisation

We have seen that large inflows (and outflows) of foreign capital pose significant challenges to developing economies. The volume and volatility of capital flows contributes to an erratic international financial system. However, capital flows, which are regulated and managed effectively, can be of enormous benefit to both investors and borrowers:

1. Foreign capital flows can transfer resources from high-saving to low-saving countries and stimulate growth by increasing investment and technology transfers. Moreover, governments may borrow from international savings to finance additional public expenditures. Foreign capital flows increase a country's available capital stock. This capital can then be used to supplement domestic resources in order to increase investment (which poses the question why Asia required so much foreign capital when the Asian region saves approximately 35% of GDP compared with the United States' 15%.)[10]

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[8]Mann, C. 2000. p.43.
[9]Wade, R. 1998/1999. p.51.
[10]Ibid. p.49.

2. Capital account convertibility will also allow enterprises and domestic and international investors to diversify their investment portfolio. This allows investors to reduce their vulnerability to income and wealth effects via domestic shocks, thereby reducing their overall investment risk.

3. Capital flows to developing countries will increase liquidity in these economies. In turn, this will enhance competition between financial intermediaries, thereby reducing margins and improving the quality of financial assets, which contributes to stronger, deeper economies.

However, capital account convertibility has obvious disadvantages, which represent significant challenges to developing economies:

1. The dramatic surge in capital flows has been stimulated by revolutionary changes in communications technology, which has helped to integrate the world's financial services industry. Investors can now access information on asset prices throughout the world, effectively, efficiently and at a modest price. However, such rapid advances in technology have made it even more difficult for governments or authorities to curb either inward or outward investment flows and financial markets can be inherently unstable.

2. Unfortunately, the efficiency of resource allocation in international financial markets is hampered by asymmetric information (where one party to a financial transaction has more information than the other). The degree of asymmetric information is believed to increase when it comes to international transactions, largely as a result of geographical and cultural factors. Thus resource allocation may be distorted.

3. Interest rates tend to be lower in developed Western economies than those in poorer developing countries. Therefore, under free capital mobility, capital will flow into the developing economy with the highest interest rate. In theory, as capital flows in, the developing countries interest rate should fall to the level of the advanced countries. "[But], the only way this can occur in the short-run is if there is a massive rise in the country's asset prices. Thus free capital flows are likely to lead to stock market and property bubbles"[11]. East Asia and Russia's dramatic build-up of debt was not complemented by an increase in the ability to service this debt.

The sequencing of capital account liberalisation

Current account liberalisation should be undertaken before the liberalisation of the capital account. Otherwise, the liberalisation of the capital account would attract large volumes of

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[11]The Economist. 14 March 1998. p.116.

capital inflows, which would lead to an appreciation of the domestic currency and a deterioration in export competitiveness. The Asian economies, as we have seen, liberalised their current accounts before introducing capital account convertibility and China is following a similar but far more gradual approach (and is, as we have seen, yet to liberalise the capital account).

The freeing of the capital account is likely to lead to a sudden and dramatic inflow of foreign capital, particularly when the exchange rate is fixed or nominally pegged. This was evident in East Asia and Russia prior to these countries' financial crises. A pegged exchange rate seemingly removes the risk of exchange rate losses via exchange rate fluctuations. This belief has resulted in an underestimation of exchange rate risks, contributing to excessive borrowing and lending. If a pegged exchange rate is in operation, the authorities will attempt to offset an appreciation of the domestic currency (a result of the capital inflows) by adopting a policy of sterilisation (which was discussed in Chapter 1). However, the increased domestic money supply ensures that policy makers maintain high nominal interest rates, which only serves to attract further capital inflows.

If the exchange rate is a floating regime, a dramatic inflow of capital will result in an appreciation of the exchange rate. The appreciation will increase the price of exports and reduce the price of imports. This will lead to a deterioration in the trade balance, which can adversely affect investor sentiment and cause a reversal of capital inflows. Thus, the liberalisation of the capital account should only be undertaken when a country's trade is sufficiently developed; otherwise the current account balance may weaken.

In East Asia, the volume of speculative investments that saw little or no returns left the economies with an absence of liquidity when investors began to call in their loans. I believe that capital account convertibility should, therefore, follow a gradual process, similar to the procedure underway in China. This can progressively eliminate weaknesses and risks while improving regulatory mechanisms. The optimal sequencing of capital account liberalisation should attempt to maximise the benefits of convertibility, whilst reducing potential hazards identified in the liberalisation of Asia's capital accounts.

The radical liberalisation of the Asian economies' capital accounts, which was recommended by both mainstream literature and the IMF, was not accompanied by the introduction of regulatory and supervisory standards that could influence the enormous inflows of foreign currency-denominated short-term capital inflows. In the aftermath of the Asian crisis analysts and market participants demanded the adoption of Western standards of

transparency and disclosure. Hence, financial transparency would also appear to be an important prerequisite prior to capital account liberalisation.

In Thailand and Korea banks were the primary financial intermediaries receiving and distributing capital inflows. The expansion of the banks' balance sheets contributed significantly to their vulnerability that was exposed following the outbreak of the crisis, which precipitated a banking crises. Therefore, fundamental improvements must be made in the developing countries' banking sectors, prior to the liberalisation of the capital account. Primarily this would include increasing capital-adequacy ratios, introducing more stringent loan criteria and improving liquidity requirements. Restrictions to limit the amount of foreign borrowing that banks can engage in may also be advisable.

The build-up of NPLs, in Asia, was accelerated by moral hazard, where implicit and explicit government guarantees promoted excessive borrowing and risk-taking by financial intermediaries. (The IMF was also criticised in regard to moral hazard and this will be discussed in Chapter 6.) These or similar 'guarantees' in other developing economies must be addressed prior to liberalisation of the capital account, otherwise a similar expansion of credit together with a rise in NPLs is likely to ensue. To counteract the potential of moral-hazard-induced lending and to maintain financial efficiency and stability, the financial institutions that pose least risk to promoting moral-hazard-related lending and those that exercise the most developed regulatory regimes evident in the economy should be granted liberalisation privileges before their domestic competitors. Support for the most prominent inefficient financial intermediaries in newly liberalised economies should be removed.

The conventional belief regarding capital account liberalisation remains that it should take place only after the macroeconomy is stabilised, indeed. Indeed, Barry Eichengreen believes that: "For emerging markets, an open capital account should be the exception not the rule."[12] Inflation should be low, imbalances in the balance of payments must be rectified and financial intermediaries should be robust and transparent. An alternative view on the sequencing of capital account liberalisation states that cogent reforms will not be implemented until the country is subjected to external pressures demanding such reforms. In turn, this may enable the economy to overcome vested interests' opposition to reforms. This approach advocates an early opening of the capital account in the economic reform process. While this may seem hasty it can be offset by the introduction of a temporary yet frugal and authoritarian institution to monitor the inflows of capital. This institution would provide time

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[12]Eichengreen, B. 1998.

to enable the development of proficient financial intermediaries, markets and instruments, which would otherwise appear to be a prerequisite for capital account convertibility.

To summarise, there are clearly costs and benefits to each approach of capital account liberalisation, which will vary between countries, depending on both their economic objectives and the economic conditions prior to the removal of capital restrictions. Fundamental weaknesses must be rectified by an economy if capital account liberalisation is to provide a sustained access to foreign private capital. If these vulnerabilities are not addressed prior to the liberalisation of the capital account, the economy may be subjected to a financial panic and ensuing economic crisis.

Corsetti *et al.* argue that: "As long as financial systems are weak, poorly regulated and subject to political distortions, a hasty rush to capital account liberalisation may be unwise and produce destabilising effects. The benefits of free capital flows are numerous and provided that financial systems are strong, the arguments in favour of free capital mobility are compelling. In the transition to a system with desirable characteristics, however, capital account liberalisation will have to be cautious, gradual and carefully managed."[13]

Thus, in my opinion, limited capital controls should be employed until the country is sufficiently developed to liberalise entirely.

4.iii. Capital controls

The efficient market hypothesis (EMH) was established to examine financial market performance in conditions of repression in the domestic economy in order to develop an analysis of the theoretical advantages of liberalisation of domestic capital markets and was later extended to the explanation of the performance of international financial markets. The EMH states that, left to themselves "capital markets generate asset prices that, given available information, are best estimates of the present value of future income streams from capital assets. Errors in asset pricing, that get generated as a result of incomplete information, get removed by signals from excess demand and the correction squeezes out 'noisy traders' who can push prices away from equilibrium by speculating on price movements instead of evaluating assets on the basis of fundamentals"[14]. But Dani Rodrik of Harvard University argues that: "In reality, financial markets are inherently unstable, subject to bubbles (rational or otherwise), panics, short-sightedness, and self-fulfilling prophecies."[15]

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[13]Corsetti et al. 1998c. p.26.
[14]Damodaran, S. 1999. p.16.
[15]Rodrik, D. 2001. p.60.

The instability of international capital markets and the recent crises has resulted in an increasing majority of market commentators endorsing an increased role for capital controls to restrict the movement of destabilising short-term capital flows. Indeed, Sumangala Damodaran of Delhi University concludes that: "The inability of financial markets to lead to optimum solutions left by themselves renders capital controls as the obvious second best solution."[16] However, Alan Greenspan, the Chairman of the U.S. Federal Reserve, opposes capital controls stating that: "The relative stability of China and India, countries whose restrictions on international financial flows have insulated them to some extent from the current maelstrom, has led some to conclude that the relatively free flow of capital is detrimental to economic growth and standards of living. Such conclusions, in my judgement, are decidedly mistaken."[17]

The case for capital controls has concentrated on two main areas: restrictions on short-term destabilising capital inflows and restrictions on capital outflows in the event of a crisis. (Although there are also proponents of restrictions on FDI, this topic is far less contentious and less relevant to this thesis than the former.)

Controls on short-term destabilising capital flows

Restrictions on short-term 'hot money' capital inflows enable the domestic authorities to regulate the composition of funds in the economy's capital account. Thus controls on capital inflows usually encourage flows of long-term FDI and restrict potential surges of short-term capital and portfolio investment. The capital controls which have been employed by China have contributed to the strengthening of the economy's external balances, while in East Asia and Russia the absence of such controls resulted in an over-reliance on short-term foreign capital and relatively small inflows of long-term FDI.

Capital account liberalisation was poorly sequenced in the Russian and East Asian economies. This posed significant dangers due to the fundamental economic weaknesses that were clearly apparent in these countries. These weaknesses should have been insulated by the imposition of limited capital controls, which would have prevented excessive borrowing and the resulting vulnerability to a financial panic. In Asia, capital controls would have provided time for the financial institutions to enhance their risk-management practices and improve the authorities' ability to regulate and supervise the composition of capital inflows. But capital controls must be impartially implemented so that financial intermediaries who enjoy a close relationship with government officials are unable to dramatically expand their

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[16]Damodaran, S. 1999. p.23.

balance sheets in the belief that they enjoy government guarantees, while 'unconnected' institutions, which are financially superior are prevented from accessing foreign funds.

Currently, the Basel Capital Accord gives a lower risk weight to short-term rather than long-term loans to banks outside the OECD. Thus, Western financial institutions are encouraged to make short-term rather than longer-term loans. The recent bout of financial crises has shown "that the standards of the Basel Capital Accord are increasingly divorced from the credit risks actually faced by many banks, and are distorting incentives for banks regarding the capital maintained for a given level of risk"[18]. Following the financial crises, there have been calls to alter the Basel Accord so that the incentives for short-term loans are removed and long-term loans are encouraged. Moreover, it is widely believed that controls on inter bank lending could improve global financial stability. Controls on short-term capital inflows can restrict all short-term inflows of foreign capital or simply curb the domestic banks' ability to lend and borrow in offshore markets. Of these two methods of controlling capital flows, the restriction of cross-border inter bank flows has received most support. Primarily, this is a result of the dramatic expansion of bank balance sheets in East Asia. The credit that had driven this expansion proved destabilising when foreign banks suddenly refused to roll-over their loans. Therefore, the imposition of controls on the domestic banks' ability to borrow in foreign currency denominated short-term debts could enhance banking standards in the developing economy. Capital controls can be effectively implemented on either the foreign lender or the domestic borrower conducting the financial transaction. But other analysts contend that controls, which are only implemented on inter bank loans will be unable to insulate a country from destabilising flows of foreign capital. Therefore, they believe that the only alternative is restrictions on all short-term capital inflows, including equities and portfolio investments.

However, it is widely agreed that any growth in foreign currency-denominated loans should be met by an increase in the banks' reserve requirement ratios. This would help to ensure that there is available liquidity to meet the demands of creditors should the loans be called in and may also help to avoid the liquidity crisis seen in the Asian banks, where short-term loans were financing long-term investments and reserve ratios were low.

Capital controls were in operation in Chile from 1991-1998. These controls encouraged long-term and FDI capital inflows, and reduced inflows of destabilising short-

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[17]In: Wade, R. 1998-1999. p.49.

[18]Akyüz & Cornford. 1999. p.27.

term capital. Indeed, empirical evidence suggests that the composition of funds in Chile's capital account was influenced in favour of FDI and long-term loans. Chile has used three main types of controls. Firstly, 30% of all non-equity capital inflows into Chile have to be deposited in the central bank for one year where they will receive no interest income. The loss of income on this money effectively works as a tax on the inflow of capital. Therefore, if the capital inflow remains in Chile for only a short period, this effective tax will be proportionally greater than if the capital remained in the country for a longer period of time. Secondly, Chilean financial institutions can only access foreign funds if at least two bond rating agencies rate their risk at the same level or lower than Chile's own government bonds. Finally, any capital that enters Chile must remain in the country for a period of at least a year. This capital control has discouraged many hedge and pension funds from investing in Chile at all.

Since the imposition of capital controls, Chile has maintained stable growth and avoided financial crises. However, whether Chile's stability and resilient growth has been the result of the restrictions on capital mobility is debatable. Joseph Stiglitz believes that Chile's capital controls have had the desired effect, arguing that "you want to look for policies that discourage hot money but facilitate the flow of long-term loans, and there is evidence that the Chilean approach or some version of it, does this"[19]. Dani Rodrik (1998) conducted a study of many countries, including those that have imposed capital controls and those that have not. He found that: "the data provides no evidence that countries without capital controls have grown faster, invested more, or experienced lower inflation. Capital controls are essentially uncorrelated with long-term performance once we control for other determinants."[20] Corsetti *et al.* believe that Chile's economic success has less to do with capital controls and more to do with "an effective prudential regulation and supervision of the financial system, more than to the presence of controls on short-term inflows"[21]. Moreover, Corsetti *et al.* provides empirical evidence to argue that the restrictions on capital mobility have become less effective over time and favoured large corporations over smaller and medium sized ones. Yet capital controls could alternatively be placed on capital outflows in the face of a potential crisis.

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[19]Edwards, S. 1998. p.26.
[20]Corsetti et al. 1998c. p.24.
[21]Ibid. p.23.

Controls on capital outflows

In the face of the Asian financial crisis the orthodox policy response was to tighten monetary policy, raising interest rates in an attempt to ensure that investors will keep their money in place, thereby contributing to exchange rate stabilisation. However, such a belief has proved perverse. The higher interest rates only indicate a declining credit worthiness and greater risk of default, whilst also reducing economic activity and the potential for future economic growth. But, as the IMF is keen to point out, a reduction in domestic interest rates when currency markets are volatile is likely to result in a continued outflow of capital. This will cause a further depreciation of the exchange rate and increase the cost of repaying foreign currency-denominated loans. Hence, the imposition of controls on capital outflows allows domestic policy makers to reduce interest rates with no adverse effects on the value of the currency. Such was the reasoning of Malaysia's Prime Minister, Mathathir Mohammad, that Malaysia imposed capital controls in August 1998. Similar controls on capital flight had previously been imposed by Spain in 1992, Thailand in 1997-98 and Russia in 1998. Advocates of these restrictions claim that they provide authorities with time to address macroeconomic imbalances and, in the case of Malaysia, successfully lengthened the maturity of debt. This represents a significant achievement because the short maturity of debt had played a prominent role in the financial crises in Mexico, Asia and Russia.

Under Malaysia's capital controls, the authorities attempted to control all purchases and sales of the ringgit. Malaysian citizens were forbidden to take as little as $100 out of the country. Following the imposition of the restrictions on capital outflows, the Malaysian government was subjected to much criticism. The more pessimistic analysts believed that the restrictions would deter legitimate foreign investments such as FDI and, worse, believed that the economy would collapse and hyperinflation ensue. Yet, Malaysia enjoyed a significant economic recovery and the controls enabled the authorities to implement significant economic reforms, which have strengthened the banking system.

Opposition to controls on capital outflows have focused on a number of arguments. Primarily, the opponents consider the imposition of restrictions on capital flows as a refusal by the countries authorities to tackle the structural problems evident within the economy. Instead, they believe that any policy interventions should aim to improve the regulation and supervision of the financial system. Secondly, if foreign creditors anticipate the implementation of capital controls in response to capital outflows, such expectations may accelerate the withdrawal of foreign funds even before the restrictions are imposed. Indeed, when Malaysia and Russia imposed capital controls in August 1998 it damaged investor

sentiment towards emerging markets worldwide and particularly Latin America. Third, according to Corsetti *et al.*, the experience of "capital controls in Latin America in the aftermath of the 1980s debt crisis ... was quite dismal. Controls tended to be ineffective, a tool of financial repression associated with negative real interest rates ... They eventually led to more, rather than less, capital flight"[22]. Finally, capital controls present ample opportunities for corruption and may also encourage rent-seeking activities and induce moral hazard.

Nonetheless, Paul Krugman argues that: "Malaysia has proved a point - namely, that controlling capital in a crisis is at least feasible. Until the Malaysian experiment, the prevailing view amongst pundits was that even if financial crises were driven by self-justifying panic, there was nothing governments could do to curb that panic except to reschedule bank debts ... and otherwise try to restore confidence by making a conspicuous display of virtue."[23]

4.iv. Other forms of protection for developing countries

Foreign exchange reserves

A key fundamental weakness of Russia and the East Asian crisis-hit countries was the inadequate level of foreign exchange reserves relative to foreign currency-denominated short-term debt. Indeed, foreign short-term debt exceeded available foreign exchange reserves in all of the worst hit countries. (See Table 2, p.118.) In contrast, Taiwan and the Chinese mainland had a massive supply of foreign reserves relative to foreign short-term debt and these were two Asian countries, which escaped the worst effects of the regional crisis. The knowledge that there are insufficient foreign reserves to pay back each creditor can accelerate the withdrawal of foreign capital as investors rush to be paid back before available foreign exchange reserves are exhausted. Therefore, an adequate level of foreign exchange reserves relative to short-term debt is an important measure to increase the resilience to financial market turmoil.

However, the accumulation of foreign exchange reserves has many economic costs. An economy can accumulate foreign currency reserves by running substantial trade surpluses over a number of years. Thus, the country must export more than it imports, which results in reduced domestic consumption and investment. Secondly, increasing foreign exchange reserves by means of sterilising capital inflows is costly because the return on foreign exchange reserves is likely to be far lower than the cost of external borrowing (foreign

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[22]Ibid. p.25.

reserves often being invested in low-yielding U.S. Treasury Bills). "[Indeed] the cost of sterilising private borrowing falls entirely on the public sector whose losses will exceed the foreign exchange cost of carrying such reserves since domestic interest rates on government debt exceed the rates earned on reserves by a larger margin than borrowing rates in international financial markets. This can give rise to large fiscal deficits"[24]. Moreover, sterilization as a means of accumulating foreign exchange reserves implies that an economy should borrow simply to amass foreign reserves rather than to promote investment through capital inflows. Alternatively, reserves can be accumulated by borrowing over longer-term periods whilst making similar investments in easily-marketed, liquid securities. This is essentially the method that China has used in amassing over $145 billion of foreign exchange reserves. "Peru's central bank holds foreign reserves equal to 15 months of imports as an insurance policy against the sudden capital outflows that financially open economies often experience. The opportunity cost of this policy amounts to almost 1% of gross domestic product annually - more than enough to fund a generous antipoverty programme"[25]. However as pointed out by Michael Naameh of Crown Agents, "having a high level of international reserves encourages inward investment, can serve as a deterrent to speculative attacks - assuming policy credibility - and can reduce borrowing costs to the whole economy and not just the public sector".[26]

A country's ultimate source of liquidity is the central bank. The central bank is able to prevent or at least contain bank runs by fulfilling its role as 'lender of last resort' where it provides emergency liquidity to its domestic banks. However, when banks have borrowed in foreign currency the central bank is unable to print that currency and act as 'lender of last resort'. Furthermore, there is no international 'lender of last resort' who can intervene by printing money and provide emergency liquidity to countries in financial distress. The only organisation that can be considered similar is the IMF. But, in contrast to a central bank which can print unlimited quantities of domestic currency, the IMF can only provide a limited amount of dollars or euros due to the IMF's limited capital resources.

