Part III

National and Regional Responses to the Instability of Financial Markets

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East Asian Response to the Instability of Financial Markets, with Special Reference to Malaysia

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I Introduction

The huge influx of capital into the East Asian markets was evident during the 1990s, as the Asian governments, encouraged by the International Monetary Fund and the World Bank, liberalised their financial systems, including their capital account, allowing firms and individuals to buy and sell financial assets more freely or engage in financial business in other countries. Concurrently, advances in information and telecommunications technology made international financial transactions much easier and faster. These trends, evident in the 1990s, have led to a rapid integration of global financial markets. The increase in international capital mobility and business exuberance along with the period of strong economic growth, had steadily eroded the role of traditional banks as the main intermediary of funds. Instead, investment funds grew rapidly in importance, operating under immense competitive pressure to earn high returns (Table 1). These capital flows, which amount to more than 70 times the volume of trade, were mostly short-term flows. The demand and supply for these funds seemed to be a win-win situation for both parties.

Inflows to East Asia came mainly from Japan, largely encouraged by the

Table 1 Gross Capital Formation per GDP

	Malaysia	Thailand	Indonesia	Korea
1990	32.4	40.4	36.1	37.1
1991	36.4	41.6	35.5	38.4
1992	34.3	39.3	35.8	36.6
1993	38.3	39.5	29.5	36.0
1994	40.1	40.0	31.1	35.7
1995	43.0	41.1	31.9	36.6
1996	42.2	41.1	30.8	36.9
1997	42.4	35.6	31.6	35.0

Sources:
IMF, *International Financial Statistics;* Bank Negara Malaysia, *Monthly Statistical Bulletin.*

imbalance between savings and investments in Japan in the 1990s, and from Europe, especially after the flight from Mexico due to the "tequila" effect in 1994-1995. On the other hand, the liberalisation of capital movement in East Asia attracted these inflows, given the Asian need to accommodate the excess of investments over savings (manifested in current account deficits). The proviso was that the East Asian currencies (with a notable exception of Korea) had been tied to the US dollar, precluding exchange rate risk. As a result, there was a tendency not to hedge foreign currency borrowings as market participants may have interpreted currency rigidity as implicit government guarantees against the risk of currency volatility (ADB, 1998). Most of these inflows went into a narrow range of sectors, including nontradable speculative ventures like property and land. Hence external borrowings have been largely directed not for consumption, but for investment. Other policy distortions include local government power to influence the allocation of investments.

It is not difficult to argue that the crisis in East Asia is essentially economic, not merely financial, as there are serious structural problems caused by overinvestments. This line of reasoning would suggest that the currency and financial crisis was simply a result of economic imbalances of different sorts in the East Asian economies. It is also equally easy to argue that macroeconomic fundamentals in the East Asian economies were fairly strong and that it were currency speculators that caused the financial crisis which then spilled over to the real sector. It is not easy, however, to establish causality between financial crisis and economic crisis and it would be hazardous to make sweeping generalisations as conditions do vary among crisis-hit countries. The main focus of this paper, however, is financial instability, not economic crisis per se.

II Roots of the East Asian Crisis

How could a region, whose economic fundamentals were marveled at, be so vulnerable to the crisis? Policies pursued by the respective governments indeed produced good results. Inflation had been kept low despite robust growth rates. Governments have been posting budget surpluses, not wholly due to fiscal discipline as they were also partly a result of rising government revenues during the boom times. Obviously, sound fundamentals were insufficient to prevent a crisis.

The strong surge in international capital mobility and escalating speculative content of the long boom had helped to conceal flaws in the macroeconomic management, primarily in the exchange rate management. Together with high interest rates, these helped to sustain the growing

Table 2 External Financing in 5 Asian Economies[1]
(in billions of dollars)

	1994	1995	1996	1997	1998
Current Account Balance	-24.5	-41.4	-55.2	-27.1	30.6
External Financing (net)	45.2	84.6	95.2	18.1	25.9
Private Flows (net)	37.9	79.2	97.1	-11.9	-0.3
Equity Investment	12.1	15.4	18.7	2.1	16.4
Direct Equity	4.7	4.9	6.3	6.4	6.9
Portfolio Equity	7.4	10.5	12.4	-4.3	9.5
Private Creditors	25.8	63.8	78.4	-14.0	-16.8
Commercial Banks	23.4	49.9	55.7	-26.9	-19.8
Non-bank Private Credit	2.4	13.8	22.7	12.9	3.0
Official Flows (net)	7.3	5.4	-1.9	30.0	26.2
Residential Lending / Other (net)[2]	-15.2	-29.2	-21.6	-30.5	-4.6
Change in reserves, excluding gold	-5.4	-14.0	-18.4	39.5	-51.9
Memo: short term credits (net)	7.3	40.4	38.5	-41.7	42.8

Notes:
[1] All 5 countries are Indonesia, Malaysia, Philippines, South Korea and Thailand.
[2] Including resident net lending, monetary gold, and errors and omissions.

Source:
Institute of International Finance, April 30, 1998.

appreciation in the East Asian currencies. Real exchange rates appreciated by more than 25% in Thailand, Indonesia, Philippines and Malaysia. These countries also maintained large current account deficits, which had been increasingly financed by short-term capital inflows (Table 2). With the regional currencies steadily appreciating against the yen from as early as 1995, there had been a gradual reduction in export competitiveness. In Thailand, exports actually fell in nominal US dollars in 1996, while in Korea, export registered a mere increase of 3.7%. This substantially reduced the earnings of the East Asian exporters, and accordingly, their ability to service their debt.

Meanwhile, these countries were experiencing the bursting of their own financial markets bubbles. Capital flows channeled into real estate, property and equity funds, resulted in the escalation of asset prices. Lendings to these sectors increased the financial institutions' vulnerability to a reversal in capital flows (Radelet and Sachs, 1998). Nevertheless, lendings continued to expand rapidly throughout the region. In Thailand, Korea and Malaysia, banking claims on the private sector increased by more than 50% relative to GDP in seven years, reaching 140% of GDP in 1996. Loans by these banks were largely financed by short-term external borrowings, indicating the relatively high ratio of short-term debt to foreign exchange reserves. In Thailand, Korea and Indonesia – the three countries

hit hardest by the crisis – the ratio exceeded unity after 1994. As stated by Radelet and Sachs (1998), while a ratio greater than one is not by itself sufficient to spark a crisis, it does indicate a vulnerability to a crisis. Once something sparks a withdrawal of foreign capital, each foreign creditor has the incentive to demand repayment quickly, since they each know there is not enough foreign exchange available to repay everyone.

The Trigger-Panic and Withdrawal

Evidence of fragility in the property sector and financial institutions grew in early 1997. In Korea, for instance, Hanbo Steel declared bankruptcy in early 1997, followed by Sammi Steel and Kia Motors. This in turn, placed pressures on merchant banks, which had extended lendings to these companies, financed largely from abroad. In Thailand, Somprasong Land was unable to meet a foreign debt payment at the due time, which was a first clear indication that financing companies heavily exposed to the Bangkok property markets were in trouble. Foreign banks later realised that they had large short-term foreign exchange loans to Thai borrowers that were unhedged and uncovered by Thai reserves. Speculation mounted that the foreign exchange reserves were dwindling and that the Thai government would have to float the baht. The growing suspicion that such a move might be in prospect, despite government insistence that it was not, led to a widening of interest premiums; these in turn increased the pressure, both by adding deflationary impetus and by creating cash flow problems for financially stressed business. Speculators continued to attack the baht, in which the Thai authorities desperately tried to defend the currency by selling foreign exchange (only to lose $8.7 billion in reserves) which proved to be futile. On July 2, 1997, Thailand finally gave in to the pressures and floated the baht.

Reversals in Capital Flows and Financial Instability

The Thai meltdown immediately led to speculation and hence withdrawal of capital from around the region, causing currency devaluations in Malaysia, Indonesia and the Philippines. Net private inflow of private capital to the five East Asian countries plunged from $97.1 billion to a deficit of $11.9 billion (Table 2). The sudden reversal of capital flows of a magnitude hitherto unseen had a strong contractionary impact on these East Asian countries by seriously restricting domestic bank lending. In the early stages, investors made little effort to distinguish amongst the East Asian countries and therefore acted on a herd mentality. Continuous attacks on these currencies resulted in desperate attempts by the East Asian govern-

ments to defend their currencies by drawing down on international reserves, which in turn added further uncertainty as to the ability of maintaining the peg. By the end of 1997, currencies in each of these countries fell by more than 50%.

Pressures for capital withdrawals increased with the belated downgrading of these countries by major rating agencies. Domestic debtors, many of whom had debt denominated in foreign currencies without hedging their exposure, began purchasing foreign currency, thereby selling their local currency. This inevitably caused their local currency to further deteriorate.

Many were unsure of the contagion at the time of the crisis. Among the hardest-hit economies, South Korea has had few linkages to the Southeast Asian countries, yet it had serious internal financial problems and a massive current account deficit. In Hong Kong, on the other hand, after much probing, the financial markets seem to have decided that the Hong Kong dollar is not at risk with the currency board in place and is pegged to the US dollar, and what is now the Special Administration Region. This has insulated Hong Kong somewhat from the adversity of the crisis.

Frustrated by the attacks, yet desperate to defend their currencies, Malaysian Prime Minister Mahathir Mohamad made vicious attacks on currency speculators, including threats to ban foreign currency trading. He argued that "currency trading is unnecessary, unproductive and immoral" and that it should be "stopped" and "made illegal". While this has been perceived by some scholars as that of denial, Jomo (1998) suggests that the government was not exactly in denial, but that it did not respond in the manner desired by the "market", i.e. mainly the Western financial community. This led to further selling of the ringgit to record low levels, drawn mainly from market sentiments rather than any serious reference to economic fundamentals.

III Diagnosing the Malaise

The Role of the IMF

The IMF has required Indonesia, Korea and Thailand to undertake deep-rooted structural reforms where the underlying problem was the imbalances reflecting inappropriate macroeconomic policies. The centrepiece of these programmes has been the comprehensive reforms of financial systems. These conditional reforms are established out of the massive bailout packages totalling more than $100 billion to the three countries. The basic characteristics of the three loan agreements were similar. In all cases, the programme has called for the closure of unviable financial institutions, the

recapitalisation of undercapitalised institutions, close supervision of weak institutions and the greater foreign participation in domestic financial systems (IMF, 1999). Steps have also been taken by the IMF to address the issue of corporate governance. Reforms in the financial systems is being buttressed by measures designed to improve the efficiency of markets, break the close link between businesses and governments and, ensure that the integration of national economy and the international financial markets is property segmented.

The stipulated programmes were aimed at diagnosing the crisis as a macroeconomic balance of payments problem and a crisis of excess consumption. Large increases in real interest rates were justified on grounds that they would create incentives for domestic capital to remain at home and for foreign lenders to resume lending. As such, the volatility of the currency would be reduced and eventually the currency would be stabilised. The programme also embarked on a fiscal austerity drive (mainly through cuts in government expenditure) and immediate closure of all insolvent financial institutions.

Initial Proposals and Reactions

By insisting on structural reforms without tackling the immediate problem, investors got the impression that these economies were basically unsound and therefore needed a complete overhaul – despite their sustained growth over the last three decades. High interest rates also gave investors the idea of an uncertain future which discouraged foreign investment into the region. This further fueled capital withdrawals, despite the pledge of more than $100 billion to the region.

The tight monetary policy forced companies to cut-back production level, sell inventories and reduce workforce. Many were on the brink of insolvency or completely insolvent and were therefore unable to repay their debt. This snow-balled into the increase of bad loans in the banking system, requiring a sharp rise in bank capital adequacy standards. In the midst of a crisis, this caused a cut in credit with a further escalation in non-performing loans and bankruptcies.