Introduction of a collateralised credit facility[27]

Vast amounts of available liquidity is an effective tool to counteract currency speculators. However, there are significant costs involved in hoarding large quantities of foreign exchange

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[23]Krugman, P. 1999b.
[24]Akyűz & Cornford. 1999. p.20.
[25]Rodrik, D. 2001. p.57.
[26]Naameh, M. 2001.

reserves. As was discussed above, this is primarily because the reserves must be held in extremely liquid low-risk and thus low interest-bearing investments, so that they can be drawn upon at short notice. The concept of a collateralised credit facility would enable countries to borrow large quantities of foreign exchange at short notice. Therefore, if the credit facility were large enough and had sufficient resources it could almost eliminate the need for countries to maintain large supplies of foreign exchange reserves and thus the costs of hoarding foreign reserves. Access to such a facility must only be granted if economic behaviour is deemed appropriate and only in the face of destabilising financial markets. Martin Feldstein argues that such a facility would be successful because of the high value that creditors place on sound collateral rather than perceived virtue. Thus, the collateralised credit facility would almost certainly provide time for a developing economy to reschedule its debts. The most appropriate collateral for this facility would be trade receivables (hard currency export earnings of domestic firms). This collateral is commonly used in private credit agreements between developing economy enterprises and their advanced country creditors. The collateral cannot be in the form of the developing country's domestic assets because this would make it difficult for creditors to both obtain and then convert into foreign currencies. Martin Feldstein reckons that: "With collateral there is no need to argue about whether a country is unable to meet its debt service requirements or is just unwilling to do so. Done properly, such a facility could substitute for an international lender of last resort, lending freely at penalty interest rates against good collateral."[28]

However, in the face of currency devaluation, I believe that such a facility would not necessarily provide sufficient confidence amongst residents to eliminate the selling of the local currency, which had such a devastating affect in the Asian region. Moreover, financial interference unavoidably promotes the risk of moral-hazard-induced lending, which may encourage domestic enterprises to take on even more foreign currency-denominated loans.

Monetary policies to maintain credit lines

Capital outflows will begin when market participants believe that there are more profitable investment opportunities elsewhere. Hence, creditors withdraw their loans in order to maximise profits and minimise losses. When the IMF provided loans to assist Thailand, Indonesia and South Korea (which will be discussed in Chapter 6) they demanded that interest rates were to be increased in an effort to ensure creditors maintain or even increase their exposures given the greater rates of return on offer. But, as previously stated, increased

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[27]Proposed by Feldstein, M. See: 1999a or 1999b.

interest rates reduced economic activity and may have little affect on creditors lending if they believe that such high levels are politically difficult to maintain.

Nonetheless, in the case of Hong Kong SAR, which operates a currency board, the persistent application of increased levels of monetary tightening eventually stabilised the currency. However, this was achieved by increasing the difficulties of the debtors and by multiplying the number of bankruptcies and defaults. This was because the stabilisation of the currency was achieved by a reduction in the selling of the domestic currency rather than increased purchases. The consequent recession and debt deflation made it increasingly difficult for debtors to raise funds and service their debt. Therefore, a persistent tightening of monetary emissions will only achieve stabilisation through a depression of the domestic economy.

Debtor-creditor burden sharing and debt standstill

The recent financial crises have created mass unemployment and increased poverty levels throughout the affected emerging markets. In contrast, the crises have had little affect upon the wealthier nations, and more specifically, on the private creditors that provided loans on a large scale to the crisis-hit developing nations and then abruptly refused to roll over their credits.

In the Asian financial crisis creditors enjoyed a far stronger bargaining position than the countries that were facing default. When a country is facing a debt default, the creditors can demand full-repayment, or rigid terms for rescheduling the debt, which may include the imposition of far higher rates of interest, or the domestic government may guarantee the debts of the private sector. A heavily indebted country is only permitted to confirm a default in the most extraordinary of circumstances. Only then can the country reorganise and establish its intention to pay only a proportion of selected loans back to the foreign creditors.

In light of recent experience, it has been evident that investors have not shared fairly in the losses that the borrowing countries have endured. Yet this is not the case in a normal commercial market situation where the creditors and borrowers share losses or profits evenly. This has prompted some analysts to propose private sector 'bail-ins' where private creditors, according to previously agreed terms, would be required to maintain or even increase their exposure to an economy in financial distress. The creditor 'bail-in' concept was applied to commercial bank credits during the 1980s debt crisis and resulted in restricted access to voluntary private foreign capital. Moreover, an additional problem with "proposals for

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[28]Feldstein, M. 1999b. p.16.

bailing in the private sector is that they could generate an adverse trade-off between mitigating the risks of crises (by discouraging excessive borrowing) and containing crises when they do occur. Specifically, application of such mechanisms on a regular basis may increase incentives for creditors to flee a country at the first signs of trouble"[29]. This is likely to increase the cost of borrowing in many emerging markets due to the greater perceived risk that such a mechanism would involve.

When an enterprise is threatened with bankruptcy they often request patience from their creditors or appeal for temporary court protection for such assistance. Barry Eichengreen, believes that this concept should be extended to international situations to assist countries facing debt difficulties. This notion, which is similar to Chapter 11 of the U.S. bankruptcy code, will enable an economy facing default to declare a debt standstill while providing court approval for protection from creditors allowing for a re-servicing of debts and an improvement in the prospects for an economic recovery. Should a standstill on the repayment of debt be imposed it would essentially be a restriction on capital mobility and thus an effective control on capital outflows. Moreover, the standstill on debt repayments would only preclude one type of capital outflow, whilst allowing the country's residents that fear a devaluation to remain free to convert domestic currency into foreign and possibly precipitate the very crisis the debt standstill was supposed to prevent. Domestic residents were, indeed, the main sellers of the local currency in the worst of the Asian crisis-hit countries.

The 'Tobin' tax

To reduce the level of speculative capital flows many analysts, particularly in Asia, have proposed the implementation of the 'Tobin' tax (after the Nobel prize winning U.S. economist James Tobin who originally suggested the concept). The Tobin tax would charge a tax on short-term foreign exchange transactions. Advocates argue that if the Tobin tax was imposed it would reduce the amount of destabilising short-term capital flows (presently over a trillion dollars a day[30]) by making such transactions more expensive. Proponents of the Tobin tax claim that it would indirectly encourage long-term capital flows, provide a central bank with greater autonomy over the value of the national currency and reduce the adverse consequences that currency volatility has inflicted upon developing countries. Additionally the tax would generate substantial revenues, which could be used to finance worthwhile

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[29]Mussa et al. 1999. p.12.
[30]Ambrose, S. 1998.

projects promoting environmentally sustainable development and address problems of climate change and poverty.

However, if the Tobin tax is to be successfully implemented and reduce the volume of capital flows, the tax percentage must be large enough so that overnight speculative transactions are reduced. The majority of proposals for the tax have ranged from 0.1%-0.5% per transaction, which would create substantial revenues. Some estimates have concluded that annual revenues could exceed $100 billion.[31] Implementation of the Tobin tax would require an effective and efficient institutional framework to regulate and supervise capital flows, ensuring that potentially destabilising flows are taxed. The primary recipients of the tax revenues should be the economies that are involved with each transaction. However, there should also be a fund where a proportion of the tax revenues are allocated to assist less developed countries with their development, while also providing rapid response emergency action for natural and environmental disaster areas. Universal adoption of the Tobin tax should be the ultimate goal but in its transitional stage the tax could effectively reduce global flows of 'hot money' by the implementation in advanced countries only.

Opponents to the Tobin initiative argue that while the imposition of the tax is in its transitional stage and is yet to be universally adopted, the tax could be dodged by moving transactions to countries that are yet to impose the tax. But, to dodge the tax in this manner would involve additional expense and effort, which may in itself help to reduce short-term capital flows. Furthermore, opponents contend that the Tobin tax would not restrict selling of the currency by domestic residents, which accelerated the crises in Asia. If the Tobin tax is adopted, political will and support by leaders of developed and developing countries is paramount to the successful and effective implementation of the tax.

The need for greater transparency and an early warning mechanism

The Asian crisis-hit countries were severely castigated for both the private and public sectors' inadequate degree of financial transparency and disclosure. Consequently, the Asian crisis has intensified initiatives advocating that market participants should receive an early warning regarding the condition of key macroeconomic variables. Such a concept is believed to be essential for enhanced decision-making by private creditors. In turn this would contribute to better market discipline, improved financial regulation and supervision and greater policy surveillance by multilateral institutions such as the IMF and World Bank.

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[31]Ibid.

In April 1996, following the Mexican 'Tequila' crisis and the desire for improved information on key macroeconomic variables, the IMF launched the Special Data Dissemination Standard (SDDS). Essentially the SDDS was established to assist member countries in the public dissemination of economic and financial data to promote continued access to global financial markets. The SDDS and the stringent rules that accompany it were supposed to provide an early warning mechanism to market participants and observers who could then assist the economy, enabling it to avert a financial crisis. However, the SDDS did not help to foresee or even preclude the Asian crisis, which was the least anticipated financial crisis in many years.

In response to the inadequate financial disclosure and ultimately the failure of the SDDS to anticipate the crisis, the Interim Committee recommended an expansion of the SDDS. Recommendations included increasing available financial information, including data on private foreign debt, net foreign exchange reserves and any other indicators, which might indicate potential financial stability. Moreover, the Committee recommended that the IMF examine the need for a code of sound practices on monetary and financial policies, which was later adopted in 1999. The code has been established to complement sound practices as regards fiscal transparency, which are designed to strengthen both the credibility and the general public's understanding of macroeconomic policies. Additionally, the code is perceived to improve the accountability and integrity of the institutions, which are responsible for the conduct of monetary policy. Further initiatives have been proposed to enhance financial regulation and supervision of capital flows to financial intermediaries.[32]

Undoubtedly, greater international transparency is desirable and would enable creditors to make improved investment decisions, which could promote greater efficiency in the allocation of capital throughout the world. Nonetheless, it is important to appreciate that while financial transparency in Asia was inadequate, it was not a fundamental cause of the regional crisis. Indeed, information was available on the quantity of short and long-term foreign debt, the balance of payments and the languishing property sector. Perhaps what was actually absent from the onset of the Asian crisis was competent appraisal by market analysts, the IMF and the World Bank. In the case of the Russian crisis, a large proportion of the purchases of the Russian governments debt took place at a time when information regarding the authorities' inability to improve tax revenues was widely available. And, more generally,

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[32]For a summary of the code of good practices on increased monetary and financial transparency, see: J. Drage & F. Mann. 'Improving the stability of the international financial system'. Financial Stability Review. June 1999. pp.44-45.

there was abundant information concerning the absence of an effective judicial system, the dire state of the country's banks and the pervasive crime and corruption. It would therefore appear that increased transparency would not greatly improve the global financial system and reduce the frequency of financial crises.

Stronger banking foundations

In January 2001 amendments to the 1988 Basel Accord were announced. The original accord required that banks' capital was at least 8% of their risk-weighted loans to the non-banking private sector. However, this notion of capital adequacy was far too simplistic, assuming that the ratio of a bank's capital to its loans would determine whether or not its capital was adequate. This resulted in perverse incentives. "At present banks have an incentive to lend to riskier credits when the capital they think they should set aside is more than regulators demand; and the reverse is also true"[33]. In June 1999 the Basel committee recommended that capital requirements represent the actual credit risk of their loans, and the details were unveiled on January 16th. They primarily address three areas, including minimum capital requirements, improved regulation and supervision, and greater transparency and disclosure. A final committee meeting will take place in May 2001 and the new timetable for implementation is 2005. Any measures that improve the strength of banks should be welcomed because "countries with healthy banking systems survived the Asian financial crisis in 1997-98 much better than those with sickly ones. The banking system acts as a shock absorber; if the shock absorber is worn out, then the shocks are magnified"[34].

4.v. Conclusion

The sequencing of capital account liberalisation in the Asian region was headlong. Capital accounts were liberalised when banking standards and regulatory mechanisms were weak. The surge in capital inflows to Asia was greatly in excess of the economies' ability to absorb them productively, which resulted in a deteriorating investment environment. In contrast, Chile's capital controls provided the economy with time to strengthen banking regulation and limit foreign currency exposures. Therefore, when Chile liberalised its capital account, good banking practices have contributed to the strength of the economy and reduced the economy's vulnerability to financial panic.

The bout of financial crises have shown that financial markets are unstable and that capital account liberalisation has precipitated financial crises in Mexico, Asia and Russia. International capital markets are prone to excessive optimism followed by excessive

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[33]The Economist. 20 January 2001. p.18.

pessimism. Paul Krugman laments that: "When things are going well there is a strong tendency to suppose that financial markets can take care of themselves. Well they can't."[35]

I believe that emerging market economies should reduce their vulnerability to a financial crisis by implementing restrictions on capital mobility. But capital controls cannot be a substitute for sound economic policies. Instead, these controls should be implemented in order to provide time for the developing country to strengthen their economic fundamentals, prior to the ultimate objective of capital account liberalisation. China has largely been insulated from financial market turbulence despite its apparent weaknesses, which are being addressed under the protection of capital controls. Capital controls should promote FDI and long-term loans.

Liquidity also appears to be an important self-protection measure for emerging market economies. But the collection and maintenance of foreign exchange reserves involves numerous costs, which would be proportionally greater for smaller, developing nations. These costs are why many emerging markets will not attempt to accumulate foreign exchange reserves and thus run the risk of a currency crisis. These economic costs would support the imposition of capital controls as an alternative self-protection mechanism. Moreover, the IMF does not have sufficient available resources to act as an international lender of last resort. Thus countries must fend for themselves. Therefore, the introduction of a collateralised credit facility would, given the available resources, provide emergency foreign exchange and possibly help to mollify erratic financial markets.

Experience has shown that when countries are faced with an impending crisis their creditors place demands on the economies that make repayment almost, if not entirely, impossible. At the same time, these countries have been led to believe by the U.S. and the IMF that implementing controls on capital flight is unthinkable. Consequently, the concept of private sector 'bail-ins' and concerted bank actions to maintain or increase creditors exposure to a country in financial distress has been proposed. But this notion will not address the selling of the currency by domestic residents. Besides the concept is comparable to controls on capital outflows, which would actually address the problem of domestic selling of the currency.

The Tobin tax is a praiseworthy initiative that would reduce the volume and volatility of short-term capital flows. However, if the tax is to be successfully and effectively

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[34]Ibid.
[35]Krugman, P. 2000c.

implemented it must be widely supported by leaders of advanced and developing economies alike, with stringent penalties accompanying evasion of the tax.

European leaders have been quick to recognise the devastation that short-term capital flows have caused in the financial crises of recent years. Robert Wade argues that the countries of the European Union appear to believe that its sympathy towards Asia's difficulties, together with their policies that favour capital controls and eventually a stable euro, will make the euro a more appealing foreign exchange reserve rather than the dollar. This would provide Europe with a far greater degree of global economic clout regarding decisions that will shape the world economy in years to come.[36]

[36]Wade, R. 1998-1999.

Table 1. Net capital inflows to Asia and the Pacific 1996-2000, U.S. $ billion.

	'96	'97	'98	'99e	'00e
Total Private Capital Inflows	176.3	67.9	5.8	39.3	59.4
Bank Loans and other	113.7	10	-54.3	-30.2	-12.6
Portfolio Investment	17.2	6	4.9	14.9	18.4
FDI	45.4	51.9	55.2	54.6	53.6
Net Official Flows	5	36.7	31.2	4.3	8.3
Total Inflows	181.3	104.6	37	43.6	67.7

1999 and 2000 are estimates.
Source: Williamson, J. 2001. p.14.

Table 2. East Asia's short-term debt versus foreign reserves 1990-1997.

Short-term debt, U.S. $ millions.

	Indonesia	Korea	Malaysia	Philippine	Thailand	Total
June '90	10,360	15,528	1,761	3,019	7,026	37,694
June '94	18,882	34,908	8,203	2,646	27,151	91,790
June '97	34,661	70,182	16,268	8,293	45,567	174,971

International reserves, U.S. $ millions.

	Indonesia	Korea	Malaysia	Philippine	Thailand	Total
June '90	4,963	14,642	8,114	948	11,882	40,279
June '94	10,915	21,684	32,608	6,527	27,375	99,109
June '97	20,336	34,069	26,586	9,781	31,361	122,133

Debt to Reserves Ratio.

	Indonesia	Korea	Malaysia	Philippine	Thailand	Total
June '90	2.21	1.06	0.22	3.19	0.59	0.94
June '94	1.73	1.61	0.25	0.41	0.99	0.92
June '97	1.7	2.06	0.61	0.85	1.45	1.43

Source: Chang and Velasco. 1998c. p.7.

CHAPTER FIVE: THE EXCHANGE RATE DEBATE

Introduction

In this chapter the plausibility of various exchange rate options will be assessed. The choice ranges from floating exchange rates (as used by most developed nations, including the U.S. dollar, the yen and the euro) to a rigidly fixed regime (such as a currency board system, as used in a small number of countries, e.g. Argentina and Bulgaria, or the special administrative region of Hong Kong), to 'dollarization' (which was recently introduced in Ecuador, El Salvador and Guatemala). With 'dollarization' a country's currency is eliminated and the country adopts a foreign currency such as the dollar as the country's legal tender. The costs and benefits of each regime will be considered.

5.i. The dilemma

The exchange rate dilemma, as described by an article in the *Economist*, primarily concerns the 'impossible trinity': "A policy maker trying to design the ideal financial system has three objectives. He wants continuing national sovereignty; financial markets that are regulated, supervised and cushioned; and the benefits of global capital markets. Unfortunately ... these three goals are incompatible. They form the 'impossible trinity' that underlies the instability of today's global architecture. Any coherent reform proposal must favour two parts of the trinity at the expense of the third. For instance, those who wish to regulate markets and maintain national sovereignty must do so at the expense of capital market integration. Those who wish to maintain sovereignty and yet allow capital markets to integrate must accept an entirely free market at the global level. Those who want capital market integration and global regulation must forfeit national sovereignty"[1].

The currency crises of recent years have all involved fixed or nominally pegged exchange rates. These crises include the E.U's Exchange Rate Mechanism (ERM) in the early 1990s, Mexico in 1994-95, Asia in 1997, Russia in 1998 and Brazil in early 1999. This striking coincidence has led many commentators to conclude that 'the peg did it'. Moreover, there has been a growing trend towards greater exchange rate flexibility. In the mid-1970s, 86% of emerging markets had some form of pegged exchange rate, but in 1996 less than half did, with approximately a third of developing countries claiming to have independently floating exchange rates.[2] (Table 1, p.149, illustrates the trend towards greater flexibility among developing countries.)

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[1]The Economist. January 30 1999. Global Finance Survey. p.4.
[2]The Economist. 20 September 1997. p.139.

The financial crises in Asia and Russia illustrated that the combination of a pegged exchange rate, extensively liberalised capital markets and interest rates above world market levels is a policy combination which tends to maximise inflows (and subsequent outflows) of short-term capital. There is, indeed, strong evidence to suggest that fixed exchange rates are prone to currency crises because they appear to be inconsistent with capital mobility. The pegged exchange rate crises of the 1990's have dramatically changed perceptions toward fixed regimes and even the euro floats against other currencies. The more flexible exchange rates of the emerging markets of South Africa, Turkey and Mexico allowed these countries to adjust accordingly to the financial turbulence following the Asian and Russian financial crises. A country's decision to adopt greater exchange rate flexibility is associated with a more liberalised, outward-looking perspective towards trade and investment flows while allowing the market to determine both the value of the exchange rate and the level of domestic interest rates. However, the adoption of fluctuating exchange rates by some emerging markets is often infeasible. This is because their financial markets are often small and are, therefore, vulnerable to the volatility that just a few large financial transactions may cause. To counteract exchange rate volatility, managed or 'dirty floating' regimes may be employed. 'Dirty floating' occurs when the authorities use official intervention to guide or target their exchange rates to some degree and do not make news of their intervention public.

5.ii. Choosing a regime

Policy makers closely analyse the effects of random shocks to the domestic economy when choosing an exchange rate regime. The most appropriate exchange rate will be the regime that stabilises the economy's macroeconomic performance and thus minimises fluctuations in consumption, output and domestic price levels. Prior to the recent bout of financial crises, policy makers believed that the choice of exchange rate was not simply a choice between fixed and flexible regimes; they considered regimes with varying degrees of fixity, such as nominally pegged exchange rates (as adopted by Russia and the crisis-hit East Asian countries). Since the outbreak of these crises, however, economists have recommended exchange rates that are either flexible or rigidly fixed, arguing, that a loosely pegged exchange rate soon becomes unsustainable (this is known as the bipolar view, or two-corner solution). "Of the 33 countries classified as emerging market economies by J.P. Morgan ... the proportion with intermediate regimes fell from 64% to 42% over the decade [1991-1999].

By the end of 1999, 16 of these countries had floating rates and 3 had very hard pegs in the form of currency boards or no legal tender.[3]

A fixed exchange rate regime is believed to be more desirable if the disturbances that a country faces are predominantly monetary (and thus affect the demand for money), which will influence general price levels.

In 1995 Russia introduced the rouble corridor, which, together with the tightening of monetary emissions, brought the rate of inflation down to around 15% in 1997. The rouble acted as an anchor of stability for the economy. It helped to increase confidence among investors who were then prepared to lend to Russian banks, enterprises and the Russian government. When investor confidence began to dwindle higher rates of interest were offered in order to sustain the rouble's semi-fixed exchange rate. But increased rates of interest inevitably reduced real economic activity. Herbert Neiss of the IMF stated that: "A fixed exchange rate ... requires a strong, credible government, the willingness to accept very high interest rates whenever the peg comes under pressure and plenty of reserves to intervene."[4] Neither Russia nor the crisis-hit Asian countries possessed significant foreign exchange reserves or strong credible governments, which indicates that the pegged regime was inappropriate. Furthermore, Jeffery Sachs has argued that: "It is neither worthwhile nor feasible to twist monetary policy to soothe panicky investors, especially at the cost of internal depression."[5]

Flexible exchange rates, on the other hand, are favoured by many countries because they provide a smooth adjustment process to external shocks such as an increase in the world price of oil. Moreover, a floating exchange rate regime enables economies to target monetary policies to meet domestic objectives, which may include price stability. This is in contrast to altering interest rates to maintain the fixed value of a pegged exchange rate. Floating a currency will also mean that both investors and firms take precautions against the potential for exchange rate losses via exchange rate fluctuations. However, the main disadvantage of a flexible exchange rate is the volatility and misalignments, which often occur with such regimes. For an emerging market economy (especially the smaller ones), an exchange rate misalignment may have a pronounced effect on the economy. If the banking sector has significant exchange rate exposure, the country's banks' solvency could be jeopardised by a

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[3]Fischer, S. 2001. p.19.
[4]Neiss, H. 1998.
[5]Sachs, J. 1998a. p.24.

modest depreciation. Exchange rate volatility may also affect the emerging markets' external trade, which, for developing economies, usually forms a large proportion of GDP.

There is no 'perfect' exchange rate regime; each system has significant costs and benefits. Indeed, Jeffrey Frankel believes that: "No single currency regime is right for all countries or at all times."[6] An economy must, therefore, determine which regime complements their country's characteristics best. The key characteristics which will determine the authorities decision include the size and openness of the economy, the level of inflation, how developed the country's financial system is, the degree of labour market rigidity, the credibility of policy makers and how open the country's capital market is to international capital flows. These characteristics are as follows:

1. The size and openness of the economy is relevant because if trade represents a significant proportion of the country's GDP then fluctuations in the value of the currency may result in widespread social consequences. This would suggest that fixed exchange rates (such as currency boards) are suited to small, open economies.

2. If a country's inflation level is far higher than its primary trading partners, its exchange rate should be flexible. This should help to prevent its exports from losing competitiveness through real exchange rate appreciation (which takes into account relative inflation rates). Moreover, in developing countries, wages and prices are lower than those in advanced countries. But, in accordance with the Balassa-Samuelson effect*, wages and prices will rise faster than the prices in advanced countries as the high-growth developing countries catch-up with the advanced countries. This will lead to an appreciation of the real exchange rate. Thus, a floating regime will enable a depreciation to offset the inflation differential.

3. A floating exchange rate in a country that has an inexperienced and under-developed financial system could result in extreme volatility of the value of the exchange rate. This is because only a small number of large inflows or outflows of capital may be sufficient to dramatically alter the value of the currency.

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[6]Frankel, J. 1999.

* The Balassa-Samuelson effect arises because the growth of productivity differs among sectors, while wages tend to be less differentiated. Typically, productivity growth is faster in the traded goods sector than in the non-traded goods sector, such as services. To the extent that the faster productivity growth in the traded goods sector pushes up wages in all sectors, the prices of non-traded goods relative to those of traded goods will rise. Thus the faster productivity growth of developing countries, implies that, other things being equal, the consumer price index will rise faster in developing countries than in advanced countries.
Definition taken from Szapàry, G. 2001. p.27.

4. A floating exchange rate is more appropriate for an economy that has particularly rigid wages. This is because the flexible exchange rate will enable a straightforward adjustment to exogenous shocks (which will be discussed in greater detail later in the chapter).

5. A country may increase foreign investor confidence by providing a greater degree of independence to the country's central bank. This is because, as stated by Berman and McNamara, "foreign investors read central bank independence as a signal of strength of domestic proponents of sound monetary policy, both within the government and among domestic interest groups"[7]. Hence, where policy makers' credibility is weak the country's commitment to fighting inflation can be emphasised by installing a fixed exchange rate peg to help contain inflation and enhance confidence in the authorities abilities.

6. In Asia, the extensive liberalisation of the capital account and consequent surge in capital inflows made the maintenance of fixed exchange rates difficult. A flexible exchange rate will adjust more smoothly to inflows and outflows of capital. Moreover, due to the element of exchange rate uncertainty, vast volumes of capital inflows may actually be deterred.

The above criteria would suggest that fixed exchange rate regimes were the best policy option for the Asian economies, even before they were struck by the regional crisis of 1997. This is because they are relatively small economies. In 1997, imports amounted to approximately 40% of GDP in Malaysia, the Philippines and Thailand, twice the average for developing economies.[8] Wages in these economies are quite flexible and inflation rates were far lower than most developing countries. However, the credibility of the region's central banks was not strong enough to convince investors that the pegs were sustainable and the heavy weighting of the dollar contributed to exchange rate overvaluations.

A fixed exchange rate regime

In a fixed exchange rate regime the monetary authorities will determine the value of the currency relative to a single currency, such as the U.S. dollar, or a 'basket' of currencies. While the system remains in operation the economy's central bank will guarantee to convert domestic currency into a fixed quantity of the other currency. As previously noted, long-term sustainability of an exchange rate commitment requires a strong government, plenty of foreign exchange reserves when the peg is 'tested' and the ability to accept high interest rates.

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[7]Berman & McNamara. 1999. p.4.

The introduction of a fixed exchange rate regime can help to improve the credibility of domestic policy makers. This is because a pegged exchange rate can act as an 'anchor' for monetary and fiscal policy by maintaining the value of the exchange rate and thus contributing to a reduction in inflation. The peg requires that a country with a poor record of controlling inflation subordinates its monetary policy to that of a low inflation economy. While the regime remains credible, expectations of high inflation will be reduced. In addition, a fixed regime removes trade uncertainties due to the absence of exchange rate fluctuations. However, if the sustainability of the exchange rate comes into question the currency may be subjected to destabilising speculative attacks, which may force the authorities to try to 'prop-up' their currency by buying it back in the foreign exchange market with their foreign exchange reserves. Alternatively, they may increase interest rates to illustrate their commitment to the peg and ward off speculation.

Jeffrey Sachs argues that: "The only real exception to floating rates comes at the start of stabilization from extreme inflations, when exchange rate targeting is more efficient than monetary targeting."[9] Israel and Poland achieved stabilization under a fixed exchange regime, and then began the transition to a more flexible regime in 1985 and 1990 respectively. But the governments of Mexico, Thailand, Russia and Brazil refused to introduce greater flexibility to their exchange rate regimes even in the face of deteriorating fundamentals. Mr Sachs points out that maintaining an over-valued exchange rate results in cheap consumer goods and high real wages in urban areas and policy makers also fear political and economic repercussions. Barry Eichengreen laments that: "Transitions from pegged to adjustable rates have been anything but smooth."[10] This is primarily because transitions have not usually been undertaken in a favourable economic environment, and the change of policy is often delayed until a devaluation is forced upon the country, e.g. when foreign reserves have been exhausted. Eichengreen and others have shown that a country should begin the transition to a more flexible regime after stabilisation has gained sufficient credibility and while the currency remains strong. However, at such a time domestic policy makers see no reason to pursue greater exchange rate flexibility.

Fixed rates have tended to cause an over-reliance on foreign financing and a refusal by the authorities to adopt a system of greater flexibility, even in the face of deteriorating economic fundamentals. However, a move towards greater flexibility at a time when the

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[8]The Economist. 20 September 1997. p.139.
[9]Sachs, J. 1998a. p.24.
[10]Eichengreen, B. 1999a. p.c4.

quantity of both Asia's private sector debt and the Russian government's short-term foreign debt exceeded foreign exchange reserves would have been an inherently risky move. Moreover, if the exchange rate peg is abandoned, the country loses policy credibility and reduces the possibility of implementing an exchange rate peg in the future. Barry Eichengreen has drawn a similarity between governments that are trying to increase their credibility by imposing an exchange rate peg and a person dieting, arguing that: "The currency peg is the lock on the refrigerator. Countries that devalue are thus seen as having removed the lock from the refrigerator and relapsing to the bad old days of inflationary excess, which leads investors to flee."[11]

Pegging: a single currency or a basket of currencies?

If a country wishes to operate a pegged exchange rate it must choose which currency or currencies it wishes to adopt as its peg. The choice of pegging between a single currency or a basket of currencies is important because the heavy weighting of the U.S. dollar in Asia's exchange rate pegs contributed to the region's vulnerability to financial crises. The Asian countries should have placed more weight on the value of the yen and the major European currencies. As it happened the appreciation of the U.S. dollar vis-à-vis the yen and the major European currencies contributed to an over-valuation of the Asian currencies and a subsequent loss of competitiveness resulting in slowing export production across the region.

The choice of the peg should primarily depend upon what currency the country's external debt is denominated in and the degree of concentration of the country's trade with its various trading partners. Hence, the main case for adopting a single peg is when that currency is the domestic economy's main trading partner and that that currency constitutes most of the country's external debt. The advantage of pegging to a basket of currencies is that it should reduce excessive fluctuations in the value of the domestic currency, which can occur when an exchange rate is pegged to a single currency. The case for adopting a basket of currencies is strongest when the country's external debt is denominated in a variety of currencies and there is no dominant trading partner.

5.iii. Effects of capital flows on exchange rates

To generate inflows of foreign portfolio capital the domestic level of interest must be greater than the world level of interest by at least the expected rate of depreciation of the domestic currency. Maintaining high levels of interest can have harmful consequences on the economy, such as the reduction of public investment, and will also make the servicing of

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[11]Eichengreen, B. 1998.

public debt more expensive. Therefore, the requirements of attracting foreign capital is likely to reduce economic activity in the host country. However, these adverse factors can be offset by an effective utilization of capital inflows.

A flexible exchange rate regime

Under a flexible exchange rate regime, an outflow of foreign capital will cause a depreciation of the domestic currency and may result in two possible outcomes. Firstly, if exports and imports are sensitive to exchange rate movements and domestic exports do not rely heavily upon imported goods that form constituent components of the final product, the depreciation of the exchange rate may improve the country's current account. However, if import elasticities are not high and export production relies heavily on imported goods as in many developing economies, then the depreciation of the currency significantly increases the price of imports, which in turn, aggravates inflation. This inflation will lead to an appreciation of the real exchange rate, which may erode the benefits of the devaluation.

Conversely, inflows of foreign capital will cause an appreciation of the domestic currency. In turn, this will make imports cheaper in the domestic market and exports more expensive. This will have an adverse effect on the current account balance. Unemployment will increase, particularly in the country's exporting sectors because these industries lose price competitiveness as a result of the domestic currency's appreciation.

However, because the flexible exchange rate possesses significant exchange rate risks it may actually discourage domestic enterprises and individuals from borrowing excessively in foreign currency-denominated loans. In contrast, the exchange rate pegs in Asia caused residents and foreign investors to underestimate exchange rate risks. Thus, a flexible exchange rate may reduce potentially large capital inflows. As previously mentioned, a flexible exchange rate also makes it far less costly for an economy to adjust to exogenous shocks, which would otherwise have serious implications for fixed exchange rates. A flexible exchange rate also provides the authorities with autonomy over the conduct of monetary policy. Nevertheless, small, open economies that consider adopting a flexible exchange rate often have a 'fear of floating' due to the volatility that such a regime can impinge on a small country.

The *Economist* argues that: "For large economies, the costs of misaligned exchange rates are rarely large enough to warrant sacrificing the benefits of an independent monetary policy. For smaller economies, however, the trade-off is different. The benefits of monetary independence are smaller, and the costs of misaligned exchange rates potentially far greater.

Once such countries might have tried to keep their currencies within target bands. But with freely mobile international capital, such arrangements are hard to sustain."[12]

Fixed exchange rates

Under a fixed or pegged regime the exchange rate is prohibited from adjusting in response to capital inflows or outflows. If the exchange rate is prevented from rising in response to capital inflows, inflationary pressures in the economy will increase, and this rise in domestic inflation results in an appreciation of the real exchange rate (RER). In an effort to avoid an appreciation of the RER central banks have attempted to sterilise these inflows of foreign capital. Under sterilisation a foreign loan's indirect consequence is to increase the central bank's foreign exchange reserves and the domestic money supply.

However, the process of sterilization only works effectively in the short-term for three reasons. Firstly, the inflationary pressures that build up as a result of the increased money supply mean that nominal interest rates do not fall and thus the country continues to attract capital inflows. Secondly, because domestic financial markets are tiny relative to international capital flows, sterilization will become less effective over time. Lastly, as discussed in Chapter 4, maintaining foreign exchange reserves is costly given that the yields earned on foreign exchange reserves are likely to be less than the amount paid on external debt denominated in domestic currency. Therefore, the costs of sterilization and maintaining foreign exchange reserves grow over time.

The upward pressure on the exchange rate via capital inflows should be limited by prudential bank regulation, which has been experimented with in a number of countries. The regulations could enforce limits upon the level of foreign currency-denominated loans, which would help to reduce exchange rate exposure and the potential for a financial panic. Alternatively, some policy makers, such as Indonesia in response to Thailand's financial crisis, have widened the exchange rate trading band. In the face of capital inflows this widened trading band will allow for some appreciation of the exchange rate and vice-versa. Selective capital controls have also been placed on short-term inflows in a number of countries including Chile. However, such controls are unable to distinguish between destabilising short-term flows and inflows that are actually desirable and help to stabilise the foreign exchange and other markets, whilst also providing liquidity to the currency market. Nevertheless, these policies have only a limited effect on easing inflationary pressures and have therefore been unable to remove upward pressures on the RER.

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[12]The Economist. 20 November 1999. p.142.

When the inflow of foreign capital accelerates, conflicting interests are likely to emerge between the policy makers desire for low inflation and the maintenance of the pegged exchange rate. If signs of overheating emerge, such as a growing current account deficit, creditors will become aware of the two conflicting policy objectives and this may initiate a reversal of capital flows. Such a deterioration in investor sentiment poses significant problems for developing and transitional economies when they have become dependent on foreign financing. In an attempt to maintain the value of the exchange rate the authorities may use their foreign exchange reserves to buy the domestic currency back and prop-up the currency. However, recent experience suggests that where external short-term debt exceeds available foreign exchange reserves there is little an economy can do to preclude a financial panic. Moreover, it would appear that even developed countries' central banks are unable to prevent such a panic and maintain the value of their exchange rate, e.g. the U.K's exit from the ERM on 16 September, 1992. In fact the combined reserves of advanced nations central banks amounts to $1.6 trillion, which is dwarfed by the quantity of foreign exchange trading given that the average daily turnover is around $2 trillion.[13]

Sustainability of Exchange Rate Undertakings

Two factors need stressing:

1. Inappropriate macroeconomic policies.

Macroeconomic policies that result in a continued deterioration of foreign exchange reserves are unsustainable once the reserves are exhausted. Thus, the macroeconomy's imbalance cannot be addressed with additional foreign exchange expenditure. An imbalance that results in the steady deterioration of foreign exchange reserves is likely to occur from an imbalance between the demand for and supply of money balances. Under a fixed exchange rate, when the money supply is increased beyond the real demand for money (for instance, with excessive capital inflows) it is likely to decrease foreign reserves in two ways. Firstly, the increase in the economy's money balances is likely to increase expenditure on goods and services. In turn, this will cause the price of non-tradable goods and services to increase and the supply of domestically produced tradable goods would fall because profits in this sector are squeezed by the higher wages of the non-tradable sector. The reduction in the output of the domestically produced tradables will affect the country's current account position, which may indirectly affect the country's foreign exchange reserves. Secondly, the excess holdings of domestic currency may encourage investors to diversify their exchange rate exposures into

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[13]Ibid.

foreign currencies and assets. This situation will reduce the demand for the domestic currency, which may require intervention in the foreign exchange market to maintain the currency's fixed value and thus a direct depletion of foreign reserves.

2. A change in portfolio preferences.

With substantial inflows of foreign capital the authorities may attempt to sterilise these inflows, which increases the country's money supply and foreign exchange reserves. However, if there is a significant change in portfolio preferences and an outflow of foreign capital, the money supply will contract in accordance with the outflow of foreign capital. Maintaining the fixed exchange rate under these circumstances will lead to a steady depletion of foreign exchange reserves, which will become unsustainable when reserves are exhausted, as seen in Thailand.

5.iv. The historical perspective of currency boards

In the 1960s currency boards were in operation in just a few economies. They were believed to be workable and desirable only in extreme circumstances, for instance, in small and extensively liberalised economies of city-states or small islands. Argentina successfully implemented a currency board to stabilise the economy following the country's hyper-inflation of 1991 and, similarly, Bulgaria did so in 1997. The implementation of a currency board has been proposed as a policy response to various economic challenges of developing and transitional countries throughout the world. For example, post-war reconstruction in Bosnia has been enhanced and a generally successful transition from a centrally planned to a market economy has been undertaken in Lithuania and Estonia. The adoption of currency boards has also been recommended to countries seeking independence such as East Timor and Palestine. No currency board has yet been abandoned and the debate on currency boards has raged in response to recent economic turmoil in developing countries throughout the world, e.g. Indonesia during the Asian crisis in 1997/1998 (Krugman, Schuler), Russia prior to the countries financial crisis (Soros) and in the aftermath of the rouble's devaluation (Hanke), and Brazil during the defence of its exchange rate (Dornbusch). Advocates of currency boards (e.g. Hanke, Walters and Schuler) argue that with strict enforcement, currency boards will promote monetary stability and credibility, which is superior to any other exchange rate regime. Their adversaries (e.g. Roubini and Schwartz) contend that the adoption of currency boards where the banking systems are weak and the economy is fragile is a perilous venture, which should only take place in the most desperate of circumstances.

The currency board regime

A currency board is similar to a fixed exchange rate regime but requires even tighter constraints on domestic policy-makers. This improves the credibility of the mechanism, which results in lower interest rates than those under fixed exchange rates. A currency board is defined as a monetary institution which issues domestic currency entirely backed by the equivalent quantity of the foreign anchor currency. The authorities guarantee to convert the domestic currency into that of the anchor (or reserve) currency at the fixed rate on demand. Hong Kong adopted a currency board in 1982 and has three commercial banks which print domestic currency. But, the currency board requirements demand that they may only issue additional domestic currency as long as they provide the equivalent quantity of U.S. dollars (Hong Kong's 'anchor' currency) to the monetary authorities at the set rate of HK$7.8 to U.S. $1.

A currency board regime combines three main characteristics. Firstly, that the exchange rate is fixed to an 'anchor' currency (although fixing to a basket of currencies would also appear to be feasible). Secondly, that of automatic convertibility, which provides the right to exchange domestic currency at the fixed rate whenever demanded. Finally, that the economy makes a long-term commitment to the system, which is usually laid-out in the central bank law.

There are essentially three differences between a pegged exchange rate and a currency board. Firstly, "in a currency board arrangement a given monetary aggregate (mostly reserve money) is fully covered by foreign exchange. This increases the credibility of the system because all outstanding liabilities can, on demand, be exchanged into the peg currency"[14]. Secondly, a currency board is a far more stringent arrangement than a pegged exchange rate, given the specified conditions laid-out in the central bank law. Outlining such procedures through parliamentary processes and public debates further enhances the credibility of the system due to the commitment and length of time that such processes reflect. Finally, an economy that has adopted a currency board cannot print money to enhance domestic liquidity or act as lender of last resort to financial enterprises, unless the authorities have excess reserves. Again this enhances credibility because there is no scope for the monetization of fiscal deficits or bank financing. Collectively these elements restrict the operations of an active central bank, which, in turn, enhances credibility and makes a distinct commitment to

[14]Ghosh et al. 2000. p.277.

pursuing anti-inflationary policies. (Table 2, p.149, compares a currency board regime to a typical central bank.)

The increased popularity of currency boards has essentially been in response to the problem of time inconsistency in monetary policies. Ghosh *et al.* state that: "This problem arises when the central bank is unable to pre-commit to a low rate of monetary growth and it imparts an inflationary bias to the economy (Barro and Gordon 1983). As noted by Cukierman (1992), the inflationary bias need not be due to an employment creation motive as in Barro and Gordon (1983), it may also reflect the desire to inflate away nominal debt or to improve the balance of payments. These last considerations are of greater importance to developing and emerging-market economies."[15] The introduction of a fixed exchange rate lowers anticipated and actual inflation in an economy, which was apparent in Russia following the adoption of the rouble corridor in 1995. But empirical evidence shows that currency boards have the most significant effect on reducing inflation. From 1975-96 countries that adopted currency boards had an average annual rate of inflation of just 5.6%, pegged exchange rate regimes averaged 22.3% and countries operating floating exchange rates averaged 43.1%.[16] The lower level of inflation of pegged exchange rates represents enhanced discipline on the part of the authorities because money growth is smaller and credibility is therefore improved.

However, Nouriel Roubini argues that pegging an economy's exchange rate, and subordinating monetary policy, to the 'anchor' currency will not lead to an immediate convergence of inflation to the world level for at least three reasons: "[First,] purchasing power parity does not hold exactly in the short-run since domestic and foreign goods are not perfectly substitutable. So domestic firms will reduce the inflation rate when the exchange rate is pegged but may not push immediately down to the world level. [Secondly,] non-tradable goods prices do not feel the same competitive pressures as tradable goods prices, thus inflation in the non-traded sector will fall only slowly. [Third,] since there is significant inertia in nominal wage growth, wage inflation might not fall right away to the world level. Many wage contracts are backward looking and the adjustment of wages will occur only slowly. Also, in countries where there is formal indexation of nominal wages, wage inflation is based on past (higher) inflation rather than current (lower) inflation; domestic inflation does not converge immediately to the world level when the exchange rate parity is fixed, a real appreciation will occur over time. This appreciation of the RER implies a loss of

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[15]Ibid. p.279.

competitiveness and the current account over time. Even small differentials between domestic and foreign inflation rates can compound rapidly into a substantial real appreciation"[17]. Roubini then uses the examples of Estonia and Lithuania, two transitional economies, which adopted currency boards in 1992 and 1994 respectively. Roubini claims that in both of these countries the change to a fixed exchange rate has been accompanied by a substantial appreciation of these countries currencies.