Notably, the IMF recommendations were not justified as the regional currencies continued to be highly volatile while investors' confidence and the resultant foreign capital flows did not return. Instead, the high interest rates strangled the real sector, resulting in a sharper than expected contraction, and increased the vulnerability of the financial sector.

During the period August-December 1997, the IMF programmes failed dramatically to meet the objective of restoring market confidence. Currencies of these countries failed to stabilise; instead they actually

worsened despite a very sharp increase in interest rates. Official reserves fell more rapidly than predicted by the IMF. In all the affected countries, economic contractions were greater than expected. Undoubtedly, the IMF programme led to painful adjustments in each of the countries with apparent adverse effects on output and employment. On December 22, Moody's downgraded the sovereign debts of all three bailout countries to "junk bond" status.

The Shift to Capital Controls

With painfully high interest rates contracting an already depressed economy, there seemed to be limited opportunities available to policymakers. What the IMF had hoped would induce foreign and domestic capital to bring their money back did not happen. In the past decade, the prevailing view among the world's economic policymakers had been that money should move freely around the globe, allowing capital to find the most profitable and productive investments. Until mid-1997, emerging market economies thrived under this arrangement, attracting hundreds of billions of dollars in foreign investments that caused an impressive lead in the standards of living in these countries.

Yet, as the crisis has clearly shown, relying on foreign money has its costs. Interestingly, some of the holdout nations that refused to adopt the free-flow-of-money orthodoxy of the 1990s now stand out as countries least affected by the financial meltdown. Declaring that "the free market has failed disastrously", Malaysian Prime Minister Mahathir Mohamad announced on September 1, 1998 that Malaysia would no longer allow its currency to be traded outside its borders. In fact, only a week before, MIT economist Paul Krugman made the case for capital controls in an article in Fortune magazine. In the interview, Krugman said that the best alternative to provide troubled economies temporary relief from the pressures of the global economy is to impose capital controls on currency trading. He later laid out four principles for employing capital controls. Accordingly, the controls should disrupt ordinary business as little as possible, clearly be temporary, be accompanied by a "highly competitive" exchange rate, and be used "as an aid to reform, not an alternative".

The Malaysian Example

Although Malaysia did not seek aid from the IMF, it was theoretically pursuing a "virtual" IMF strategy. The high interest rate policy instituted to deter speculative attacks on the ringgit was choking businesses. In fact, the attacks became more pronounced resulting in increased capital outflows

from the country. Efforts made by the government to raise some $2 billion in the international capital market for the banking sector restructuring programme had to be abandoned following the unanticipated downgrading of credit ratings by international rating agencies. This had essentially made it more expensive for Malaysia to tap the international capital markets for funds. After announcing that the economy had a worse-than-expected contraction in the second quarter in 1998, the government imposed selective capital controls on September 2, 1998.

The move, meant to provide the economy with a temporary respite from external volatility, effectively withdrew the ringgit from the international trading system. The ringgit was thus non-convertible on the capital account (but not on the current account) and this essentially prevented buying foreign exchange for speculative purposes. This made the ringgit a non-legal tender outside the country and thereby encouraged the remittance of the ringgit back into the country. Initially, all receipts from the capital account transactions were required to be held in the country for at least a year from the date of purchase of ringgit-denominated assets or securities before they were eligible for repatriation. These would take place under a fixed ringgit of RM3.80 vis-à-vis the US dollar.

The controls were aimed at curbing short-term capital flows and have thus not been a retreat from the country's long standing commitment to an open trade and investment policy. In other words, international trade was unaffected by the controls and foreign investors in the country were free to repatriate dividends and equity arising from their direct investment in the country.

Traders reacted favourably towards the controls and were of the opinion that the peg made their products more competitive in the export market. A survey conducted by MIER among companies in the manufacturing sector to determine the impact of the currency control measures revealed that 81% of the respondents said that their products for the export market are competitive with the ringgit at RM3.80 against the US dollar. The control measures in turn brought a stabilising effect, which freed the manufacturers from having to wrestle with exchange rate risks. This subsequently allows them to concentrate on production and marketing.

Nevertheless, critics have pointed out that the controls may have hampered economic recovery by adversely affecting foreign direct investments in the country. Investor confidence was dampened since other markets in the region did not impose control requirements (Haflah and Tan, 1999). It was feared that long-term overall investment activity would be affected as well, which is detrimental to a country that is highly dependent on external trade and foreign investments. Moreover, since the onset of the crisis, there had been a massive capital outflow from the country. There was thus

an urgent need for capital infusion from external sources.

Capital controls were therefore significantly relaxed with effect on February 15, 1999, allowing foreign short-term capital to leave the country after paying a graduated exit tax ranging from 10-30%. For capital brought in after February 15, 1999, the exit tax has been replaced by a 10-30% graduated tax on profits repatriated.

It appears that the controversial currency and capital controls have been vindicated by subsequent positive developments. Net international reserves have increased significantly to $28.6 billion in March 1999 from $19.5 billion in August 1998. Exports, which have been declining in US dollar terms since the beginning of the crisis, started to rise since September 1998. What's more, the stock market perked up remarkably with the KLSE indices more than doubling from 300 prior to the control measures to more than 600 in February 1999. These positive developments took place in a situation of low interest rates, with the base lending rate of commercial banks at 8.04% in March 1999, compared with a much higher rate of 13.1% in August 1998.

Business and consumer sentiments have also improved following the imposition of capital controls. The MIER Business Conditions Index (BCI) registered upward increases following the third quarter of 1998 after falling to an all-time low of 41 points in the first quarter of 1998. The index stood at 48.2 points in the first quarter of 1999. The Consumer Sentiments Index (CSI) had also shown some improvement, albeit marginally, after the third quarter of 1998. Sentiments were at the lowest in the second quarter of 1998, with the CSI at 79.1 points. Better sentiments were seen in the first quarter of 1999 with the index recording 84 points. Sentiments were largely boosted through better expectations for the second half of 1999, although the present financial income position and job market outlook still appear weak.