Irrespective of Roubini's argument the basic problem of monetary policy time inconsistency will prevail. To counteract this problem and obtain longer-term credibility benefits, the costs of abandoning the currency board must remain high. This underlines the authorities pre commitment to anti-inflationary policies. The parliamentary processes and public debates make the transition to, and the adoption of a currency board, expensive. In turn, this increases the cost of exiting the system and thus improves the regime's credibility. Currency boards can only maintain credibility providing the central bank maintains a sufficient quantity of foreign exchange reserves, which at least equal the appropriately defined domestic money supply. Market participants, therefore, know that each unit of domestic currency is matched by the equivalent quantity of the 'anchor' currency. This guarantee means that the demand for a currency board currency will be greater than the demand for currencies that do not provide such guarantees under their exchange rate regimes. This is because investors know that the currency board's authorities will guarantee to exchange their liquid money into a major foreign currency upon demand.

If the currency board is tested, as in Hong Kong in October 1997, advocates argue that the systems' automatic stabilisers will prevent destabilising volumes of capital outflows from leaving the economy. The automatic stabilisers of the currency board system work through changes in the economy's money supply. For example, when the domestic currency is exchanged for the anchor currency the domestic money supply will contract accordingly. In turn, this will prompt interest rates to rise until they are sufficiently high, so that they encourage capital to return to the domestic economy.

However, a currency board is unable to adjust smoothly to exogenous shocks and the authorities are unable to intervene in the foreign exchange market to maintain the value of the currency. Therefore, the economy must suffer the real consequences (nominal wage and price adjustments) of the commitment to the monetary regime, for example, through the recession, high unemployment and financial distress experienced in Hong Kong throughout

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[16]Ibid. p.282.

1998. The currency board's adjustment mechanism is similar to that of a fixed exchange rate where interest rates are used to defend the value of the currency. But what is unique to the currency board is the guarantee that such a regime provides to market participants. Only when policy makers are unwilling to accept the real consequences of a testing of the system is there cause for currency speculation.

Despite currency boards' recent successes in weathering volatile financial markets and enhancing monetary stability in numerous countries, some economists such as Nouriel Roubini contend that a country's economic success has little to do with the adoption of a currency board but actually reflects macroeconomic and structural liberalisation policies that are consistent with maintaining a fixed exchange rate. Roubini argues that without such sound economic policies the currency board or fixed exchange rate would be jeopardised and a currency crisis and financial collapse would ensue. Therefore, he believes that implementing the correct economic policies for the economy means that there is no need to adopt a fixed exchange rate or currency board; an economy may perform well with or without one. But a more flexible exchange rate would allow the economy to adjust smoothly to exogenous shocks. However, Roubini admits that: "[There are] some marginal benefits of a currency board that one can point to: short-run credibility when you start from hyper-inflation (like in Argentina), stronger incentives not to monetize and run budget deficits under some conditions. But those are all results a country can achieve without a currency board and therefore avoid the other costs of having one."[18]

Important considerations prior to the implementation of a currency board

Currency boards require a strong legal and institutional infrastructure. Despite the fact that a currency board does appear to be a straightforward monetary regime, various decisions must be made regarding its particular features. In particular, the judicial conditions where central banking is conducted and the institutional infrastructure for the sound financial management of the economy. These time-consuming measures must be resolved, often in full public view (such as parliamentary debates), if the country is to maximise the credibility effects, which accompany the introduction of a currency board. Parliamentary debates enhance credibility because they illustrate widespread support for the currency board. This sends a clear signal to market participants that the economy is committed to the currency board. Conversely, a lack of political support may trigger self-fulfilling speculative attacks. Credibility is a vital part of a currency board arrangement, which means that a sound legal basis is essential for

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[17]Roubini, N. 1998.

the sustainability of the system. Thus the country that introduces the currency board may wish to include some or all of the regime's features of a currency board in central bank law. This may involve a definition of the exchange rate level, the volume of foreign reserves and a definition of the few capabilities that the authorities will possess.

The most obvious decision faced by a country considering the adoption of a currency board is the choice of the 'anchor' currency and at what level to fix the exchange rate to this currency. The most widely used criteria to determine which currency to adopt as the 'anchor' include the currency's global usability and strength, but also the inflation level of the anchor currency's country.

These considerations leave only a few currencies, which are used in the fourteen countries that currently operate currency boards. These include the U.S. dollar in ten countries, the Deutsche Mark in three countries and the Singapore dollar in one country. (Table 3, p.150, outlines currency board countries.) But other considerations should include the country's prevailing and prospective trading partners and other economic linkages such as financial ties between the country and the anchor currency country. If the economy has a number of major trading partner countries a basket of currencies would appear to be the most appropriate option. However, the countries that have so far adopted currency boards have simply chosen to peg to just one currency.

Determining the level at which the exchange rate is fixed would, according to Enoch and Gulde, "appear straight-forward, given that a currency board arrangement by definition has to cover a monetary aggregate, usually the full amount of reserve money but sometimes narrower definitions of money. Yet the rate at which the central bank's available international reserves cover the monetary aggregate in question varies depending on the exact definition of reserves used"[19].

A healthy financial system is important for the successful operation of a currency board because the regime provides little scope for the authorities to act as 'lender of last resort' and rescue failing banks. The absence of a lender of last resort removes the potential for moral hazard, which is often evident in bail-out loans. But the authorities may be unable to prevent a temporary liquidity problem in the banking system, which could develop into a larger crisis. Indeed, the anticipated lower level of inflation associated with currency boards would be outweighed by a banking crisis. But, Ghosh *et al.* argue that: "Prearranged credit

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[18]Ibid.
[19]Enoch & Gulde. 1998. p.43.

lines with foreign lenders can be used to provide partial lender-of-last-resort functions."[20] The country adopting the currency board may also decide to maintain a safety margin and hold excess foreign reserves of the base money supply, which could then be used to increase domestic liquidity. Transparency is essential to maintain credibility and, in turn, the sustainability of the currency board. Transparency and accountability were cited as reasons why Hong Kong successfully defended their currency board in October 1997. Adequate backing of base money by means of foreign reserves represents a strong commitment to the currency board.

The initial difficulty of collecting adequate foreign reserves to back the monetary base may deter many developing economies from establishing a currency board. However, there is an alternative option available to countries that do not have the available quantity of foreign reserves. Countries may opt for the untested 'marginal currency board arrangement'. Under this regime only domestic money that has just been issued would be backed by foreign reserves. In the long-term, foreign reserve coverage could be built up to exceed the base money supply by the interest earned on the central bank's foreign currency reserves.

The introduction of a currency board system requires clarification of the financial relationship between the government and the central bank. To recall, the commitment to the currency board reflects tight monetary policy. Hence the central bank is unable to monetize budget deficits because this is not consistent with maintaining a fixed exchange rate regime. Therefore, a currency board will force a government to rectify its deficit. Moreover, laws may also be introduced, to reduce real and anticipated inflation, by guaranteeing that the central bank will not finance government expenditures. Once again, transparency and openness is vital in maintaining the currency board. However, some countries operating currency boards continue to administer government accounts, but this would appear to jeopardise transparency. Additionally, as stated by Enoch and Gulde: "Difficulties may arise from the fact that government deposits are callable at short notice, and consistency with currency board arrangement rules can be achieved only if such accounts are fully covered by foreign reserve holdings."[21] For the above reasons Hong Kong decided to increase the transparency and credibility of the economy's currency board by moving all government accounts to commercial banks.

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[20]Ghosh et al. 2000. p.296.

Currency boards: costs and benefits

Benefits

Strictly enforced currency boards provide enhanced economic credibility, low inflation and low interest rates. The empirical evidence given by Ghosh *et al.* indicates that currency boards are more successful at controlling inflation than standard exchange rate pegs and far more successful than floating exchange rate regimes. Moreover, Ghosh *et al.* found that: "Growth performance has been better under currency boards than under either standard pegs or floating rates, an effect which is robust to allowing for fixed effects, and controlling for the rebound effects from the low pre-currency board growth rate ... [However,] modern currency boards have a short track record, and a fuller assessment, especially of the downside risks, must await the passage of time."[22] Moreover, currency boards appear to be an exceptionally versatile exchange rate regime having been adopted by a variety of countries facing various challenges from volatile terms of trade to a post-local war environment or transitional economies.

Costs

1. The most significant cost of adopting a currency board system is the restrictions that such an arrangement places on a country's central bank, limiting the bank's ability to act as 'lender of last resort'. This can undermine the health of the financial sector. However, in a currency board country, the financial sector's resilience can be enhanced by the introduction of a prudential framework, which could help to compensate for the absence of a lender of last resort. The introduction of firm regulatory and supervisional measures may improve the financial management of the banking sector. The following measures could strengthen the financial sector. Firstly, an increase in reserve requirement ratios, which would ensure banks maintain sufficient liquidity in relation to the bank's potential requirement for liquidity. Moreover, liquidity requirements could be enhanced to complement reserve requirements. This liquidity is important because, as noted by Ghosh *et al.*, "most assets - even treasury bills in deep markets - are less liquid than reserve requirements"[23]. Secondly, an increase in the ratio of capital to risk-weighted assets would provide an additional safeguard against the potential for bankruptcy. Finally, the underestimation of exchange rate risks contributed to the meltdown of Asia's banks. Therefore, restrictions may be placed on the volume of foreign currency-denominated borrowing and to encourage banks to maintain sufficient

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[21]Enoch and Gulde. 1998. p.42.
[22]Ghosh et al. 2000. p.294.
[23]Ibid. p.296.

liquidity in the 'anchor' currency. Although the above measures will improve the strength of the financial sector, such criteria will impose significant costs on the banking sector including a reduction in profits. Therefore, these measures should be regarded as disadvantages that are specific costs associated with the adoption of a currency board rather than any other exchange rate regime[24]. Furthermore, maintaining a currency board in the face of destabilising speculative pressures results in significant economic costs, which may actually undermine the health of the strongest financial sectors. This is because of the way that the currency board regime reacts to changes in the money supply. In Hong Kong in October 1997, capital outflows resulted in increased interest rates, which briefly touched 300% on overnight loans. The severe monetary contraction resulted in a domestic recession in 1998. The monetary tightening may cause banks to call in loans to domestic enterprises, which may go bankrupt in the process. This will damage the health of the financial sector and may even induce bankruptcies of domestic banks. In 1995, in the face of large-scale capital outflows, Argentina should have reduced the monetary base by the equivalent quantity of outflows. However, according to Nouriel Roubini, the authorities realised that to do so would be to trigger "a sharp contraction of bank loans and deposits and banking collapse; the monetary authorities [therefore] cheated: they cut the monetary base but then they significantly reduced the required reserve ratios of the banks to avoid a sharp fall in the money supply, loans and deposits"[25].

2. Under a currency board arrangement, the authorities forego the ability to introduce active monetary policies because the currency board is completely passive to changes in monetary conditions. Therefore, the economies' liquidity will be procyclical, which was apparent in Hong Kong. Prior to 1997, the economy was very healthy, capital was flowing in supplementing domestic liquidity, interest rates were low and growth was high. However, following the Asian crisis, capital began to leave Hong Kong, liquidity dried up, interest rates rose dramatically and GDP growth in 1998 was negative. Adherence to the currency board regime requires maintenance of the fixed exchange rate, meaning that the authorities cannot allow a depreciation of the regime in an attempt to drive economic growth. Thus, economic adjustment will occur through wage and price adjustments, which is a slower and more costly process.

3. Despite the expected lower levels of inflation, currency boards do not prevent an appreciation of the real exchange rate and a subsequent loss of competitiveness. Indeed, the

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[24]Ibid. p.297.

appreciation of Hong Kong's RER, between 1990 and 1997, was the highest appreciation in the Asian region, at just over 30%, twice the weight of average RER appreciations in Asia.[26] The RER will appreciate when the level of inflation in the economy is above the world level for a prolonged period of time. Moreover, under a currency board the central bank is unable to sterilise the inflows of foreign capital, which may well make the task of managing capital flows even harder. When capital flows into the country, the authorities are unable to offset the increased demand for the domestic currency by sterilising the capital inflows. This may result in excessive monetary growth, which may lead to overheating and higher inflation. Conversely, when capital leaves the economy, the outflows may significantly reduce the monetary base and interest rates will increase, in turn, reducing economic activity.

A number of commentators (most notably the currency speculator George Soros prior to the August 1998 devaluation) proposed that Russia should adopt a currency board system to enhance economic credibility and control inflation. But this option was rejected. Firstly, this was because Russia had reduced inflation substantially since 1995. Secondly, Russia has for many years exhibited large volumes of capital flight. Under a currency board arrangement capital outflows would reduce the money supply and increase interest rates dramatically, which would have had a devastating effect on Russia's fragile banking system and weak economy. Moreover the former European Union monetary affairs commissioner, Yves-Thibault de Silguy, argued that three required conditions for the successful implementation of the currency board were not fulfilled by Russia. "These were adequate hard currency reserves, a 'credible and sound' economic programme to inspire market confidence, and a sufficient well-established domestic banking system"[27]. Furthermore, to maximise the credibility effects of a currency board arrangement, the time-consuming implementation of required legal and institutional changes must take place, which confirms the country's commitment to the currency board. But if a currency board had been implemented in Russia in response to the looming crisis the legal and administration processes would have been rushed in an effort to obtain the credibility benefits of the currency board. This hasty response may well have undermined the country's commitment to the currency board because the policy makers would have appeared to have been seeking a quick fix to Russia's economic difficulties.

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[25]Roubini, N. 1998.
[26]Ibid.
[27]Blandinieres, J. P. 1999. p.7.

Enoch and Gulde believe that: "[The above prerequisites] to establishing a currency board may, in many cases, be too involved and take too much time to make it advisable for a country to attempt to do so during a macroeconomic crisis."[28]

Longer-run considerations

Some economists consider currency boards to be a permanent method of achieving monetary stability. But, I believe that currency boards should only be considered as a medium-term arrangement that enables a developing country to achieve a consistent record of monetary stability. Bulgaria has achieved stabilisation following the introduction of a currency board in response to hyperinflation, unrestrained central bank lending to banks and excessively high interest rates on government debt. The results have been striking. (Table 4, p.151, illustrates Bulgaria's experience before and after the adoption of a currency board.) This track record, therefore, improves the country's hold on investor confidence making the transition to a flexible regime less hazardous. Developing economies are likely to benefit greatly from the increased credibility that a currency board provides. Flexible exchange rates are rarely appropriate for developing countries because they are rarely considered to pursue sound macroeconomic policies. For many developing economies floating regimes may be inoperable without restrictions on capital mobility. But a currency board would improve credibility and enable the country's capital account to remain open. Moreover, the 'confidence effect' of a currency board arrangement would reduce risk premiums and, the regime, may also strengthen the economy's financial sector. This then prepares the country for the transition, to what is often considered to be the ultimate goal, of a floating exchange rate and independent monetary policy.

A rapid shift from a currency board to a flexible exchange rate may risk a significant depreciation of the currency value, which may bankrupt financial intermediaries that possess significant exchange rate exposures. However, this swift approach would alleviate the potential for a run on the currency that may take place under a more gradual transition. The slower approach would change the currency board to a straightforward pegged exchange rate, which has been the chosen method of exit by classical currency board economies. Ghosh *et al.* stated that: "Available records do not suggest that exits from currency boards to pegs were accompanied by panics, suggesting that the credibility difference between a locally operated peg and an externally administered board was in fact perceived to be quite small."[29] However, the authors acknowledge that the classic exits took place "in the euphoria of

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[28]Enoch and Gulde. 1998. p.43.

national independence, and against a background of decades of stability, and of much smaller international capital flows." But, to date, no modern currency board economy has began the transition to an alternative regime, although, Argentina has been considering various exit strategies, including that of dollarization.

Striking economic achievements have been realised in many of the countries, which have adopted currency boards. Lower inflation (than that achieved by pegged or floating regimes) and reduced expectations of future inflation even after prolonged hyperinflation appear to be the most immediate benefits of adopting a currency board. Moreover, according to Ghosh *et al.*, the better inflation performance has not been at the expense of lower GDP growth. They have found that currency board countries output growth has surpassed growth under pegged or floating exchange rate regimes. Further benefits include a greater incentive not to run or monetize budget deficits.

But, when a currency board economy is struck by exogenous shocks the effects on real economic activity can be devastating as the money supply tightens and interest rates rise, which in turn, increases unemployment and jeopardises the health of the banking system.

Yet the credibility benefits that accompany currency boards can, according to Roubini, be achieved through sound economic policies implemented over a number of years. Prudent macroeconomic policies and a more flexible exchange rate would allow the economy to adjust more smoothly to exogenous disturbances rather than suffering the real consequences of the currency board's self-adjusting mechanism. However, it appears that the adoption of a currency board is by far the quickest method of improving a country's economic credibility.

Performance of the macroeconomy under the various exchange rate regimes

Currency boards and fixed exchange rates have a significant effect on reducing inflation in comparison with floating exchange rates. Countries that have adopted currency boards between 1975 and 1996, according to Ghosh *et al.*, have averaged an inflation level of 5.6% per year, countries that operate pegged exchange rates averaged 22.3% per year and those economies who administer a floating regime averaged 43.1% per year. Moreover, Ghosh *et al.* believe that: "The better inflation performance does not come at the cost of lower overall or per capita growth; countries under currency boards outgrew both pegged and floating rate economies, the difference widens once time effects are taken into account. In interpreting this finding it must be borne in mind, however, that most modern currency board

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[29]Ghosh et al. 2000. p.275.

arrangements came into existence in the aftermath of economic crisis. As such, currency boards may have benefited from an initial period of 'soft growth' as output rebounded to pre-crisis levels."[30] Caramassa *et al.* argue that: "Evidence also suggests that, contrary to conventional wisdom, misalignments and currency 'crashes' are equally likely under pegged and flexible exchange rate regimes."[31]

5.v. Dollarization

The dramatic surge in international capital flows has been accompanied by an increased frequency of financial crises, which have cast major doubts on the sustainability of exchange rate commitments. Additionally, floating regimes are unsuitable for many emerging markets due to potentially destabilising fluctuations in the exchange rate. Such conclusions have led analysts to conclude that only extreme measures, such as currency boards are sustainable for emerging markets in today's volatile international capital markets. But more recently another alternative has emerged, which involves eliminating the use of the domestic currency and adopting the U.S. dollar (or another stable internationally recognised currency) as the country's legal tender. This is known as dollarization and was introduced in Ecuador in late 2000, in response to the authorities inability to curb pressures on the domestic currency and a loss of confidence in the government's economic policy.

The closest regime to dollarization is a currency board system where the authorities guarantee to convert domestic currency into the 'anchor' currency at the fixed rate and the monetary authorities hold 'anchor' currency reserves which often exceed the entire national money supply. Under a currency board the authorities forego the ability to increase the base money supply, meaning that there is also no lender of last resort. However, the most notable difference is that dollarizing an economy will incur the loss of seigniorage revenues for the government and this would be a permanent loss. These revenues are received from the government's ability to issue currency and are derived, according to Berg and Borensztein, from the "difference between the cost of producing and distributing paper money and coins and their (greater) purchasing power. The central bank can use currency, which does not bear interest, to purchase interest bearing assets, such as foreign reserves. These seigniorage revenues show up as central bank profits and are transferred to the government"[32]. A currency board is often viewed as a temporary arrangement to improve credibility.

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[30]Ibid. p.282.
[31]Caramazza & Aziz. 1998.
[32]Berg and Borensztein. 2000. p.39.

Dollarization, however, is likely to be an almost irreversible process and this substantially enhances credibility.

The key reasons for a country to abolish their national currency and impose the U.S. dollar as legal tender are that dollarization will enable the country to avoid balance of payments and currency crises. The abolition of the domestic currency means that the country will no longer be vulnerable to sudden capital outflows motivated by fears of devaluation. The consistency of the exchange rate following dollarization will reassure investors that the value of their investments will be maintained and this helps to eliminate much of the potential for a financial panic. Dollarization has other benefits including a closer economic integration with the U.S. and the global economy due to the lower transaction costs and guaranteed price stability that dollarization brings. Consequently, dollarization may actually promote additional trade ties with the U.S.. Furthermore, dollarization eliminates the possibility of the monetization of federal deficits, reducing inflationary impulses and providing an environment that promotes a strong financial sector, due to the absence of a 'lender of last resort'. Alesina and Barro argue that: "For many developing countries, dollarization provides a much better commitment device than alternative forms of fixed exchange rates."[33] This is because adopting another currency, or creating a currency union with a new currency, makes the costs of abandoning the regime extremely high. This provides far greater credibility to the regime than a standard currency peg. Many developing countries also lack a firm commitment to monetary policies that are consistent with price stability.

However, the elimination of the national currency may be met with reluctance to forego a country's national economic symbol and, more importantly, dollarization would eliminate seigniorage revenues for the government. Dollarized countries would forego seigniorage revenues and the only way they could obtain such revenues would be if the the U.S. were to share a proportion of the extra seigniorage it would obtain from the dollarization of other countries. Seigniorage losses in dollarization can be significant. Dollarization requires the purchase of domestic currency held by the public and banks with dollars from the economy's stock of foreign reserves or with borrowed capital. Additional seigniorage revenues are forgone because new currency is not printed each year to meet the increased demand for money. In Argentina, the domestic currency in circulation amounts to approximately $15 billion (5% of GDP) and the recent annual increase in demand for the domestic currency has averaged approximately $1 billion (0.3% of GDP). Berg and

[33]Alesina and Barro. 2001. p.382.