Forex controls have helped the economy in the short term by forcing some RM12 billion deposits parked abroad to come back and by preventing foreign portfolio funds, estimated at 23% of KLSE capitalisation, from leaving the country. Currently, the large current account surplus and international reserves have helped alleviate the short-term concerns on capital needs but the longer the controls and the peg remain in place, the greater the distortion in competitiveness and capital flows into the country will be (Haflah and Tan, 1999). It has also been projected that once the economy picks up, the increase in demand for imports will put pressure on the external liquidity sector.

Nevertheless, the unorthodox measures imposed by the Malaysian government have helped to end what may be termed "confidence crisis". Prior to these controls, the perception was that the government did not under-

stand the problem, let alone find the solutions. The control measures thus conveyed a strong message in that the government could come to terms with the new realities and act in an assertive fashion. Malaysia's sovereign rating outlook has also improved since the last downgrade in August 1998. In April 1999, Moody's revised the country's sovereign rating outlook from "negative" to "stable".

Are Capital Controls Necessary?

At present, the possibility of sudden reversals of capital flows is a major policy concern for many East Asian countries that rely heavily on foreign capital to finance large current account deficits. As the East Asian crisis clearly had shown, large-scale capital inflows lead to an overheated economy, an appreciated real exchange rate and unsustainable current account deficit. On the other hand, large outflows could produce a recession and a decline in investment thereby reducing medium-term growth prospects. Moreover, as the East Asian crisis so vividly illustrated, the abrupt reversal of capital flows threatens the stability of the banking sector. Indeed, free cross-border movement of capital could prove destabilising and there is a growing consensus on the need to curb these capital flows.

Realising the potential disrupting effects of free capital movement, several countries currently seek to promote long-term capital inflows, while discriminating against short-term flows. It is assumed that long-term capital flows take longer to withdraw from the economy, so the sudden reversal brought about by the short-term flows can be mitigated. Furthermore, long-term flows (e.g. foreign direct investment) are less sensitive to fluctuations in domestic and international interest rates and as such, tend to provide more support to medium-term fundamentals.

It must be noted that it is difficult to distinguish between short- and long-term flows, which makes it difficult to design capital controls targeted at short-term flows. Standard balance of payments classifications – direct investment, portfolio flows, short-term flows, etc. – are not neatly categorised in terms of the volatility and liquidity of the flows. As argued by Reinhart and Smith (1997), even if a set of controls is effective in limiting "short-term" foreign financing, if incentives are not enough, even flows that are perceived by policymakers to be "long-term" may in fact be considerably liquid. In fact, the very presence of capital controls would be discouraging to capital flows as a whole, regardless of their "targets".

If the ultimate objective of capital controls is to attain sustainable growth, where large external disturbances become a major hindrance, then the effectiveness of such a measure relies on several conditions. Prime consideration must be given to the prevailing degree of openness and size of

trade flows in determining the scope and extent of its enforcement. China, for example, has been relatively successful in its measures simply because it had started from a relatively closed base. It is also important to consider the misalignment that gave rise to the outflows in the first place. Did the outrage arise due to structural weaknesses and improper incentives in the domestic financial system, or to the inherent instability in the international capital market? Equally important is the availability of the resources to enforce these regulations. Capital controls must, however, remain a temporary measure. Otherwise, they may prove to be detrimental to the country's economic health. It must be remembered that "insulation through capital control may lead to isolation by default" (Ariff, *et al.*, 1999).

IV Reforms in the Financial Sector

Miscalculated Moves

The initial reforms undertaken in the banking sector had done little to instill public confidence. Reforms initiated by the IMF programme were designed to remedy the structural weaknesses in the economy. These, they presumed, were the root of the economic difficulties faced. In restoring macroeconomic stability and addressing the structural problems of the financial sector, weak financial institutions were shut down, while distorting links between the government, financial sector and corporations were rectified. In addition, the new role of the government would be defined. Above all, there was a call for greater transparency in information flows.

The financial reforms stipulated by the IMF brought severe pressure onto the real sector. Following the stock market crash in East Asia, the collateral and equity capitalisation capacity of firms dwindled sharply. This, in turn, sent signals that the waning economy was worse than it actually was. Comprehensive reforms and restructuring in the banking sector were introduced. Insolvent banks and finance companies were closed, while weak but viable ones were rehabilitated through recapitalisation or mergers. The closure of several financial institutions in Thailand and later Indonesia precipitated bank rush, panic buying and capital flight that led to both internal and external liquidity crunch. In Thailand, all but two of the 58 finance companies suspended earlier would be closed down. Similarly, the IMF made a recommendation to close 16 non-viable banks in Indonesia at the end of 1997 without adequate preparation to support the viable ones.

Despite inferences by many, the initial reform package by the Malaysian government was not totally comparable to the IMF programme. For one,

there was no commitment to raise domestic interest rates to support the currency or to control inflationary pressures. Neither was there any concrete strategy proposed for restructuring the financial system. At the very onset of the crisis, policies introduced were intended to strengthen the resilience of the financial sector so as to avoid systemic risks. On December 5, 1997, several austerity measures were unveiled by the finance minister. Among those introduced were the tightening of credit growth and allocation of credit to priority sectors. New company listings, right issues and corporate restructuring were frozen to ensure that liquidity would not be drained from the system. Further announcements were made by the central bank for strengthening the financial system. This included the reclassification of non-performing loans as loans that had been in arrears for six instead of three months. The central bank also pushed for consolidation of finance companies through mergers.

However, it soon became apparent that there were sharp differences of opinion within the government itself as to how the economy should be steered out of the crisis. This had resulted in many policy changes, and on occasion, even policy reversals (Ariff and Syarisa, 1998). The combination of fiscal and monetary austerity was stifling the Malaysian economy. Businesses were forced to declare bankruptcy due to escalating debt repayment and high cost of borrowing. Meanwhile, depressed consumer spending from nationwide layoffs, with many maintaining a cautious stance, dragged down the economy further. Amidst the panic, the ringgit continued to slide downwards while the stock market was in the verge of collapse.

Initiatives to liquidate debt-ridden banks and squeeze credit outlays drove shock waves across Southeast Asia that local banks would either be closed or forced to merge and accept painful reforms. This led to a massive capital flight from local banks to foreign banks. Sadly, this move blanketed across all banks alike, regardless of their financial sounding, thereby creating a severe liquidity crunch in the country.

The Malaysian Experience

Only much later did the Malaysian government embark on concrete measures to recapitalise and restructure the banking system. In May 1998, an Asset Management Company (Danaharta) was established to manage non-performing loans and assets in the banking system. This is akin to AMC implemented by the Central Bank of Thailand in October 1997. Another special purpose vehicle (Danamodal) was also introduced to spearhead the recapitalisation of the banking sector. However, difficulties in obtaining the required funds by the Malaysian government precluded concrete policy initiatives. At the same time, there had been an apparent conflict between

Prime Minister Mahathir and his deputy and Finance Minister on how to best manage the economy, causing ambiguity about who was in charge. The situation worsened with the establishment of the National Economic Action Council (NEAC), which was seen as an attempt to override the finance minister (Jomo, 1998). Many observers were of the view that this high-level conflict contributed to policy indecisiveness and ineffectiveness in tackling the crisis thereby increasing the "political risk premium".

With limited degree of freedom in place to revive the waning economy and subsequent downgradings by the international rating agencies, selective capital controls were introduced. A day after these controls were imposed, Finance Minister Anwar Ibrahim was dismissed. With these "distractions" put aside, the government was able to embark on a monetary and fiscal stimulus package to prevent further contraction of the economy and to concentrate on reflating and restructuring both the financial and corporate sector.

Almost immediately, the three-month intervention rate was lowered from 9.5 to 8%. This was later followed by the two reductions made in the statutory reserve requirement (SRR). From 8% on September 1, 1998, the SRR was reduced to 6 and later 4% in less than three weeks. Consequently, RM16 billion was released into the banking system. To reduce lending rates, the central bank also imposed a maximum limit of 2.5% on credit margins (from about 4% earlier) and revised the Base Lending Rate formula. It then acted to reverse the decline in loan growth by announcing a minimum 8% loan growth for financial institutions to be achieved by year-end 1998.

Rescue Operations

The rise in non-performing loans (NPLs) has been a cause of concern. Given the increasing rate of default in lendings, banks became more cautious of new loans. Apart from providing these banks a "breathing space" through the relaxation of interest rates, the government also reverted the definition of NPLs from three months in arrears to six-month in arrears in an attempt to downside it on paper. As at end-December 1998, the ratio of NPLs to total loans stood at 9%, based on the six-month definition, or 14.9% using the three-month definition.

Attention was then steered towards freeing the banks from the management of the mounting NPLs and recapitalising them to maintain the soundness of the financial system. Danaharta, which had been set up earlier, began to buy over the assets and NPLs from the banks, enabling the banks to write-off these loans, hence, ensuring their continued liquidity to fund other viable projects. Danamodal then began to undertake recapitali-

sation of the banking system. The exercise would require an estimated funding of RM41 billion (RM16 billion for Danamodal and RM25 billion for Danaharta).

The central bank has identified 14 commercial banks, 7 finance companies and 4 merchant banks as potential candidates for recapitalisation. Of these, eight banks, five finance companies and two merchant banks have NPLs exceeding 15% based on the six-month definition. Using the yardstick of the BIS, NPL of over 15% is an indicator of a troubled bank. A stress test carried out by the central bank has shown that RM16 billion is adequate for the recapitalisation of financial institutions giving them a capital adequacy ratio of over 8%, the critical minimum by BIS standards.

Consolidation in the financial institutions is necessary given the small market in Malaysia. The banking sector in the country is overcrowded due to the large number of players jostling for market share. For example, with as few as four or five big banks serving larger markets compared to that in Malaysia, the existence of 36 commercial banks in the country along with other financial institutions such as finance companies, merchant banks and discount houses has resulted in a highly fragmented market with even bigger banks finding it difficult to reap economies of scale. Also with the increasing need to make huge investments in Information Technology to keep abreast with international banking developments, many of the smaller banks will be unable to make the necessary IT investments.

Mergers in the financial institutions are seen as a solution. The central bank aims to reduce the number of local banks from 22 to 16, although forced mergers are clearly out of the equation. There are also plans to reduce the number of finance companies to eight. Thus far, seven finance companies have been absorbed by their parent companies. However, there has not been much progress in the consolidation of commercial banks, which form the backbone of the banking system and make up some 70% of total bank assets (MIER, 1998). There is scope to reduce the number of commercial banks in Malaysia, which is 36 currently. With the exemption of one or two banks, most are too small to compete at the international level. Consolidation of the banking sector will need to pick up.

Financing the Recovery

The Malaysian government has estimated that a total of RM62 billion is needed to finance the economic recovery plan. In addition to the sum of RM41 billion needed for Danaharta and Danamodal, RM31 billion is needed to finance the Infrastructure Development Fund (RM5 billion) and the Seventh Malaysian Plan (RM26 billion). The sources of funding have also been identified (Table 3). More than two-thirds of the total funding

Table 3 Sources of Funds, 1999-2000
(in billions of Malaysian ringgits)

Source	Amount
Foreign sources	
Bilateral	10.0
Multilateral	3.0
Sovereign bonds/loans	8.0
Total foreign sources	21.0
Local sources	
Outstanding cash balances:	
Provident, pension and insurance funds	42.0
Annual inflows:	
Provident, pension and insurance funds	30.0
Oil revenue	9.0
Total local sources	81.0
Grand Total	102.0

Source:
White Paper, Status of the Malaysian Economy.

required would be derived from domestic sources. Prior plans to raise funds abroad were aborted when both Moody's and Standard & Poor's downgraded Malaysia's sovereign rating from A2 to BAA2, and from A- to BBB+, respectively. Subsequent rating downgrades for both Malaysia and local corporations to just investment grade or below have made it very costly to secure external funds.