Borensztein argue that around $0.7 billion (0.2% of GDP) would be lost annually on the existing stock of currency if dollarization were implemented. As money demand increases the quantity of lost interest earnings would also grow. "Argentina's seigniorage loss would be the United States' gain"[34]. Therefore, the authors propose that the U.S. should share the additional seigniorage revenues, which the country derives from emerging markets becoming dollarized. The revenues should be distributed in accordance with an agreed formula in a similar vein to the euro region. But Rudi Dornbusch argues that: "There is an important offset to the loss of seigniorage from the reduction in public debt service costs that result from reduced interest rates. This factor is surely far more significant than the 1% or so of GDP in seigniorage loss."[35] Furthermore, as noted above, dollarization would tie the hands of the country's monetary and exchange rate policy makers, leaving only fiscal policy available as a policy tool to the authorities. Hence, dollarization and the authorities inability to use monetary policy largely places the country's prospects for economic growth in the hands of U.S. policy makers. Nevertheless, a country can counteract the absence of a lender of last resort by establishing external lines of credit, which could be drawn upon in the event of a crisis. Moreover, dollarization may reduce the possibility of bank runs because it is unlikely, in a dollarized economy, that there will be a significant mismatch of foreign currencies on the banks' balance sheets. Thus, dollarization may improve the credibility of the domestic banking system. Dollarization is also likely to involve an increased role of foreign banks in the domestic economy, which would promote sound banking practices.

The countries that are likely to benefit most from dollarizing their economies are those that enjoy strong trade and financial integration with the U.S., or, alternatively, emerging markets that do not enjoy particularly strong ties with the U.S. but do exhibit partial or widespread use of dollarization in domestic goods and financial markets. For such economies the benefits of dollarization will be greater and the advantages of keeping their national currencies smaller. Additionally, economies which use the dollar extensively in domestic transactions would have low seigniorage revenues and the cost of buying back the existing stock of domestic currency would be small. Moreover, countries whose financial and corporate sectors have substantial dollar debts and also exhibit wage and price stickiness, in dollar terms, may have more to gain than to lose by dollarizing their economy. Wage and price stickiness and large exchange rate exposures indicate that an exchange rate devaluation will not serve as a useful policy tool.

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[34]Ibid. p.40.

Dollarization: reduced risk and its limitations

The most notable advantage of dollarization is the reduction of currency risks, which, in turn, reduces interest rates, thereby increasing investment, economic growth and resulting in a lower cost of servicing public debt. The inability of the dollarized country to devalue the dollar reduces the overall risk of a debt default, e.g. the Asian devaluations raised the burden of dollar-denominated debts and increased the possibility of financial sector bankruptcies due to such exchange rate exposures. But sovereign debt defaults can still occur as a result of an unsustainable federal budget deficit or a volatile political environment. Therefore, when an economy is experiencing market volatility, investors may re-call their loans due to the greater perceived risk of default. Thus, dollarized countries are still vulnerable to an adverse turn in investor sentiment, but speculative attacks and currency contagion would be avoided.

Opponents to dollarization have argued that dollarization removes the potential for stimulating domestic demand through currency devaluations. But, while devaluations are considered to be expansionary by advanced economies, such as the devaluation of the British pound in 1992, in emerging markets they often induce acute economic pain. True, exports are made more competitive and the current account balance will improve, but the banking sector and private companies, as in Asia, may be saddled with considerable foreign currency-denominated loans. Hence a devaluation may bankrupt banks and companies owing to their exchange rate exposure. This suggests that dollarization would not restrict an inherently useful policy tool to developing countries. (A discussion on the different perceptions of advanced and developing country devaluations will follow in Chapter 6.)

A further disadvantage of dollarization is the potential for exchange rate overvaluation, which occurred in Asia and was reflected in deteriorating current account balances. Under a dollarized economy real exchange rate overvaluation can occur through excessive wage increases or a deterioration in the terms of trade. A flexible exchange rate would allow economies to adjust smoothly to such shocks but with dollarization, or a currency board regime, the real devaluation has to be achieved through a reduction in nominal prices and wages. However, evidence indicates that there is strong resistance to such wage and price reductions.

To recall, dollarization appears to be an irreversible process meaning that there may be no escape from such economic consequences. Currency boards, on the other hand, can be abandoned if the pain of economic adjustment is too great. Indeed, Blandinieres argues that:

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[35]Dornbusch, R. 2001. p.239.

"One reason why every fixed exchange rate regime since (and including) the gold standard has ultimately broken down is because over time, differences in productivity growth rates between countries need to be reflected in changes in relative prices and allocation of resources between the traded and non-traded good sectors. If a country is dollarized, the development process will be distorted from what it would be if the relative price in these sectors was allowed to evolve according to its own trajectory appropriate for that stage of development."[36]

Dollarization is a new phenomenon, which is difficult to appraise due to the absence of evidence and experience on the subject. Paul Krugman believes that: "[Ecuador's] experience is likely to have a disproportionate effect on how the next [financial] crisis is handled."[37]

5.vi. An Asian currency union?

The Asian financial crisis brought the Asian region together. This has driven talk of a regional currency union comprising the countries of Association of South-East Asian Nations (ASEAN) plus the region's three larger northern neighbours, Japan, South Korea and China. An Asian currency union would integrate a third of the world's population and in 1999 the combined GDP amounted to $7 trillion.[38] This would make the Asian region a challenger to the supremacy of the U.S. and the countries of the E.U. The Asian currency union should also increase the economic and political stability of the Asian region. Most analysts believe that the currency of the union would be the Japanese yen, which has lost global prominence since the introduction of the euro in 1999. In a November 1999 summit, 'ASEAN-plus-three,' agreed to accelerate the removal of tariff barriers reflecting their commitment to an Asian free trade zone. The accession of China into the World Trade Organisation will improve the economy's competitiveness and make the country more receptive to investment from its regional neighbours. Indeed, Japan and South Korea would increase their (already substantial) foreign investment in the Asian region should the single ASEAN market be adopted. Yet, South East Asia possesses one of the world's greatest potential flashpoints in the Taiwan straits, where China has threatened to invade Taiwan if the country declares independence from the mainland. But other tensions still remain. As noted by the *Economist*: "For South-east Asian countries that have been variously colonised, invaded or pushed around by China or Japan in the past, the prospect of either country extending its

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[36]Blandinieres, J. P. 1999. p.8.
[37]Krugman, P. 2000b.
[38]The Economist. South East Asia Survey. 12 February 2000. p.16.

influence in the region is a highly sensitive issue."[39] Consequently, an Asian currency union is unlikely to be implemented in the foreseeable future.

5.vii. Conclusion

The integration of global capital markets requires stringent macroeconomic discipline by developing countries' policy makers, which must be consistent with the objectives of the country. Massive and highly mobile international capital flows mean that countries cannot peg or fix their exchange rates and maintain an independent monetary policy. In the light of recent experience a new consensus has developed, which advocates that countries must choose between the credibility and stability of a rigidly fixed regime (such as a currency board or even dollarization) or the autonomy over monetary policy provided by a freely floating exchange rates.

A floating exchange rate will allow an economy to adjust smoothly through the exchange rate to exogenous shocks. In contrast, under a fixed currency domestic wages and prices will be forced to adjust, which may only be achieved through a recession. However, a floating exchange rate regime could prove devastating for small developing economies. Furthermore, flexible exchange rates have had the highest levels of inflation, which can undermine investors' confidence. To counteract this, the country's central bank should be autonomous, which may improve the policy-makers' commitment to fighting inflation. Prior to the Asian and Russian financial crises analysts believed that the limited flexibility approach was a good compromise. However, these crises proved that such a belief was mistaken. Even if the current choice of exchange rate regimes has been reduced to a choice between fixed or floating, academics still disagree. For example, Jeffrey Sachs favours floating regimes (with the exception noted earlier), arguing that it is simply not worth restricting growth by the implementation of tight monetary policy in order to maintain a fixed exchange rate and investor confidence. In contrast, Rudi Dornbusch is adamant that a currency board regime is the best option for emerging markets.

Flexible exchange rate regimes are far more appropriate and consistent with the free flow of international capital. True, excessive volatility could cause emerging markets serious economic pain, but flows of short-term capital can be discouraged by the implementation of selective capital controls. This would help to minimise exchange rate volatility while providing time for the authorities to strengthen economic fundamentals, such as the banking sector. The Chinese currency, the renminbi, was insulated from the Asian crisis as a result of

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[39]Ibid. p.17.

the country's gradual approach to capital account liberalisation and restrictions on financial transactions. While such capital controls may induce corrupt practices by officials and restrict peoples' economic freedom, I believe that they are a favourable alternative to excessive inflows and outflows of capital, which may precipitate devastating financial crises.

Greater exchange rate flexibility allowed Taiwan and Singapore to weather the Asian crisis far better than Hong Kong's rigid currency board arrangement. Taiwan and Singapore allowed a moderate depreciation of their currencies and both countries continued to enjoy positive growth in 1998. In contrast, Hong Kong suffered a severe recession, which saw the economy contract by 10.4%. While maintaining the Hong Kong dollar's fixed value was undoubtedly the correct choice, the currency board's economic costs were clearly illustrated in Hong Kong. In my opinion, these costs far exceed the mechanism's shorter-term benefits of increased credibility. Flexible exchange rates will not avoid currency or financial crises, but I believe that they will provide a softer landing. Indeed, the World Bank has stated that over the past thirty years flexible exchange rates have been subjected to more crises than fixed exchange rates, though the bank itself admits that fixed exchange rate crises have been more severe.[40] And this fact may explain the global trend towards greater exchange rate flexibility since the 1970s.

Dollarization will have a number of obvious effects on the economy, which will include a loss of seigniorage revenues while bringing the benefit of lower interest rates. The absence of a dollarization exit option is a considerable disadvantage of the regime because the pain of adjustment may become too great. But if dollarization is successful it will encourage other developing countries, to follow suit. Indeed, Alesina and Barro believe that in the course of the next few decades we will see a transition toward a world in which the number of countries greatly exceeds the number of the world's currencies.[41] Moreover, in the event of a future emerging market crisis it may inspire policy makers to respond by the abolishing the domestic currency. But if Ecuador's experiment is a failure, dollarization may be revoked as a possible policy alternative in response to currency or financial crises.

The *Economist* argues that: "The best guess at the moment is that emerging markets will divide into two groups: those with flexible exchange rates and a relatively low level of integration into global capital markets; and those that bind tightly through currency boards or currency unions, and as a result have heavily integrated financial systems with strong foreign ownership ... Different countries will have taken different routes to achieving the 'impossible

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[40]The Economist. Global Finance Survey. 30 January 1999. p.18.

trinity' of integration, regulation and sovereignty. Those in regional unions will have given up sovereignty for integration; those with floating rates will have maintained sovereignty, but often at the cost of restricting integration with the rest of the world."[42]

[41] Alesina and Barro. 2001. p.384.
[42] Ibid. p.21.

Table 1. Developing countries: officially reported exchange rate arrangements 1976-1996 % of total

	'76	'81	'86	'91	'96
Pegged	86	75	67	57	45
U.S dollar	42	32	25	19	15
French franc	13	12	11	11	11
Other	7	4	4	3	4
SDR	12	13	8	5	2
Composite	12	14	18	20	14
Limited Flexibility	3	10	5	4	3
Single	3	10	5	4	3
Cooperative	-	-	-	-	-
More Flexible	11	15	28	39	52
Set to Indicators	6	3	4	4	0.2
Managed floating	4	9	13	16	21
Independent Float	1	4	11	19	29
No. of Countries	100	113	119	123	123

Source: Edwards and Savastano. 1999. p.9.

Table 2. Currency board regime versus typical central bank

Currency Board Regime	Typical Central Bank
1. Maintains a fixed exchange rate with the anchor currency.	Maintains a pegged or floating exchange rate.
2. Holds foreign reserves of 100% or more of base money or currency in circulation.	Holdings of foreign reserves not based on any rules.
3. Has full convertibility of its currency; it passively exchanges its liabilities for reserve currency at a fixed exchange rate without limit.	Convertibility of currency is a policy decision.
4. Unable to pursue an independent monetary policy. Cannot engage in sterilised intervention.	Ability to pursue discretionary monetary policy.
5. Since it cannot create credit, it cannot be a lender of last resort for the government, nor the banking sector.	Fulfils a lender of last resort role.

Source: Blandinieres, J. P. 1999. p5.

Table 3. Currency boards in operation

Country	Years in Operation	Peg Currency	Special Features
Antigua and Barbuda	35	U.S.dollar	Member of ECCB
Argentina	9	U.S.dollar	One-third of coverage can be in U.S.dollar denominated bonds
Bosnia and Herzegovina	4	Deutsche mark	
Brunei Darussalam	33	Singapore dollar	
Bulgaria	4	Deutsche mark	Excess coverage in banking department to deal with banking sector weaknesses
Djibouti	51	U.S. dollar	Changed peg currency from French france to U.S dollar
Dominica	35	U.S. dollar	Member of ECCB
Estonia	9	Deutsche mark	Excess coverage for domestic monetary interventions.
Grenada	35	U.S. dollar	Member of ECCB
Hong Kong SAR	17	U.S. dollar	
Lithuania	7	U.S. dollar	Central bank has the right to appreciate the exchange rate
St. Kitts and Nevis	35	U.S. dollar	Member of ECCB
St. Lucia	35	U.S. dollar	Member of ECCB
St. Vincent and the Grenadines	35	U.S. dollar	Member of ECCB

ECCB (East Caribbean Central Bank).
Source: Enoch and Gulde. 1998. p.40.

Table 4. Macroeconomic indicators before and after Bulgaria's adoption of a currency board 1995-1998

	'95	'96	'97 Q1	'97	'98
Real GDP Growth	2.1	-10.9	-	-6.9	3.5
Inflation*	32.9	310.8	2,040.4	578.5	1
Fiscal Balance % of GDP	-6.4	-13.4	-52.1	-2.1	1.3
Bank Financing of Fiscal Balance	4.9	14.5	40.7	-3.2	-0.3
Growth in Reserve Money	50.5	92.4	780	780	9.8*
Growth in real broad money	5.1	-45.4	-75.3	-32.3	2.8
BNB credits to banks (% change in monetary liabilities	-7.8	122.4	67.5	4.5	-36.6
Foreign reserves# ($ million)	1,546.0	781.0	826.0	2,474.0	3,056.0
In months of imports	2.9	1.6	1.7	5.1	6.1
Nominal interest rate differential**	19.4	116.6	128.6	0.03	0.38
Exchange Rate Lev/U.S$	70.7	487.4	1,021.9	1,776.5	1,675.1
Exchange Rate lev/Deutsche mark.	49.3	313.4	946.9	1,000.0	1,000.0

* 12 month change, end of period. # including gold. ** End of year differential between three month deposit rates in Bulgaria and Germany. - data not available. BNB (Bulgarian National Bank).
Source: Gulde. 1999. p.39.

CHAPTER SIX: THE CONTROVERSIAL ROLE OF THE INTERNATIONAL MONETARY FUND

Background

The Asian and Russian financial crises of 1997-98 threw the IMF into the international spotlight. The IMF is the world's most powerful financial organisation, receiving the majority of contributions from U.S. taxpayers, its headquarters is in Washington. Financial assistance from the IMF was accompanied by conditions, which overstretched the Fund's expertise. The Fund's 'conditionality' approach was heavily criticised and aggravated Asia's financial crisis. The Fund has also suffered criticism because its 'bail-out' loans have arguably induced worldwide moral hazard. My analysis of the IMF's performance during the recent bout of financial crises indicates that the Fund has been trying to do too much. To be more effective its objectives must be reduced.

The IMF 'bail-out' loans

On August the 20th 1997, just over a month after Thailand had allowed the baht to float, a thirty-four month $17.2 billion standby arrangement was approved by the IMF Board to assist Thailand with policy reforms. Yet the U.S. Failed to contribute to the financial package. Just over two months later, on October 31st, Indonesia signed for a $40 billion package to be disbursed over the course of thirty-six months. Korea was the next recipient of an IMF brokered package on December 4th 1997, amounting to $57 billion. (Table 1, p.175, illustrates financial contributors.) The implementation of these financial packages, together with the Philippines' previously pledged assistance programme, meant that four out of the five worst hit Asian economies were under the guidance of the IMF. Only Malaysia rejected the possibility of IMF assistance, preferring, instead, to insulate the economy by adopting capital controls. Russia also received a $22 billion financial package from the IMF prior to the country's default in August 1998.

Prior to the crises in 1997, the IMF enjoyed a strong influence over the development policy of Russia and the Asian countries. Thus criticisms of the Fund are not solely concerned with the disbursement of 'bail-out' loans and their accompanying demands.

6.i. Indiscriminant capital account liberalisation

The IMF pushed for the liberalisation of Asian and Russian capital accounts before regulatory measures had been developed. This premature liberalisation of capital accounts contradicts Article 17 of the Maastricht Treaty, which outlines the European Union's criterion for development assistance, assuring the community will work towards "the smooth

and gradual integration of the developing countries into the world economy"[1]. But the liberalisation of developing countries' capital accounts has left these economies, which lack experience of regulating capital flows, vulnerable to excessive inflows and outflows of foreign capital.

Before 1992, the Thai economy was highly regulated. Domestic savings financed much of investment, which was supplemented by FDI, and the economy was largely insulated from destabilising short-term capital flows. But in 1992 extensive deregulatory measures were encouraged by the IMF. Measures included an expansion of banks' and other financial intermediaries' activities together with looser criteria on capital adequacy levels, the elimination of restrictions on foreign exchange transactions and a reduced level of control on the portfolio management of banks and financial intermediaries. Most significantly, in 1993, Thailand established the Bangkok International Banking Facility (BIBF), which allowed Thai investors to borrow at lower foreign interest rates in offshore markets. (The BIBF was discussed in Chapter 1.) The combination of the extensively liberalised capital account and the pegged exchange rate regime attracted vast quantities of capital inflows to Thailand over a short period of time, a country which had no previous experience of regulating such inflows. The majority of foreign capital entering Thailand was channelled through dollar loans and amounted to approximately $50 billion between 1993 and 1996. The liberalisation of the Thai stock exchange increased portfolio investment dramatically and in late 1996 there was around $24 billion in 'hot money' deposited in stocks, corporate paper or in non-resident bank accounts. Walden Bello of the University of the Philippines argued that: "What both the IMF and its Thai pupils failed to foresee was that while the liberalised capital account would be the conduit for huge capital inflows when there was confidence in the country, it would also be the wide highway through which capital would flee at the slightest sign of trouble."[2] Further criticism was attributed to the Fund and the World Bank because neither institution managed to foresee the Asian crisis. The Fund was still praising Thailand's "consistent record of sound macroeconomic management policies"[3] in late 1996. Thailand's external debt snowballed from $21 billion in 1988 to $55 billion in 1994 to $89 billion by 1996, yet the IMF was not overly concerned because 80% of Thailand's debt was held by the private sector. The World Bank in 1994, at the height of capital inflows to Thailand, commented in its annual report that: "Thailand provides an excellent example of the

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[1]Bullard et al. 1998. p.29.
[2]Bello, W. 1998b.
[3]Ibid.

dividends to be obtained through outward orientation, receptivity to foreign investment, and a market friendly philosophy backed up by conservative macroeconomic management and cautious external borrowing policies."[4]

Criticism of IMF policy towards Russia has been focused on the failure of the country's economic reforms, which were advocated by both the IMF and Western governments. Boris Kargarlitsky, one of the State Duma's chief economic advisers, lamented that: "[The August 1998 devaluation] marked the definitive failure of the key strategies that the IMF and major world governments had urged on Moscow throughout much of the 1990s ... A great deal of blame lies with the IMF. Not only did the IMF encourage the Russian leaders in the illusion that squashing inflation would automatically lead to growth, but IMF spokespeople also fed the misconception that if things went wrong, there'd be plenty of money in the world financial system to bail the Russians out."[5] However, the former managing director of the IMF, Michel Camdessus, argued that: "What Asian countries, Russia and too many other countries did not do was build sound financial systems quickly enough and give attention to the proper phasing and sequencing of capital account liberalisation. Their 'disorderly' liberalisation now threatens to give liberalisation itself an undeserved bad reputation."[6]

The Asian financial crisis caused a slump in the price of global commodities, which hit the currencies of commodity producing countries such as Australia, Canada, Mexico and Chile. At this stage Russia largely avoided a financial crisis thanks to prearranged assurances of IMF financial assistance and strong demand for Russian GKOs. But in the spring and summer of 1998 the IMF's commitment to Russia was tested by the emergence of the country's first post-communist trade deficit and the prolonged existence of a large federal budget deficit. Prior to the August 1998 default, the IMF announced a $22 billion package for Russia, but the fiscal situation in Russia was so delicate that the market decided that the package was not substantial enough to prevent a crisis.

6.ii. Objectives of the Asian 'bail-out' loans

The IMF assistance to Thailand, Indonesia and South Korea were phased. Not all of the money was available at the outset of the crisis and was, therefore, unable to counteract market pressures at this time. The financial assistance was provided in tranches. This helps to ensure that the countries have an incentive to adhere to the conditions agreed prior to the

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[4]Ibid.
[5]Kagarlitsky, B. 1998a.
[6]Camdessus, M. 1998.

granting of IMF assistance. The initial goal of the IMF packages was to impress the market and convince foreign investors to maintain or even extend their credit lines to these countries. Yet Korea endured vast capital outflows during the first three weeks of its reform programme and default was only avoided by a last minute agreement to reschedule short-term debt.