The IMF Programme

From the very beginning, the IMF took great strides to overcome the structural imbalances which impinged on the three worst-hit countries of Thailand, Indonesia and South Korea. The typical IMF programme seeks to restore macroeconomic stability and hence lays the foundation for sustainable growth. Funds would be disbursed upon the strength of each country's implementation. However, the support of the international community comes with a cost. This includes the loss of community control over natural resources and growth without economic democracy or expansion of political participation.

Country Experiences

Among the three countries, Thailand had moved the fastest in the pace of financial liberalisation. What was perhaps the most significant step taken

by the Thai government to deregulate its financial system was the establishment of the Bangkok International Banking Facility (BIBF) in 1993. With the BIBF, both local and foreign banks were able to engage in both offshore and onshore lending activities. Soon, most foreign capital flows into Bangkok were in the form of BIBF loans, reaching about $50 billion over the three-year period. This made the baht more vulnerable to attacks, which happened as early as February 1997 by foreign speculators known as hedge funds. By July, official reserves, that were used to defend the baht, declined significantly, thereby forcing the Thai government to seek IMF aid.

The IMF policy conditionalities highlighted, amongst others, the development of the institutional framework for the systematic financial restructuring, to better withstand international competition. As a first step, the IMF took charge to oversee the screening of rehabilitation plans submitted by the 58 finance companies, which had earlier been suspended by the Bank of Thailand. In fact, the Financial Restructuring Authority (FRA), which had initially been assigned to undertake the screening had been side-stepped. It was later announced that 56 out of 58 finance companies were subjected to liquidation. Reportedly, the subsequent disbursement of loans by the IMF was dependent on the government's announcement. Supervision of the commercial banks also tightened, upgrading loan classification and provisioning and recapitalisation to international standards. To foster recapitalisation, restriction on foreign ownership was relaxed, allowing foreign investors to acquire majority shareholding in financial institutions for up to 10 years.

In Indonesia, the structural reforms, aimed at establishing international standards, had largely depleted public confidence. The various measures introduced to stabilise the Indonesian economy involved tremendous social costs. Like in Thailand, the closure of 16 insolvent banks under IMF pressure came at the time the market had already turned jittery. The situation nevertheless deteriorated to a near breakdown of intermediary functions of banks. On January 27, 1998, a programme for reforming banks and solving the problem of private foreign debts was announced. It included a temporary freeze on corporate debt servicing by Indonesian companies, along with a new government agency to oversee bank reforms, including closing down non-viable banks and selling assets. This caused a capital flight out of the country with the financial sector close to jeopardy. Since the Indonesian banking sector as a whole lost its credibility, foreign exporters began to refuse the letters of credit issued by Indonesian banks. The situation was aggravated with the political uncertainty and social unrest in May which disrupted productive and distribution activities. As a result, the country was unable to import raw materials needed for re-exports. This

sent the economy into severe recession with hyperinflation and continued downward pressure on the rupiah. The chaos continued even until the resignation of President Suharto on May 21. On October 19, the IMF and the Indonesian government signed a new letter of intent, clearing way for the further release of assistance funds for the country.

Reform of South Korea's long-troubled financial sector also began through the external pressure of the IMF funding. This began with the nationalisation and closure of several banking institutions, which had invested heavily in closely connected companies. On May 20, 1998, the scope of funding for revival of the financial sector was set at 64 trillion won, including 14 trillion won already paid out. Of the new 50 trillion won, there was 25 trillion won of debt purchases by the Korea Asset Management Corporation. Reportedly, the government, through the Asset Management Corporation, purchased about half of the impaired loans discounted to face value. It also subscribed to subordinated debt issued by commercial banks (sufficient to raise the capital adequacy ratio by 1-2 percentage points).

It was apparent that policy responses from the three countries had resulted in an overadjustment in the real sector and credit crunch wherein viable but liquid companies faced the same difficulties as the unviable ones. Emphasising the removal of structural rigidities, the IMF programme had failed to tackle the more pressing issues, like the private debt problem. These various policy mistakes help to explain why the slump has been so protracted. Moreover, the policy conditions imposed have involved far-reaching structural changes that do not relate in any direct way to resolving the financial crisis at hand. They touched on the governance of the economy, including politically sensitive issues that lie beyond the mandate and competence of the IMF.

Foreign Buyout

All three countries were forced to lift restrictions on ownerships in their financial institutions, to allow for greater foreign participation. In Thailand, the FRA was given sweeping authority in that it could ease restrictions on foreign ownership of financial institutions and nominate directors, as well as liquidate the assets of troubled financial institutions by offering them for sale through general bidding. Presently, over 49% of shares in financial institutions can be acquired by foreign nationals, though shareholding must be reduced to 49% or lower in ten years time.

Economic reforms in South Korea were closely followed by the opening up of both domestic financial and industrial markets. Critics noted that the slow disbursement of the IMF funds was partly because the US in particu-

lar was keen to extract additional concessions from South Korea in return for the tranche of cash. Financial liberalisation included liberalisation of the bond market by end-1997, allowing foreign banks and financial institutions to set-up wholly owned branches ahead of schedule and closing merchant banks and reducing risky assets to make them more attractive for foreign takeover. In addition, South Korea had to agree to open domestic markets to cars and other key Japanese industrial goods by mid-1999.

Is Recovery Taking Root?

In hindsight, the financial crisis came as a blessing in disguise for the East Asian economy. It has precipitated and accelerated economic reforms that ought to lead to more stability in the future. Glimpses of turnaround can be seen for most countries. At the very least, major economic indicators show a more stable situation when compared to a year ago. The exchange rates for the three hardest hit countries have been somewhat less volatile in recent months. Interest rates have dropped to levels needed to stimulate domestic demand and governments are running budget deficits to spearhead the recovery. Most importantly, consumers around the region have shown some return of confidence. An increase in confidence is necessary to precipitate a rebound in domestic consumption, which at the moment is crucial for economic recovery.