The financial packages which were granted to the countries of Thailand, Indonesia and South Korea had nine key goals: (1). Prevent a default on foreign obligations. (2). Limit the extent of currency devaluations. (3). Maintain a fiscal balance. (4). Limit the increase in inflation. (5). Replenish foreign exchange reserves. (6). Reform of the banking sector. (7). Eliminate monopoly practices and reform the domestic, non-financial, economy. (8). Preserve investor confidence and creditworthiness. (9). Minimise the reduction in output.[7] The attainment of these goals was based on six major policy measures:

1. Prevention of outright default.

With the IMF deal in Korea, creditor governments forced Korean private banks to guarantee the repayment of bad debts to private banks in the U.S., Europe and Japan backed by the Fund's 'bail-out' loans. Korean taxpayers, therefore, paid taxes amounting to billions of dollars to enable the government to make good the bad private loans. Understandably, East Asians felt aggrieved by such treatment. "While squeezing local businesses, the IMF programmes are serving as a safety net for the big Japanese, European and American banks that have made irresponsible lending decisions ... We are not asking for the IMF to bail out our firms, we are simply asking for a sharing of the market's punishment for making the wrong decisions"[8]. One of the Asian countries key fundamental weaknesses was the fact that foreign currency-denominated short-term loans exceeded foreign exchange reserves in all of the worst hit crisis countries. The IMF has, therefore, recommended that countries maintain adequate levels of foreign exchange reserves. Indeed, foreign exchange reserves increased in South Korea from $21.1 billion in December 1997 to $61.3 billion in May 1999, in Thailand from $26.2 billion in December 1997 to $30.7 billion in June 1999, and in Indonesia from $18.9 billion in October 1997 to $26.3 billion in June 1999.[9]

2. To minimise currency depreciation and inflation.

In response to capital outflows interest rates inevitably rose, but the IMF demanded additional increases in interest rates in an effort to minimise the extent of currency depreciations and the increase in inflation through imports. This action suggests that higher

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[7]Radelet & Sachs. 1998. p.41.
[8]Bello, W. 1998b.
[9]The Economist. 14 February 1998 & 28 August 1999.

rates of interest will lead to either currency stability or currency appreciation and that the benefits of currency stability exceed the short-term costs of a reduction in output. However, the higher interest rates did not significantly reduce currency depreciations and actually worsened the magnitude of the crisis by causing corporate and banking sector bankruptcies due to the economies' declining level of economic activity. Korea, for instance, has one of the world's highest levels of savings, yet the IMF demanded that interest rates be increased. They reached 30% in early 1998; at the same time inflation was only about 5%. This amounted to a real interest rate of 25%, which put many of Korea's companies at risk of bankruptcy.[10]

However, it must be acknowledged that a loose monetary policy at the early stage of the crises may not have limited the depreciation of the currency and a further depreciation would have increased the burden of foreign currency-denominated debt. Thus, the IMF argues, an expansionary monetary policy would have had a devastating effect on companies and financial intermediaries with significant exchange rate exposures. But Harvard's Jeffrey Sachs argued that maintaining a loose monetary policy would have only resulted in modest devaluations and a superior economic environment. At the time of the Asian crisis few believed Sachs's conviction was conceivable. Instead, they believed that such a theory would lead to a downward spiral of currency depreciation and surges in inflation. But, following Brazil's crisis in January 1999, Sachs's view has gained far more credibility.

Following the Russian crisis in August 1998, investors began to withdraw their credit lines from Brazil, believing that the country had a number of similar fundamental weaknesses (most notably a budget deficit) that had contributed to Russia's economic downfall. Subsequently, Brazil endured a steady depletion of its foreign exchange reserves, so the IMF intervened with its usual prescription of increased taxes, lower spending and higher interest rates. Inevitably, a recession ensued and by January 1999 the situation had become unsustainable. The Brazilian currency, the real, was floated on January 15th yet the market reaction was surprisingly positive. The real dropped by only 10% and the stock market soared by 33%. Paul Krugman believes this favourable response was because the market thought that the austerity programme would be dropped, allowing interest rates to be slashed, and thus resulting in an economic recovery.[11] However, the following day, the Brazilian government met with senior IMF officials the following day who demanded interest rate increases. This depressed the market and the real and the stock market plunged on Monday

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[10]Feldstein, M. 1998. p.29.

January 18th 1999. It is inconceivable why the IMF officials refused to allow the real to float. Paul Krugman suspects that the IMF was afraid to see Jeffrey Sachs proved correct. If Brazil could successfully have let its currency float, without raising interest rates, it would have meant that the "recession being imposed on Brazil - and perhaps the recessions being imposed elsewhere - had been unnecessary, gratuitously imposed on behalf of an incorrect theory"[12].

3. Fiscal policy.

The IMF claimed that "fiscal policy is the key to the overall credibility of the programme"[13] and initially demanded a fiscal surplus amounting to 1% of GDP in each of the three countries under IMF tutelage. The key objectives of the tight fiscal policy were: firstly, to reinforce the monetary contraction and to support the exchange rate and; secondly, to raise sufficient funds to provide liquidity and enable effective reform of the financial systems. With the tight monetary policy and currency crises the fiscal targets exacerbated the contractionary effects of the crisis. It is difficult to understand the demands of the IMF for fiscal surpluses because the Asian financial crisis was, after all, a crisis of private sector excesses rather than a result of public sector profligacy. Moreover, Nicola Bullard of the Thai-based development agency Focus of the Global South, argued that: "The tight fiscal requirements of the IMF deepened the crisis by squeezing domestic credit and pushing up interest rates, turning what had thus far been a crisis of the financial sector into a crisis of the real economy. Real people with real jobs started to feel the pinch."[14] The austere economic measures were demanded by the IMF because the Fund believed that the return of foreign capital would result in Asia's economic recovery. When capital returned, the IMF assumed, domestic liquidity would be enhanced and currencies would stabilise; in turn, interest rates would also decline. Yet capital continued to leave the region, further reducing domestic liquidity and forced the IMF's Asia Pacific Director Herbert Neiss to admit that: "The economy had slowed down to such an extent that a continued stringent austerity regime may prompt a new economic crisis."[15] This acknowledgement was reflected in the IMF's policy adjustment, which permitted Thailand's government to run a budget deficit of 1-2% of GDP, rather than the 1% surplus the Fund had originally demanded.

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[11]Krugman, P. 2000a. p.149.
[12]Krugman, P. 1999a.
[13]Radelet & Sachs. 1998. p.42.
[14]Bullard et al. 1998. p.33.
[15]Ibid. p.6.

It was disconcerting that the IMF's main policy objective was the return of foreign capital, because the Asian governments had no other means of improving the domestic economic environment through expansionary monetary or fiscal policies. The health of the region now appeared to rely entirely on erratic waves of foreign capital. Moreover, critics argued that if foreign capital was to return where would profitable investments be made?

4. Closure of financial intermediaries and the enforcement of capital adequacy standards.

The heart of the IMF's structural reforms for the three Asian economies were in the financial and corporate sectors where insolvent institutions were merged or liquidated. The objectives of closing down bankrupt finance institutions was essentially to minimise the losses that these intermediaries were accumulating and also to improve market and banking sector confidence by illustrating the domestic authorities commitment to reform. But rather than restoring confidence, the IMF demands for the abrupt closure of financial intermediaries deepened the economic crisis. Thailand had fifty-eight out of ninety-one finance companies suspended, and fifty-six of these were subsequently liquidated. In Korea, fourteen out of the country's thirty merchant banks suspended operations and Indonesia had sixteen commercial banks closed.[16] The IMF directive of suddenly closing down sixteen Indonesian banks actually caused a bank run on approximately two-thirds of the country's other banks, additionally undermining both the health of the Indonesian financial sector and market confidence.[17] The bank run occurred because Indonesians do not enjoy Western-style guarantees of deposit insurance. Fearing that their bank would be closed next, depositors shifted their capital from private banks to state-owned banks believing that the state owned banks provided more guarantees. The New York Times wrote that: "A confidential report by the IMF on Indonesia's economic crisis acknowledges that an important element of the IMF's rescue strategy backfired, causing a bank panic that helped set off financial market declines in much of Asia ... These closures, far from improving public confidence in the banking system, have instead set off a renewed 'flight-to-safety'. Over two thirds of the country's banks were affected, and more than $2 billion was withdrawn from the [Indonesian] banking system."[18] Indonesian bank closures should instead have been phased over a longer period of time, rather than at the height of the financial crisis. This would have provided more scope (and time) for bank restructuring.

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[16]Radelet & Sachs. 1998. p.42.
[17]Bullard et al. 1998. p.9.
[18]Sanger, D. 1998.

The second measure of structural reform was to establish a firm base for the financial sector and, most notably, improve regulatory and supervisional procedures. This area of reform is inter-linked with the first because only profitable institutions should have been allowed to continue operations, while the development of sound regulatory measures should have strengthened the financial sector. Ending subsidies to insolvent institutions was also important. Prior to the Thai devaluation, for example, several bankrupt finance companies absorbed approximately 17 billion baht in subsidies. The majority of these finance companies spent these subsidies on expanding their portfolios and re-lending rather than restructuring and cutting their exposures.

Asian banks required recapitalisation as a result of the increase in NPLs due to both the crisis and high interest rates. The currency devaluations hurt even the strongest of the region's banks due to their exchange rate exposures. In response, the IMF forced a dramatic recapitalisation of banks. In Indonesia the central bank demanded that capital adequacy levels be raised to 9% by the end of 1997 and to 12% by the end of 2001. Pressuring the banks to recapitalise in such a short period of time caused an additional reduction in lending of even the healthiest banks, further contributing to the credit crunch. Radelet and Sachs argued that: "[If] more forbearance [had] been given on the capital adequacy ratios early in the crisis, with a clear and longer-term schedule for otherwise strong banks to return to full compliance, the extent of the credit squeeze would have been much less severe."[19]

5. Removal of competition impediments.

Measures were taken to reduce or reform state-sponsored monopolies and cartels to help improve market competition and attempts to increase the transparency of financial and economic information of private enterprises. Moreover, Timothy Lane of the IMF stated that: "International trade reforms were aimed mainly at continuing existing liberalisation plans to prevent a lapse into beggar-my-neighbour restrictions."[20]

6. Reform of the social sector.

These reforms primarily focused on improving and broadening social safety nets. Attempts were also made to minimise unemployment by the establishment of training and employment schemes and to limit the effect of inflation (as a result of the devaluation) on the poorest households by continuing to provide subsidies for food, energy, transportation and retaining access of the poor to education and health care.

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[19]Radelet & Sachs. 1998. p.48

6.iii. Did the IMF policies make the crises worse?

Did the IMF exceed its designated purposes?

The IMF exists for the following reasons: (1). To promote international monetary cooperation through a permanent institution that provides the basis for consultation and collaboration on international monetary difficulties. (2). To encourage and promote a diversified and sustainable growth of trade, while contributing to increased and maintained levels of employment. (3). To support exchange rate stability and to ensure that exchange rates between members are appropriate and that member countries refrain from competitive devaluations. (4). The abolition of restrictions on foreign exchange transactions, which impede the diversification and growth of world trade. (5). To allow members to borrow the Fund's capital to enable member countries to correct potential balance of payments deficits under adequate safeguards. (6). Accompanying the above practice, to limit the period and reduce the degree of disequilibrium in the balance of payments of IMF member countries. Nicola Bullard argues that the Fund greatly exceeded its designated purposes. "[The Fund's stated objectives include] nothing about trade and investment liberalisation, privatisation, foreign investment or public sector austerity measures, all of which have become central to the IMF's demands in Asia. Article II, however, mentions the Fund's role in promoting high levels of employment and real income - purposes which the Fund has clearly failed to achieve in South Korea, Thailand and Indonesia"[21].

Incorrect diagnosis of the causes of the Asian crisis

The IMF failed to foresee the Asian crisis and, according to Jeffrey Sachs, "arrived in Thailand ... filled with ostentatious declarations that all was wrong and that fundamental and immediate surgery was needed ... The IMF deepened the sense of panic not only because of its dire pronouncements but also because its proposed medicine - high interest rates, budget cuts, and immediate bank closures - convinced the markets that Asia indeed was about to enter a severe economic contraction. Instead of dousing the fire, the IMF in effect screamed fire in the theatre"[22].

The most obvious criticism of the IMF's performance in East Asia is that the Fund appeared to be treating the crisis as if it was the result of public sector profligacy rather than a crisis caused by private sector excesses. The region did not suffer from excessive inflation, yet the IMF demanded increases in interest rates, a policy response that is, again, consistent

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[20]Lane, T. 1999. p.46.
[21]Bullard et al. 1998. p.30.
[22]In Bello, W. 1998c. p.422.

with the IMF's traditional crisis response package. (Table 2, p.175, shows East Asia's low consumer price index and fiscal surpluses.) The consequence of the Fund's response was to apply additional deflationary pressures to the recessionary effects of the financial crises. Leaver and Seabrooke argued that: "These measures (intended to deflate the ailing economy and its import bill, so producing the current account surplus needed to service external debt) are believed to have had the effect of converting a liquidity crisis into an insolvency crisis."[23]

Despite the fact that budget deficits were not a concern of the market, the IMF believed they soon would be arguing that the cut back of government expenditures would illustrate the virtue of the authorities and their opposition to crony capitalism. Perhaps a more appropriate response to the financial crises would have been to allow the Asian governments to increase expenditures to counteract the reduction in private sector economic activity.

IMF assistance programmes have been significantly influenced by the United States

The United States is the most powerful member country of the IMF, holding 18% of the overall member countries vote; together the countries of the European Union control 29% of the vote.[24] Since the Reagan administration in the mid-1980s, the U.S. has aggressively promoted the globalisation of trade and investment flows through the country's foreign economic policy. The main objective has been to eliminate both protectionism and the subsidisation of domestic producers, thus removing the obstacles faced by outward looking, market-orientated American enterprises and establishing an unbiased global market, which minimises distortions and maximises efficiency.

The U.S. accelerated its process of economic liberalisation throughout the Asian region in the early 1990's, culminating in the extensive liberalisation of the East Asian capital accounts. Walden Bello argued that: "With structural adjustment programs becoming ineffective, Washington relied on other mechanisms, foremost of which were a harsh unilateralist trade campaign employing the threat of trade retaliation to open up markets and stop unauthorised use of U.S. high technologies; a drive to create an APEC [Asian Pacific Economic Co-operation] free trade area with a comprehensive liberalisation program leading to borderless trade among eighteen countries; and a strong push on the Asian countries to implement the GATT Uruguay round agreements that eliminated trade quotas, reduced

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[23]Leaver & Seabrooke. In: 'Global Finance: New Thinking on Regulating Speculative Capital Markets.' 2000. p.154.
[24]Bullard et al. 1998. p.29.

not in biblio.

tariffs, banned the use of trade policy for industrialisation purposes, and opened up agricultural markets."[25]

Many Koreans believe that the U.S. and IMF have exploited the region's misfortune to impose a programme of liberalisation and deregulation of trade, investment and finance that Washington's economists had been advocating prior to the Asian crisis with little success. The then U.S. trade representative, Charlene Barshefsky, told the U.S. Congress that: "Policy-driven rather than market-driven economic activity ... meant that U.S. industry encountered many specific structural barriers to trade, investment and competition in Korea. For example, Korea maintained restrictions on foreign ownership and operation, and had a list of market access impediments ... The Korea stabilisation package, negotiated with the IMF in December 1997, should help open and expand competition in Korea by creating a more market-driven economy ... If it continues on the path to reform there will be important benefits not only for Korea but also the United States."[26]

The United States' free-market philosophy has for many years been concerned with the degree of market penetration that it has allowed the East Asian economies in the U.S. market. In contrast, the U.S., despite the liberalisation of the Asian capital accounts, has been unable to penetrate Asian markets due to state intervention, mercantilism and protectionism, which has curbed U.S. exports to and investments in East Asia. However, the Asian crisis provided the U.S. with the opportunity to gain greater influence in and impose the U.S. free-market philosophy on the region. The IMF stabilisation programmes demanded a reduction in protectionism and state intervention. Thailand removed all restrictions on foreign ownership of Thai financial intermediaries. Korea raised the limit of foreign ownership of corporate stocks to 55%. It also allowed the establishment of foreign financial enterprises, an agreement ending government-directed lending and also the full liberalisation of the capital and financial markets.

Harvard's Martin Feldstein commented that: "Several features of the IMF plan are replays of the policies that Japan and the U.S. have long been trying to get Korea to adopt. These included accelerating the previously agreed upon reductions of trade barriers to specific Japanese products and opening capital markets so that foreign investors can have majority ownership of Korean firms, engage in hostile take-overs opposed by local management, and expand direct participation in banking and financial services."[27] Both

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[25]Bello, W. 1998a.
[26]Bello, W. 1998c. p.425.
[27]Feldstein, M. 1998. p.32.

market analysts and Koreans believed that these features of the IMF programme were an abuse of the IMF's authority, forcing Korea, in the midst of a crisis, to accept policies that the country had previously refused to implement.

Jeffrey Garten, the former under-secretary of commerce during Bill Clinton's first term as president, stated that: "There is going to be a significantly different Asia in which American firms have achieved much deeper market penetration, much greater access."[28]

Moreover, the U.S. has a strong interest in the preservation and diversification of free global capital mobility because America's current account deficit is financed by external borrowing. Furthermore, the low level of U.S. savings (see Chapter 4) means that the U.S. economy must supplement these savings with foreign capital inflows to maintain the economy's high level of consumption. It is, therefore, in America's interest for developing economies to play by American rules.

Political influence within the Fund should be distributed according to the principle of equal national representation. Instead, IMF voting power is essentially allocated in proportion to the quota subscriptions made by member countries to the IMF. These subscriptions are determined by the economy's relative importance within the global economy. This fact helps to explain the dominance of American influence on the conduct of the IMF. But the fact that the U.S. dominates the IMF's policy conduct seems perverse, for the U.S. is the world's largest debtor country (running the world's largest current account deficit). Yet it still dominates the IMF *modus operandi.* Leaver and Seabrooke commented: "Don't creditors rather than debtors usually run banks? ... How is it that the normal operating procedures that are implemented so mechanically for other deficit economies can be entirely waived for the U.S?"[29]

The double standard of international capital markets

Paul Krugman has argued that: "The real critique of the IMF, the one we should worry about, is the accusation that it failed to understand the panic element in the Asian crisis, and that it concentrated on disciplining countries when it should have concentrated on reassuring markets ... What the Fund should have done in Asia was to treat the crisis as a pure panic, completely unjustified by fundamentals. It should, therefore, have acted as a pure lender of last resort - making credit lines available to Asian economies with no questions asked."[30]

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[28]Garten, J. 1998.
[29]Leaver & Seabrooke. In 'Global Finance: New Thinking on Regulating Speculative Capital Markets.' 2000. pp.160 & 165.
[30]Krugman, P. 1998d.

However, Mr Krugman admits that the IMF does not have the available resources to act as a lender of last resort and that there were fundamental weaknesses evident in the Asian economies, which undoubtedly precipitated the crisis. The IMF response of tightening monetary and fiscal policy deepened the financial crisis and it remains questionable how these measures were supposed to bolster market confidence. Instead, Paul Krugman believes that the IMF response only exacerbated the panic by "criticising country policies and imposing conditions; the IMF should have acted as a booster: Michel Camdessus and Larry Summers should have tried to look happy as they toured Asian capitals, and should have declared at each stop that the real economies were in excellent shape"[31].

International capital markets respond adversely to developing country devaluations. This is because imports usually represent a much greater share of consumption; hence, a substantial depreciation will lead to a dramatic rise in inflation. Moreover, developing economies' financial intermediaries often possess significant exchange rate exposures. Thus a significant currency depreciation would increase the cost of servicing foreign debt and may cause widespread bankruptcies. In contrast, advanced country devaluations are perceived to be expansionary and developed countries often gain from a depreciation of their currency. For example, the U.S. economy suffered from an increasing and potentially unsustainable trade deficit in 1985. In response to growing market pessimism, the Federal Reserve cut interest rates, allowing the dollar to fall from 240 yen to 140 and the U.S. economy continued to prosper. Moreover, Britain's exit from the ERM in 1992, resulted in only a 15% devaluation, a modest increase in inflation, and a rapid economic recovery.[32]

Yet the Fund's response to the emerging market crisis in Asia was to demand higher interest rates as a precondition for IMF assistance. The higher interest rates were intended to encourage investors to maintain their credit lines and thus arrest any further decline in the currency. But, the tight monetary policy, together with fiscal austerity measures, meant that Asia's recovery relied on the return of foreign capital rather than expansionary macroeconomic policies. However, there is an additional concern of the IMF and the leaders of developing economies, namely that of self-fulfilling speculative crises.

Paul Krugman has compared the slide in the Australian dollar shortly after the Asian crisis with the case of Indonesia. Mr Krugman highlights that Australia has a considerable dependence on foreign capital because the country has run a current account deficit of 4% or more of GDP for decades. But to investors Australia remains a sound country, which is

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[31]Ibid.

economically and politically stable. "[Therefore,] the markets response to a decline in the Australian dollar is in effect to say, 'good that's over, let's buy Australian and the economy actually benefits. The market's good opinion is, therefore, confirmed ... On the other hand, suppose that despite some twenty years of remarkable progress people are not quite convinced that Indonesia is no longer the country of the year of living dangerously. Then when the rupiah falls they may say. 'Oh my god, they're reverting to the bad old days.' The resulting capital flight leads to financial, economic, and political crisis, and the markets bad opinion is similarly confirmed"[33].

A self-fulfilling, speculative attack may occur when a developing economy, which possesses some fundamental weakness (such as a budget deficit), suffers an adverse turn in investor sentiment. This may be due to a crisis in an emerging market possessing broadly similar problems, which then highlights the economy's weaknesses. In normal times investors would have maintained their credit lines enabling the economy to address these weaknesses, but, instead, they withdraw their credit and the economy endures economic difficulties. The stock market nose-dives and interest rates rise in an effort to attract capital. The country's fundamentals remain unchanged, but this situation does not represent an opportunity to buy because other investors are also fleeing the country. Banks and corporates go bankrupt and the high interest rates aggravate the economic contraction. Therefore, if you wish to minimise your losses you should follow the example set by the market and withdraw your credit.

The IMF response to the Asian crisis attempted to restore market confidence in countries that have a feeble hold on investor confidence. Paul Krugman argues that: "Because crises can be self-fulfilling, sound economic policy is not sufficient to gain market confidence; one must cater to the perceptions, the prejudices, and the whims of the market. Or, rather, one must cater to what one hopes will be the perceptions of the market ... What remedy does Washington offer? None. The perceived need to play the confidence game supersedes the normal concerns of economic policy. It sounds pretty crazy and it is ... [But] as long as capital flows freely, nations will be vulnerable to self-fulfilling speculative attacks, and policy makers will be forced to play the confidence game."[34]

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[32]Ibid.
[33]Krugman, P. 2000a. p.110.
[34]Krugman, P. 1998d.

Has the IMF encouraged world wide moral hazard?

Moral hazard has received considerable coverage throughout the 1990s in debates on the global financial system and the IMF has endured much criticism for its own contribution to the role of moral hazard. According to Bordo and Schwartz, "emerging countries may believe that they have an implicit contract with the IMF to be saved from their own folly. This is an expansion of the original terms of the Articles of Agreement at Bretton Woods that established the IMF as a social insurance fund in which members contributed resources, which would be made available to them or other members as needed"[35]. Therefore, the prospect of an IMF 'bail-out' loan may encourage domestic authorities to pursue reckless economic policies, increasing the country's vulnerability to a financial collapse. Walden Bello believes that the IMF has provided a "safety net for the global financial elite"[36]. Furthermore, "lending to Russia has been known in the markets from time to time as the 'moral hazard play'"[37].

The concept of IMF induced moral hazard, suggests that both debtors and creditors are encouraged to act irresponsibly due to the prospect of a 'bail-out' loan. This has led Schultz, Simon and Wriston to conclude that: "[IMF] interference will only encourage more crises."[38] According to this notion, the financial crisis in Mexico in 1995 led to the Asian crisis in 1997, which then precipitated the Russian financial crisis in 1998. In July 1998, Russia secured a $17.1 billion rescue package from the IMF, prompting Jeffrey Sachs to write: "U.S. investors wanted to get their money out of Russia ... without devaluation losses, [so the IMF stepped in believing it could] outsmart the market."[39]

Nevertheless, concerns regarding moral hazard can be greatly exaggerated. Firstly, on the debtor side, IMF rescue packages are accompanied by many stringent conditions that cause pain and upheaval in the domestic economies; this per se may deter domestic policy makers from pursuing inappropriate policies. Moreover, governments of countries that request assistance from the IMF do not usually survive politically, so the prospect of an IMF 'bail-out' loan would hardly appear to be an incentive for governments to behave recklessly. Secondly, moral hazard is often regarded as the lesser evil, for if the IMF were abolished the absence of a lender of last resort may result in worse consequences. Without the Fund's provision of international liquidity a financial crisis in an emerging market may result in

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[35]Bordo & Schwartz. 1998. p.45.
[36]Bello, W. 1998b.
[37]The Economist. 17 February 2001. pp.107-8
[38]In: Haas & Litan. 1998. p.5.

economic turmoil, significant increases in poverty, prolonged dislocation from international capital markets and a perpetuated economic contraction. Such a devastating crisis would also lead to contagious effects through the host country's financial and trade ties, while also increasing the possibility of additional financial panics. Third, capital from the IMF should be available when the financial markets behave unexpectedly or irrationally to help restore market confidence. For example, when foreign loans were called in from Asia it resulted in a liquidity crisis, which may have been ameliorated if the market had had the confidence to lengthen maturities of the region's debts.

Arguments against moral hazard from a creditor's perspective have centred on two particular areas. Firstly, there is little evidence to suggest that the rise in capital flows to Asia was due to an implicit guarantee from the IMF to provide an international rescue loan if the region suffered a crises. This notion has been suggested by some economists due to the IMF rescue loan in response to the Mexican crisis, where owners of Mexican government debt were perceived to have been bailed out by the IMF. Secondly, the IMF has often made a point of illustrating that many investors suffered losses during the Asian crisis, particularly foreign equity investors. (There are various proposals to make creditors share the costs of financial crises more evenly, including private sector bail-ins and a standstill on debt repayments. See Chapter 4.)

Eliminating the potential for moral hazard is impossible. The IMF, the only institution that can effectively provide emergency international liquidity, is urgently needed to administer the world's erratic capital markets and provide capital to economies that suffer a contraction of domestic credit. For if the IMF does not involve itself with developing country crises the domestic crisis would become deeper and longer and may also spread to neighbouring countries. Liquidity is the key that enables emerging markets to sustain market confidence. Countries that choose not to maintain substantial quantities of foreign exchange reserves have no other choice but to call on the IMF when they experience destabilising speculative pressures. The Russian and Asian economies found themselves drastically short of liquidity when investors began to recall their loans. Hence, the recent crises highlight the need for emerging markets to maintain large quantities of foreign exchange reserves relative to short-term debt.

In my opinion, the IMF's austere response to the Asian crises will reduce the possibility for government-related moral-hazard plays because the Fund's conditionality has

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[39]Sachs, J. 1999a.

served as a warning to other emerging markets. Thus, developing economies will be encouraged to follow prudent macroeconomic policies so to avoid calling upon the Fund.

An Asian Monetary Fund?

The absence of an American contribution to the IMF's 'bail-out' loan to Thailand, together with the harsh demands of the Fund, prompted Japan to propose an Asian Monetary Fund (AMF), which would disperse capital to its regional members more leniently. The AMF would have a potential capitalisation of $100 billion (provided by Asian member countries.)[40] This capital would be available to provide emergency liquidity, enabling Asian countries to rectify macroeconomic imbalances and provide loans for long-term economic adjustment programmes. However, the former managing director of the IMF, Michel Camdessus, argued that the establishment of and the provision of financing by the AMF would not ensure that tough economic reforms are implemented effectively. Yet few believed the IMF claims. The reality is that the AMF would establish an institution that could directly compete and thus jeopardise the monopoly of the IMF in policy making in the face of financial crises.

Has the IMF outlived its usefulness?

The IMF was established in 1947 following the Bretton Woods Conference in 1944. At the time the IMF's role was to supervise the newly introduced adjustable peg exchange rate system. But the IMF has also attracted criticism precisely because it was conceived to help sustain pegged exchange rates, which are inconsistent with today's world of high capital mobility. Indeed, when the IMF was established international capital movements were small due to both the Great Depression and World War Two. Consequently, critics have argued that these factors promoted an inability of the IMF to see beyond the economic conditions prevailing at the time of the Bretton Woods negotiations. Moreover, the negotiations took place when the U.S. enjoyed a position of economic supremacy even greater than that enjoyed today. At the time, the U.S. held 30% of the voting powers and America's economy was ten times larger than, today's second largest economy, Japan. In 1990 it was only 1.5 times larger.[41] Answer to the question?

6.iv. The IMF's response to criticisms

The IMF managing director at the time of the Asian crisis, Michel Camdessus, responded to the Fund's critics with the following statement: "As soon as it was called upon, the IMF moved quickly to help Thailand, then Indonesia, and then Korea formulate reform

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[40]Kotler & Kartajaya. 2000. p.119.

[41]Leaver & Seabrooke. In 'Global Finance: New Thinking on Regulating Speculative Capital Markets'. 2000. p.162.

programmes aimed at tackling the roots of their problems and restoring investor confidence. In view of the nature of the crisis, these programmes had to go far beyond addressing the major fiscal, monetary or external balances. Their aim is to strengthen financial systems, improve governance and transparency, restore economic competitiveness, and modernise the legal and regulatory environment."[42]

Stanley Fischer the then deputy director of the Fund, opposed the belief of many economists, including Jeffrey Sachs, who claimed that the IMF response to the Asian crisis was the Fund's usual prescription to address a crisis of public sector indebtedness. "The IMF supported programmes in Thailand, Indonesia and South Korea are anything but the usual medicine, precisely because of their heavy constructural components, which are included because structural problems lie at the heart of the economic crises in the three countries. To ignore the structural issues would invite a repetition of the crisis. The macroeconomic parts of these programmes consist of a combination of tight money to restore confidence in the currency and a modest firming up of fiscal policy to offset in part the massive costs of financial restructuring. And the moral hazard concern, while essential to deal with, is easily exaggerated"[43].

Stanley Fischer stated that the first concern of the IMF was to restore confidence in the currencies of Thailand, South Korea and Indonesia. Each of these countries had endured a substantial drain on foreign exchange reserves and Mr Fischer, therefore, argues that the domestic currencies had to be made more attractive to foreign investors. Thus interest rates were raised. Therefore, the IMF believes that the short-run costs of higher interest rates (further bankruptcies of banks and corporations) are outweighed by the benefits that the return of foreign capital will bring, which will eventually allow interest rates to decline. Yet it is widely agreed that when interest rates are maintained at levels beyond an emergency scenario they will induce debilitating effects. Interest rates in Korea and Thailand fell to pre-crisis levels in the summer of 1998, but at the time these countries were enduring a credit crunch unrelated to the level of interest rates. Corsetti *et al.* argued that: "[Instead,] it has more to do with the inability of financially distressed banks to lend to a corporate sector labouring under the weight of a severe debt overhang."[44]

Stanley Fischer argued that the fiscal programmes varied from country to country and were introduced to promote a sustainable balance of payments. Thailand, which had a large

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[42]Corsetti et al. 1998c. p.15.
[43]Fischer, S. 1998a. p.103.
[44]Corsetti et al. 1998c. p.17.

current account deficit, was required to carry out a fiscal adjustment of 3% of GDP, Korea 1½% of GDP and Indonesia 1% of GDP. At the time, Mr Fischer believed that the majority of these adjustments could be accomplished by abolishing public investment activities yielding low rates of return. Yet, Timothy Lane, chief of the Policy Review Division of the IMF's Policy Development and Review Department, admitted: "[With] hindsight, given the sharp decline in private sector demand that was under way, fiscal policy should have been more expansionary, and there was a major change in course as the situation became clear. The deteriorating economic environment led directly to substantial increases in fiscal deficits, which, from the beginning of 1998 on, were accommodated by easing the programmes fiscal objectives"[45].

The IMF believes that the moral hazard issue has been exaggerated. Mr Fischer argues that countries will try to avoid calling on the Fund, knowing full well that any loan will be accompanied by stringent conditions and, more often than not, a political fall-out. Thus, the conditionality that accompanies any financial assistance encourages policy makers to follow correct macroeconomic policies.

Stanley Fischer concludes that: "The basic approach of the IMF to these crises has been appropriate not perfect, to be sure, but far better than if the structural elements had been ignored or if the Fund had not been involved. Of course, one cannot know for certain what would have happened had there been no official lending."[46]

6.v. Reforming the IMF

The former U.S. Treasury Secretary, Larry Summers, commented that: "The global economy has changed since the World Bank and the IMF were created, and these international financial institutions must change as well."[47] Proposed reforms of the IMF have received widespread media coverage following the recent bout of financial crises, which have perhaps raised the greatest questions about the future role of the IMF. The most extreme proposals have called for the abolition of the Fund.

The Meltzer Commission has suggested various reforms of the IMF. The Commission is sponsored by Congress and led by the economist Allan Meltzer of Carnegie Mellon University. Thus far, the members of the Commission are agreed that both the IMF and the World Bank have previously attempted to do far too much. "The IMF, first conceived as a provider of liquidity in emergencies, has become a development institution,

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[45]Lane, T. 1999. p.46.
[46]Fischer, S. 1998a. p.106.
[47]Summers, L. 2000. p.29.

advising and requiring borrowers not merely to repay, but to reform the deep micro-structure of their economies. It has little expertise in this area; such policies, forced on governments in circumstances like these, tend not to stick; and so wide a development remit in any case overlaps with that of the Bank ... Most of [the World Bank's] loans go to countries with access to private international capital. The countries that, according to the Bank's own analysis, could make best use of its resources receive a comparatively small share. To be more effective, the Fund and the Bank both need to do less"[48]. The Meltzer Commission is recommending that the World Bank alter its title to the World Development Agency, indicating that the focuses of the Bank will be specifically directed to assisting the very poorest countries. "Overall, the commission's aim is to render the institutions more effective, to reduce overlap and to ensure that policy recommendations do not conflict"[49].

Indeed, Lawrence Summers and other critics, such as Jeffrey Sachs, claim that the Fund should concentrate its scarce resources on providing short-term emergency loans to countries experiencing potentially destabilising speculative attacks. However, emergency loans should not be available to rescue irresponsible governments. Mr Summers believes that developing economies should borrow primarily from private creditors, thus the IMF should only intervene when this private capital is unavailable to the developing country. Stanley Fischer responded: "Crisis lending is a critical part of what we do [but] it is far from being the only thing we do ... [In general] the Fund is one of the most important ways, possibly the most important way, that the international community promotes good macroeconomic policies around the world."[50]

The Fund is currently addressing the problems that have been caused by the harsh conditions, which have accompanied IMF loans. Such demands have been unpopular in the emerging economies receiving IMF assistance. The IMF conditions have been similar to the foreign policy interests of the Fund's largest shareholder - the U.S. The new managing director of the Fund, Hörst Kohler, is attempting to 'streamline' IMF conditionality by reducing the number of specific requirements prescribed to a country when financial assistance is agreed. Mr Kohler, therefore, acknowledges that the Fund has been trying to do too much.

The IMF has been developing ambitious early-warning systems to help foresee potential crises. However, H`rst Kohler acknowledges that highlighting a country's

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[48]The Economist. 17 February 2001. p.24.
[49]The Economist. 17 February 2001. p.108.

vulnerability to crisis may encourage self-fulfilling speculative attacks.[51] While the IMF is keen to demand greater global transparency and accountability to improve the prospect of predicting future financial crises, the Fund itself should set an example to its member countries and become more transparent. Mark Weisbrot has argued that: "The IMF is the financial equivalent of the CIA: its documents and proceedings are shrouded in secrecy, its bureaucracy is unaccountable, blinded by ideology, and dedicated to protecting the interests of the rich and powerful. And the Fund has probably topped more governments, democratically elected or otherwise, than the CIA."[52]

The strong influence of the U.S. on IMF conduct should be reduced, whilst the shareholder rights of countries of the European Union and Asia should be increased. The more equal distribution of shareholder rights could help to ensure that the above reform proposals are pushed through. In the meantime, regional initiatives like the AMF, should be pursued, so that additional supplies of emergency liquidity are available, possibly providing an alternative to the narrow policy responses of the IMF.

Presently, doubts remain over the future role of the World Bank and the IMF. According to the *Economist*, "[the U.S. president George W. Bush] will be very interested in the report of the Meltzer Commission ... which recommended a dramatic scaling back of the activities of both the IMF amd the Bank ... [Although,] the main threat to the institutions probably comes not from the White House or the Treasury but from Capitol Hill. Congress has little regard for the Fund and the Bank"[53].

6.vi. Conclusion

The IMF should have supervised the liberalisation of the region's capital accounts ensuring that sound financial practices were developed. This would have improved the management and regulation of financial intermediaries, in turn reducing exchange rate exposures and NPLs. It is therefore hypocritical of Michel Camdessus to declare that: "[Asia's] 'disorderly' liberalisation now threatens to give liberalisation itself an undeserved bad reputation."[54] For these emerging markets were pushed into rapid capital account liberalisation by the Fund.

The primary objective of the IMF's assistance to Thailand, Indonesia and South Korea was to restore market confidence in these economies, culminating in the return of

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[50]Burgess, J. 2000. p.9.
[51]Interview with Hörst Kohler. 2001. pp.48-49.
[52]Weisbrot, M.
[53]The Economist. 17 February 2001. p.108.
[54]Camdessus, M. 1998.

foreign capital. The IMF has forced countries to repay, in an attempt to sustain favourable market sentiment. Losses should have been equally attributed to both borrower and creditor. The IMF demanded substantial increases in interest rates, assuming that the higher rates of return would encourage capital to return and stabilise the region's exchange rates. This seems to illustrate the IMF's bias towards foreign creditors and free capital mobility rather than economic growth and sustained employment in developing economies. But Brazil's brief experience of low interest rates in the midst of the country's 1999 crisis may well have proved the IMF's theory (of higher interest rates leading to exchange rate stability) incorrect. Unfortunately, we may never know.

The Fund's demands for tightening fiscal policy were arguably unnecessary and only worsened the economic contraction. No one else appeared to be concerned with the Asian governments' budgets. The Asian crisis was, after all, a crisis of the private sector. The United States and the IMF have used the Asian financial crisis to exploit Asia's fragility and impose policies, which had previously been rejected by, most notably, South Korea.

When Japan proposed an Asian Monetary Fund, the IMF, rather predictably, re-acted with hostility given that the AMF would effectively challenge the IMF's power and weaken American global influence. But I believe the notion of the AMF represents a significant problem within the IMF, that of unfair representation of member countries. Perhaps a new role for the IMF should be to oversee newly established regional monetary funds such as the AMF, a European Monetary Fund and so on. This would help to ensure that the interests of regional members are clearly recognised, understood and respected by their regional monetary funds. It would also help to remove the current dominance of the world's number one country in IMF policy. After all, just because liberalised trade and investment is the most appropriate policy for the U.S. does not mean that such policies are suitable for emerging markets.

Jeffrey Sachs believes that: "Complaints about the IMF and World Bank destroy any pretence that these are global institutions with more than 180 countries. The truth, of course, is that they are the instruments of a few rich governments, which hold a majority of the dollar-based votes and would rather pretend that all is well in the world than ask their taxpayers to address the urgent problems of the poor."[55] The *Economist* argues that: "Those

[55]Sachs, J. 2000.

beleaguered institutions have enabled America to protect its interests while sharing the burden of cost with others."[56]

Moral hazard concerns do require attention. But moral hazard is actually the preferred alternative to otherwise leaving a country to its own extremely limited resources during a financial crisis. Ignoring a country's plight in the midst of a financial crises would exacerbate the crisis, whilst also isolating the economy from international capital markets for a prolonged period. One favourable outcome of the Fund's stringent conditionality is that such measures have probably deterred future government-related moral hazard. However, the IMF's bias in favour of international creditors and its desire to maintain market confidence regardless of the costs to the developing country, may only have served to promote a cavalier attitude among foreign creditors.

The IMF was established to provide emergency liquidity to countries experiencing short-term balance of payments problems. It is not a development institution and, according to Mr Sachs, "knows very little about economic development challenges"[57]. The key role of the IMF should be the surveillance of the international financial system and the exchange rate regimes employed by IMF member countries. The IMF should, therefore, concentrate its scarce resources on monitoring international financial markets and providing emergency liquidity. In 1999 three new IMF initiatives were introduced: (1). The Supplemental Reserve Facility, conceived to enable the Fund to react more effectively to financial crises. (2). To allow countries the possibility of applying for Contingent Credit Lines from the IMF, to instil confidence amongst foreign creditors regarding the strength and responsibility of their economic policies. (3). The expansion of the Special Data Dissemination Standard to improve public dissemination of economic and financial data, to promote continued access to global financial markets.

Ultimately the IMF would like to eliminate the possibility of future financial crises, but this appears impossible.[58] The financial turmoil of the late 1990's, precipitated by erratic flows of international capital and the integration of ever more countries into the global financial system, means that a reformed IMF is needed now more than ever before.

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[56]The Economist. 17 February 2001. p.108.
[57]Sachs, J. 2000.
[58]The Economist. 17 February 2001. p.107.

Table 1. The IMF 'bail-out' Loan Contributors, $ billion.

	Thailand	Indonesia	Korea
The IMF	4	10	21
World Bank and Asian Development Bank	2.7	8	14
Individual Governments	10.5	22	22
Total	**17.2**	**40**	**57**

Source: Radelet and Sachs. 1998.

Table 2. % GDP change on Year Earlier, CPI % and Fiscal Surpluses 1995-1997.

	GDP			CPI			Fiscal Surpluses %GDP		
	'95	**'96**	**'97**	**'95**	**'96**	**'97**	**'95**	**'96**	**'97**
Indo	8.2	8	5	9	6.6	11.6	0.8	1.4	1.9
Korea	8.9	7.1	5.9	4.7	4.9	6.6	0.4	0.3	-0.5
Malay	9.5	8.6	7.3	3.2	3.3	2.9	3.8	4.2	2.8
Phili	4.8	5.7	5.1	11	5.2	6.1	-1.4	-0.4	-1
Thai	8.7	6.4	0	7.5	4.8	7.7	2.6	1.6	-1.1
H.K	3.9	4.9	5.3	7	6.6	5.2	-0.3	2.2	3.8
Singa	8.7	7	7.6	0.9	2	2	2.7	2.8	1.8
Taiw	6	5.7	6.9	4.6	2.5	-0.5	0.4	0.2	0.2
Japan	1.5	3.9	0.9	-0.1	0.1	1.7	-3.6	-1.1	-0.2
USA	2	2.8	3.8	2.8	2.9	2.3	-1.9	-1.1	-0.2

Source: Radelet & Sachs. 1998.