The IMF has indicated that it expects Thailand to be the first Asian economy to pull out of the crisis. The Thai government has forecast economic growth of 1% for 1999, following a 8% economic contraction in the year before. After contracting more than 5% in 1998, South Korea posted a higher than expected growth of 4.6% in the first quarter 1999. In Malaysia, the economy apparently stabilised with the imposition of capital controls and was seen bottoming-out in recent months. MIER projected some growth of 1.3% 1999, stemming from a sharp contraction of 6.7% in 1998 (Table 4).

With seemingly positive indicators, it is perhaps pertinent to reflect upon what went wrong in 1998 and whether these problems have been rectified. At the upfront, currency speculation rampant over the previous months has eased tremendously. In Malaysia, the imposition of capital controls and the pegging of the ringgit to the US dollar did immediately fend off all speculators of the ringgit. Coincidentally, the attacks on the other regional currencies had subdued and although their levels are far from those seen in the pre-crisis level, these regional currencies had in fact regained strength. Nevertheless, with the ringgit now pegged to the US dollar, the Malaysian authorities are able to ease monetary policy somewhat without putting undue pressure on the ringgit. The detached link

Table 4 Growth of Real Domestic Product, 1997-1999

GDP (percentage)

	1997	1998	1999
Malaysia	7.7	-6.7	1.3*
Indonesia	4.9	-13.7	-4.0-0.0
Philippines	5.2	- 0.5	2.5-3.2
Singapore	8.0	1.5	-1.0-1.0
Thailand	-0.4	-8.0	1.0
South Korea	5.5	-5.4	3.2
China	8.8	7.8	7.0
Hong Kong	5.3	-5.1	0.5
Taiwan	6.8	4.8	4.7

Inflation (percentage)

	1997	1998	1999
Malaysia	2.7	5.3	4.0
Indonesia	10.3	77.6	12.0-17.0
Philippines	6.0	9.7	8.0-9.0
Singapore	2.0	-0.3	-1.0-0.0
Thailand	5.6	8.1	3.0
South Korea	4.5	7.5	3.0
China	0.8	-2.6	2.0
Hong Kong	5.7	2.6	-2.0
Taiwan	0.9	1.7	1.6

Current Account Balance (as percentage of GDP)

	1997	1998	1999
Malaysia	-5.1	12.9	10.4
Indonesia	-2.3	4.4	2.5
Philippines	-5.3	1.1**	0.6**
Singapore	15.8	20.9	–
Thailand	-2.0	12.3	8.5
South Korea	-1.9	–	7.0
China	3.3	2.4	1.8
Hong Kong	-3.5	–	–
Taiwan	2.7	1.3	–

Notes:
* MIER
** as percentage of GNP

Source:
IMF, *World Economic Outlook*, December 1998.

between the exchange rate and interest rates, allowed the central bank to reduce the cost of borrowing, which were until then, suffocating businesses

and increasing the probability of loan defaults. Insulating its economy from the uncertainties of the external sector, allows the government to fully concentrate on revitalising and restructuring the stricken economy. Adjustment in the interest rates, for instance, is solely to add boost to the economy. Elsewhere, fine-tuning interest rates is necessary in order to both stabilise the currency and to stimulate the economy.

Various measures had been implemented to address the deficiencies and inadequacies in the banking sector. In all countries under the IMF umbrella, banking restructuring precipitated in the sale of assets, bankruptcies and a rising unemployment rate (FEER, April 8, 1999). These are consequences of massive overcapacity in a lot of areas. Even Singapore, with the healthiest of financial sector, has embarked on an aggressive plan to ensure the country's competitiveness in banking systems. The Singaporean authorities recently announced the relaxation of the 40% cap on foreign stake in local banks and allowed six foreign banks to open up more branches. In Korea, the crisis had forced many *chaebols* to downsize. The Daewoo group, for instance, announced plans to sell many of its assets, including one of the world's biggest shipyards, hotels, telecom companies and units making trucks and engines, to repay its debts. President Kim Dae Jung is honouring its pledge to sell weak or failed banks to foreigners. According to an official in the Finance Ministry, "The crisis has taught us that we can't prevent exposure from the global economy" (Business Week, May 3, 1999).

Undeniably, Malaysia has been successful in putting in place a credible framework to deal with non-performing loans and to recapitalise the banking sector. In 1998, RM19.2 billion in NPLs from the financial system has been acquired and managed by Danaharta. This had led to a decline in the NPL ratio of the banking system to 8% and 13.6% under the six-month and three-month classifications respectively. NPLs was at the highest in August 1998, at 11.4% based on the three-month classification. As in January 1999, the risk-weighted capital ratio of the banking system stood at 11.9%, way above the minimum of 8% recommended by the BIS. The question, however, remains whether there is sufficient funding requirements for both Danaharta and Danamodal to carry out their tasks. Together with the higher budget deficit (resulting from the fiscal stimulus package to boost economic growth) requiring financing, this places increasing pressure on securing external financing (MIER, April 1999).

Given the closed capital market that Malaysia is currently experiencing, attracting foreign investments into the country could prove to be challenging, especially when regional countries are also steadily recovering. As these countries chart path for recovery, foreign investors will start to trickle in. As it is, there had been an increase in foreign capital inflows into Thailand and South Korea in the third quarter of 1998. Gradual increases

in the percentage of foreign participation is in the medium to longer term interest of the country from a competitive viewpoint. If Malaysia is slow to opening up to greater foreign participation, the risk is that the best foreign investors will flock into neighbouring countries in the region. This would be disadvantageous for the country in the longer term.

V Policy Implications for Preventing Future Crises

The need to prevent the occurrence of a crisis is obvious. As the East Asian experience so clearly demonstrates, such crises enormously disrupt people's lives and, economic and social development. Besides, the huge cost of economic and financial restructuring would be borne by respective governments and citizens in the affected countries. With this in mind, a number of interesting proposals for crisis prevention are currently being discussed. While each of them has a role to play in strengthening the international financial system, it is unlikely that these measures alone could prevent future crises.