CONCLUSION

Financial contagion spread throughout the world following Thailand's devaluation on July 2nd 1997. The crisis first hit Thailand's neighbouring countries before spreading to Taiwan, Hong Kong and South Korea. Japan's prolonged recession, the depreciation of the yen, and the Asian crisis exerted considerable pressures on the Chinese renminbi.

Following the Asian crisis, international investors demanded increased risk premiums. This made financing Russia's budget deficit more expensive, and the fall in the world price of oil precipitated an unsustainable fiscal situation, culminating in the devaluation of the rouble. Meanwhile, the trading rooms of London, New York, Singapore and Tokyo were shocked by Russia's default and devaluation. The investment bank J.P. Morgan even predicted a severe American recession in 1999.[1] The U.S. Federal Reserve responded by cutting interest rates three times between September 29 and November 17 1998.

The economic environment in Latin America also deteriorated. The Mexican peso hit record lows against the dollar and interest rates rose to almost 50%. Brazil received a financial support programme from the IMF totalling $41.5 billion, but later devalued the real in January 1999. Yet the Chinese economy remained largely unscathed from the global financial turmoil due to the country's cautious approach to financial liberalisation.

Proponents of the Western capitalist model continue to argue that the Asian crisis was punishment for the sins of excessive government intervention and crony or alliance capitalism, which distorted resource allocation and led to speculative bubbles in the stock and property markets. But if this is the case, the severe economic crises were entirely disproportionate to the cause, particularly given that these evils had existed in the Asian economies for decades, during which time growth had been rapid. Moreover, why did the IMF and investment analysts fail to foresee the crisis? And worse, just three months before Korea's 1997 crisis, the IMF annual report stated that: "Directors welcomed Korea's continued impressive macroeconomic performance and praised the authorities for their enviable fiscal record." The same report praised "Thailand's remarkable economic performance and the authorities' consistent record of sound macroeconomic policies" – shortly before the devaluation of the baht.[2]

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[1] See: Krugman, P. 2000a. P.135.

[2] Wade. The Asian debt-and-development crisis of 1997-?: Causes and consequences. World Development, Vol 26, No.8. p.1537.

The conflicting view is that the Asian crisis was the result of extensive capital account liberalisation in a basically sound but under-regulated economy, which made Asia susceptible to a financial panic. The Asian economies were vulnerable primarily because they had financed investments with debt rather than equity, and a large proportion of that debt was short-term dollar denominated debt.[3] Consequently, the devaluation of the Asian currencies dramatically increased the real value of the debt, bankrupting banks and companies whilst sending the real economy into a tailspin. This is the only explanation that makes sense to me. As I see it, the real cause of the crisis was the dramatic liberalisation of the region's capital accounts while supervisory and regulatory procedures remained weak. This provided financial intermediaries with the freedom and incentives to become heavily over-extended through borrowing in offshore markets.

Placing my argument in the context of the wider debate, concerning the exact cause of the Asian crisis, it is clearly evident that Asia's crisis was borne of a growing vulnerability to a financial panic. Throughout my thesis I have argued that it is certain fundamental weaknesses that make a developing country vulnerable to a financial crisis. China was largely insulated from the Asian financial turbulence precisely because of its closed capital account and large pool of foreign exchange reserves. By way of contrast, Russia was adversely affected due to its over-reliance on short-term foreign debt, which greatly exceeded the country's meagre supply of foreign reserves. These weaknesses, among others, made Russia, which like all developing countries possesses a fragile hold on investor confidence, extremely vulnerable to an adverse turn in investor sentiment and a self-fulfilling financial panic. This study has illustrated that in order to minimise the possibility of a financial panic and ensuing economic crisis, the following vulnerabilities must be avoided:

1. A fixed exchange rate.

A fixed exchange rate has led to an underestimation of exchange rate exposures by both debtors and creditors. In turn, this has led developing economies to become over-dependent on foreign capital. Moreover, the exchange rate peg provides a target for speculators in a world where private capital flows dwarf official reserves.

Today's world of increased capital mobility means that pegging exchange rates soon becomes unsustainable. It appears that only flexible or rigidly fixed regimes, such as

[3]Wade & Veneroso argue that the combination of high savings and high corporate debt provides a strong advantage in terms of national economic development. They also provide a clear example of the greater

currency board arrangements, are consistent with capital mobility. In my opinion, currency boards should only be considered as a means of improving credibility before beginning the transition to a floating regime, which provides a far smoother adjustment to exogenous shocks. Yet there is not one exchange rate regime that is suitable for all economies. Certain exchange rates can achieve specific benefits depending on a country's objectives.

The developing country crises of the 1990s also highlights the inability of emerging markets to carry out successful devaluations. When Britain devalued the pound in 1992, speculators stopped betting on further currency depreciations. But with emerging markets, the abandonment of the exchange rate peg has been perceived as the first of many depreciations, resulting in even greater speculative pressures. Paul Krugman believes that when developing countries devalue their currencies they must follow certain rules. First, that the devaluation is significant enough to restrain expectations of future depreciations. Second, following the devaluation, the government must provide clear signals to appease the market; assuring investors that everything is under control.[4] But all too often emerging markets break both of these rules, further deteriorating investor confidence, resulting in a prolonged isolation from international capital markets. This severely restricts the policy options of the developing country. Their creditors often demand repayment on short notice and their difficulties are compounded by the fact that the debts are denominated in foreign currencies. In contrast, advanced country devaluations seldom result in isolation from international capital markets.

2. Minimise short-term foreign currency-denominated debt.

Short-term capital inflows have proved to be synonymous with pegged exchange rates. Because the developing country's central bank guarantees to convert local currency into the foreign anchor currency, exchange rate risks are greatly reduced. Under a flexible exchange rate there is no such guarantee. Hence, the potential for exchange rate losses will make creditors more reluctant to lend and domestic institutions less willing to borrow.

While it can be argued that flexible regimes would deprive developing economies of cheap foreign capital and that many domestic borrowers would be unable to afford the high local-currency interest rates, Alan Blinder of Princeton University disagrees for three

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vulnerability to shocks involved in a high debt/equity 'Asian style' economic system. See The New Left Review March-April 1998, pp.3-23.

[4]Krugman, P. 2000a. p.52.

reasons.[5] Firstly, a considerable proportion of Asia's external borrowing was not necessary for development (but this was not the case in Mexico or Russia). Mr Blinder points out that the Asian economies attracted foreign capital inflows in excess of their ability to absorb this capital productively. The result was overcapacity and speculative bubbles in equity and real estate markets. Second, if a country's fundamentals are reasonable, the interest rate for borrowing in domestic currency may not be that costly. The author specifies that markets were only charging South Africa three percentage points more to borrow in rands rather than dollars in 1999. Finally, pegged exchange rate regimes lead to excessive foreign borrowing and large exchange rate exposures. For instance, if Thai companies had been forced to borrow domestically at greater risk premiums, they would have borrowed far less, which would have avoided both the rapid creation of speculative bubbles and the substantial exchange rate exposures. The author believes that the wrong people bore the exchange rate exposures in the Asian crisis. He argues that international banks should bear the exchange rate risks, e.g. by lending the money to Thailand in baht rather than dollars. True, this would have resulted in higher risk premiums, but this would have represented the actual risks rather than concealing them. However, Mr Blinder admits that no one can force international banks to lend to developing countries in local currencies so he proposes lower supervisory ratings and greater capital charges on banks that lend in dollars.

3. To maintain foreign exchange reserves in excess of short-term foreign debt.

When foreign exchange reserves exceed short-term debt each creditor knows that the economy has sufficient liquidity to pay back each and every loan if they are re-called. But in the crisis-hit countries short-term foreign currency-denominated debt exceeded foreign exchange reserves by over 100%. Thus, once the financial panic began it became impossible to stop. China and Taiwan maintained a large supply of foreign reserves in relation to their short-term foreign debt and they escaped the worst effects of the regional crisis. Maintaining foreign exchange reserves in excess of short-term debt substantially reduces the potential for financial panics.

4. "For emerging markets, an open capital account should be the exception not the rule"[6].

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[5]Blinder, A. 1999. pp.56-57.
[6]Eichengreen, B. 1998.

The IMF's initial desire for all of its member countries to have open capital accounts was the central cause of Asia's crisis. International capital markets are prone to excessive optimism followed by excessive pessimism, which poses great dangers for developing economies that are ill prepared for global financial integration. Consequently, emerging markets should maintain restrictions on capital mobility until their economic fundamentals are strengthened. In my opinion, capital controls should be effective while also minimising the restrictions that they actually place on economic freedoms. Hence, I favour Chilean-style restrictions on short-term capital inflows rather than draconian controls on capital flight.

Asia's capital account liberalisation was poorly sequenced. The economies' capital accounts were dramatically liberalised while banking standards and regulatory mechanisms were weak. The surge in capital inflows, and the combination of both deficient supervisory structures and moral-hazard-induced lending, resulted in a dramatic expansion in bank balance sheets and significant exchange rate exposures. Capital account sequencing, instead, should be a long-run process, continually addressing weaknesses until the economy is prepared for full liberalisation. Global financial integration should not be considered as a substitute for a development strategy.[7]

China (despite some notable weaknesses) has avoided a financial crisis, precisely because its capital account remains closed. China's inconvertible currency has indirectly strengthened China's external fundamentals resulting in a current account surplus and low levels of short-term foreign debt. Capital controls have prevented weak Chinese banks from borrowing in foreign currencies, whilst also restricting speculative behaviour towards the renminbi.

5. Imprudent macroeconomic objectives.

An additional fundamental weakness has been the absence of sound monetary and fiscal policies. Asia failed on the monetary front, running large current account deficits prior to the crisis. Thailand's peaked at 8% of GDP.[8] Russia's inability to collect significant tax revenues resulted in a budget deficit of 6.5% in 1997.[9] These deficits were financed by borrowing in international capital markets. Trade flows are now dwarfed by international capital flows, so these deficits could actually have been sustained over many years. But developing countries have a fragile hold on investor confidence. Consequently, economies

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[7]See: Rodrik, D. 2001.
[8]Kotler & Kartajaya. 2000. p.3.

that have become overly dependent on foreign-financing are vulnerable to an adverse change in investor sentiment. The lesson is clear: emerging markets must avoid substantial macroeconomic imbalances.

6. Weak financial sector.

Capital was not efficiently allocated in Asia's crisis-hit economies. They did not possess sound financial infrastructures and the absence of transparent and efficient domestic asset markets resulted in an inefficient and often corrupt allocation of resources. The currency strategist Callum Henderson argues that prior to capital account liberalisation "deep and liquid capital markets have to be created first ... [along with] the appropriate regulatory bodies to oversee both the capital market and the domestic banking industry"[10]. In Thailand, financial intermediaries borrowed dollars to lend baht to drive a construction boom. In Korea state-directed lending led to an increasing number of non-performing loans. Mr Henderson asserts that: "It is no coincidence whatsoever that the least degree of economic structural damage as a result of the Asian crisis occurred in Singapore and Hong Kong where the degree of institutional infrastructure development was the greatest and the extent of regulatory supervision the most vigilant."[11]

The need for greater transparency was also re-emphasized following Asia's crisis: While enhanced international transparency may improve the allocation of international capital flows, I do not believe that it will greatly improve the ability to foresee potential financial crises. Indeed, the Special Data Dissemination Standard (discussed in Chapter 4), was established to provide an early warning mechanism to market participants, but failed to recognise the looming crisis despite information being widely available on the level of short and long-term debt and the balance of payments. Moreover, a large proportion of Russian government debt was purchased while information regarding the authorities' inability to collect sufficient tax revenues was widely available.

However, it is clear that foreign fund managers must lend more responsibly, whilst appreciating that developing countries lack maturity in a number of areas where investment is needed. These include political, legal, social and administrative spheres. But instead, foreign creditors characterise developing countries as emerging markets suggesting that they are countries who are ready for various business and financial investment where high investment

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[9]RET. March 1998. p.1.
[10]Henderson, C. 2000. p.6.

risks are offset by high profits owing to the fast rates of GDP growth. Wade and Veneroso commented that "foreign investors were providing funds to Asian firms with debt ratios and long-term alliance relationships that would have been unacceptable in the West. When the crisis hit, the violence of the outflow owed much to the realisation that much of the capital should not have been committed in the first place, according to Western prudential standards".[12]

The IMF: a more understanding approach?

I have three main criticisms of the IMF's response to the Asian crisis:

1. Financial crises can and will occur, but what developing economies will need to help them recover quickly is an IMF which provides remedies tailored to that country's particular weaknesses. For example, the Fund was correct to demand fiscal and monetary austerity from Latin American governments which fuelled inflation by monetising large budget deficit in the 1980's. But Asia's crisis was a result of private sector over-indebtedness; most of the region's governments possessed budget surpluses prior to the crisis and inflation was relatively low. The IMF austerity demands only exacerbated the contractionary effects of the crisis.

The IMF philosophy regarding the defence of exchange rates through higher interest rates should also be addressed. First, if exchange rates were flexible there would be no target to defend and no need for higher interest rates. The Fund is quick to point out that further currency depreciations would have raised the burden of dollar-denominated debts. But if developing country's implement controls on capital inflows while maintaining a flexible exchange rate this would substantially reduce dependence on foreign capital. Second, as noted by Harvard's Jeffrey Sachs, "it is neither worthwhile nor feasible to twist monetary policy to soothe panicky investors, especially at the cost of internal depression"[13].

The IMF must realise that today's global macroeconomic environment is fundamentally different from the conditions in the 1970s and 1980s. Alan Blinder argues that: "Inflation - which was the bane of the 1970s and 1980s, and the other rationale for austerity - is no longer a problem. Instead, a worldwide shortage of aggregate demand has emerged as the world's premier macroeconomic malady. Programmes that force austerity everywhere aggravate this problem rather than ameliorating it. In a world with floating

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[11] Ibid.

[12] Wade and Veneroso. The Economist. p.26.

exchange rates and low inflation, fiscal and monetary austerity ought to be prescribed far less"[14].

2. The IMF has clearly favoured international creditors rather than developing country borrowers who have been forced to guarantee the repayment of bad debts to Western private banks. Martin Khor reckons that: "Foreign banks will, in short, be given large susbsidies so that they don't have to carry the costs of their mistakes, while local banks and companies are forced to go under. No wonder the IMF's main role in Asia is increasingly seen as chief debt collector for international banks."[15] Foreign banks that made irresponsible lending decisions should share both the profits and losses of their commercial risks. As it is, the IMF may only have served to create a cavalier attitude amongst international creditors.

3. The IMF saw additional capital account liberalisation as part of the solution to Asia's crisis rather than its direct cause. The expansion of international trade and capital markets is consistent with the foreign policy objectives of the IMF's largest contributor, the United States. The IMF should actually reflect the objectives of all of its member countries rather than adopting a one-size-fits-all approach to global capitalism.

A stronger infrastructure for global capitalism?

If emerging markets can avoid the fundamental weaknesses that I have outlined throughout my study they will be far less vulnerable to future financial crises. In my opinion, the two most important principles are to avoid pegging the exchange rate and to minimise short-term foreign debt. These two measures reinforce one-another for borrowing (or lending) in foreign currencies would be far less attractive if the exchange rate is flexible. China's experience illustrates the usefulness of employing capital controls and a gradual approach to capital account liberalisation. But, developing country crises will occur and what will be needed is an IMF that recognises the country's specific problems. The Fund should then resolve the economy's weaknesses in unison with the developing country rather than issuing their usual crisis response package, which is shrouded in secrecy and rarely negotiated with the governments that are recipients of IMF loans.

Jeffrey Garten argues that: "The crucial challenge facing policy makers and financiers is the development of a stronger infrastructure for global capitalism ... The world economy is crisis-prone because it is evolving at breakneck pace and has many seriously weak economic

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[13]Sachs, J. 1998a. p.24.
[14]Blinder, A. 1999. p.59.

and political links. The crisis was the fruit of a general overestimation of the strength of the framework for global finance."[16]

A final word

As this thesis has been a discursive study, a wide range of highly contentious issues have been considered, although I have been unable to go into as much detail as I would like. Throughout my paper it has been my intention to provide a fair and concise argument and come to independent conclusions. Many of the subject areas are matters for personal interpretation and opinion: for example, the extent to which capital account liberalisation is desirable for emerging markets, the preferred exchange rate regime, and the IMF's response to the Asian crisis.

The exact causes of the Asian financial crisis have received widespread scrutiny. The opinion of commentators, not surprisingly, has varied throughout the world. Radelet and Sachs believe that the Asian economies were essentially in good shape and they attribute the crisis to a gratuitous financial panic by foreign creditors. In contrast, the IMF reckoned that the extent of crony capitalism, and the consequent misallocation of capital, was far greater than my analysis implies. Some in Asia even suggest that Washington and the IMF conspired with international banks and speculators to cause the region's crisis. These issues will be debated for many years to come. In contrast, the causes of the Russian financial crisis are widely accepted among commentators.

The countries of East Asia, China and Russia face many obstacles if they are to achieve long-term economic growth. The situation is constantly changing. America's slowdown jeopardises Asia's recovery; a fall in the world price of oil will reduce Russia's GDP growth, and the competitive benefits of the rouble's devaluation are already wearing off. China, which has performed remarkably well since 1978, must reduce the role of the state and transform SOEs into profitable state or private companies. "This is the task that proved so difficult in the constituent parts of what was once the Soviet Union and in the countries of the European empire"[17]. The need for effective and swift reforms are prerequisites for sustainable economic growth in all of these economies.

Russia's economic reforms have been too partial and erratic and indirectly resulted in a substantial fiscal imbalance. China, on the other hand, was insulated from the world-wide

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[15]In: Biers, D. 1998. p.163.
[16]Garten, J. 1999. p.85.

financial turbulence precisely because its reforms have been so cautious. But the fact that Russia's transition experience has been mixed does not indicate that China's gradualist approach is without its problems.[18]

My study has outlined the devastating macroeconomic effects of the financial crises in Asia and Russia. But I have not examined the implications of these crises on many innocent bystanders, who should receive greater protection from the fall-out of financial crises. Currently, the IMF pays more attention to international creditors than to the impoverished. The IMF austerity measures have only worsened the plight of the poor. The following situation has occurred in many developing country crises. In a crisis the government prepares itself for a major banking 'bail-out' strategy. But the IMF demands that the overall budget deficit must be reduced. The government is then unable to transfer payments to the country's poor and unemployed. The financial crises also had implications for the environment as the increased unemployment levels led to an exploitation of natural resources. This was epitomised by the attempts of the Philippine's former President Fidel Ramos to remove the ban on the export of lumber, which had been introduced a decade before to protect East Asia's last remaining forests.

I have not analysed the role of the world's second largest economy, and Asia's troubled leader, Japan. The economy throughout the 1990s has been in a classical liquidity mire straining under a large and increasing debt burden that is a direct result of its asset bubble in the 1980s. But a recovery in the Japanese economy will have profound effects on both the Asian region and the world economy.

If I were to proceed with my study I would like to pursue the reasons for the wide disparities in the economic growth of developing countries. The Asian region has grown rapidly since 1965. In contrast, Latin America, according to Radelet and Sachs, has effectively stagnated on a par with sub-Saharan Africa despite being more receptive to foreign investment, and India, the world's largest democracy, has only grown by 2.2% per year between 1965-1995. (See Table 1, below.) India's experience over the last fifty years reflects a political success but an economic failure.[19] China, on the other hand, enjoys rapid economic growth and large inflows of foreign investment. But Chris Patten believes that:

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[17]Patten, C. 1999. p.143.
[18]See: Economies in Transition. 1997. p.14.
[19]Patten, C. 1999. p.197.

"Democracy and market forces in India will prove a potent combination as fund managers will sooner or later realise."[20]

I suspect that the role of the ethnic Chinese in Asia has facilitated an environment for economic growth. Chinese communities are found throughout the Asian region and form a considerable economic and social network commanding an economic clout disproportionate to their numbers. (See Table 2, below.)

Table 1. Per capita average annual GDP growth 1965-1995.

Four Tigers*	6.6%
South-east Asia**	3.9
China	5.6
South Asia#	1.9
OECD	2.1
Latin America	0.9
Sub-Saharan Africa	0.2

* Hong Kong, Korea, Singapore and Taiwan. ** Indonesia, Malaysia, Philippines and Thailand. # Bangladesh, India, Pakistan and Sri Lanka.
Source: Radelet and Sachs. 'Asia's reemergence'. Foreign Affairs. November/December 1997. p.52.

Table 2. Economic participation of the overseas Chinese

	Chinese as % of Population	% of Market Capital Controlled by Chinese
Indonesia	3.5	73*
Malaysia	29	69**
Philippines	2	50-60**
Singapore	77	81*
Thailand	10	81*

* of listed firms by market capitalisation. ** of share capital by market capitalisation.
Source: M. Vatikiotis. 'The Chinese Way'. Far Eastern Economic Review. 26 February 1998.

[20]Ibid.

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