Reconciling Greater Competition with Tighter Regulations

Beneath the irrationality of international investors which had caused widespread skepticism in the workings of the international capital market, there is a large number of weak financial institutions with inadequate supervision and regulation. As asserted by the Asian Development Bank, the most important aspect of promoting competition in a financial industry is to ensure that the industry is "contestable". What this essentially means is that barriers to entry must be reduced or eliminated. Although the East Asian countries have begun liberalising their financial system since the 1990s, this was not in terms of a more competitive and open system, but rather it meant that banks owned by domestic players had an easier time in obtaining licenses and were allowed to seek deposits from the public without much capital or scrutiny of their lending practices (Ichimura, 1998). Often, the easier access is due to close relations between the governments, banks and corporations.

The implicit protection of local financial institutions by the governments has led to the problem of moral hazard which is closely associated with reckless borrowing and lending by these institutions. Poor and inadequate banking supervision was a major reason for the imprudent lending. Lending went into adverse investment selections. In the case of Korea, most of the borrowings of the *chaebols* were for reckless expansions and diversifications of business empires. Hence, not only a clear and rational set of financial disclosure requirements need to be drawn up, but also

disclosure requirements should be transparent to allow participants in the financial markets to put pressure on financial institutions to engage in prudent lending practices.

Proper Timing and Sequencing of Financial Liberalisation and Deregulation

The East Asian crisis proved that the costs of liberalisation would overwhelm the benefits if the financial system is weak. In the IMF analysis, capital account liberalisation is problematic when macroeconomic conditions are not adequate, or when not accompanied by reforms in the domestic financial system. Accordingly, the liberalisation of trade and the real economy should precede the liberalisation of the financial sector in order to prevent perverse investment selection. In addition, the sequence of financial sector reform should initially emphasise domestic financial markets and only later should external account transactions be fully liberalised.

While the liberalisation of the financial sector, trade sector, and capital markets proceeded rapidly in many countries, the development of an adequate supervisory and regulatory system in the financial sector lagged behind. In Thailand, the establishment of the BIBF in 1993 encouraged local firms to borrow abroad at low interest rates and thereafter allowed these firms to redeposit those borrowings on shore at higher rates. The liberalisation in financial flows took place in an environment of fixed exchange rates, and even with the persistence of large current account deficits, the Thai authority insisted in maintaining the peg to the US dollar. This eventually drove the economy to the brink of default.

Proper Supervision at the International Level

The destabilising effects of short-term capital flows on the economy (even where the fundamentals are strong) has received widespread concern. It is now an accepted fact that short-term capital flows have played an important role in undermining the stability of the world capital and financial markets. As the frequency and magnitude of the financial crises intensify, they should no longer be accepted as mere aberrations in the world capital market. Supervision and governance should be stepped up and improved. Since international official funding has played and probably will continue playing a large role in providing finance during crisis periods, to avoid moral hazard, there is a clear need for international and source country regulation that will discourage short-term capital inflows that may contribute to a costly crisis. If such international and source country regulation is not developed, international private creditors will continue to

assume excessive risks, in the knowledge that they will be bailed out if the situation becomes critical.

Calls for the need to improve supervision and regulation of international capital flows to emerging markets began to be heard after the Asian crisis. ASEAN leaders have also called for a monitoring mechanism to be implemented as an early warning defense system against any future crisis. It was reported that the ASEAN Surveillance Mechanism would be established within the general framework of the IMF with the assistance of the Asian Development Bank following the Manila Framework agreed upon in November 1997. The ASEAN Surveillance Mechanism would also provide the channel by which countries in Southeast Asia could discuss and coordinate their economic development policies with each other. It was stressed that the measure was in no way an attempt to undermine the sovereignty of the individual countries, but instead it is a way to integrate individual country policies so that there will be a single, clear policy of recovery for Asia.

Lately, there has been increasing support for better regulation in the global markets. The Asian and Russian crises are forcing rules on the global market. It is now openly recognised that lenders and borrowers must be regulated, and negotiations have begun over what strictures to impose on them. There have been talks among the officials of the World Bank and the IMF on raising reserve requirements on short-term loans, and of requiring bondholders to postpone repayment in the event of a crisis. The Chilean approach in curbing short-term borrowing has been given due attention. Chile was the first country to introduce central bank "reserve requirement" on all foreign borrowing, at the rate of 20% (which was later increased to 30%) for loans up to a year. All foreign borrowings and investments are taxed, but its incidence on short-term borrowing is particularly high.

These issues are no doubt complicated and the policy debate needs to be underpinned by improved knowledge. However, they need to be urgently addressed, so as to avoid costly financial crises from happening again and/or to better manage them if they unfortunately should happen.

VI Concluding Remarks

Signs of recovery for the region have already emerged in the first quarter of 1999. Leading the recovery process is South Korea, which registered a positive GDP growth of 4.6% in the first quarter of 1999. After contracting by 8% in 1998, Thailand showed some growth of 1.5% in the first quarter. Even Indonesia, at times described as a basket-case, has posted a positive 1.3% growth in the same quarter.

The recovery in Malaysia, which had opted to impose exchange and capital controls may seem slow in comparison with those in South Korea, Thailand or even Indonesia. While these countries are reporting positive growth in the first quarter of 1999, Malaysia appears to have registered a small negative growth in that period. The recent sovereign bond issue was a bold attempt by Malaysia to test the water after the downgrading in its sovereign ratings in August 1998. Malaysia's bond were sold at 330 basis points above the US Treasury equivalent, which is quite high compared with South Korea's 240 basis points or Thailand's 230 points, but marginally lower than the Philippines' 350 basis points. It is certainly not advisable to seek external funds at 8.86% yield rate, as the high premium will exacerbate the country's external debt burden. Besides, foreign funds are no substitute for foreign equity capital. As Malaysia's recovery gets stronger and investors' confidence continues to improve in the next few quarters, there will not only be an increase in the inflow of foreign equity capital but also a greater offer of external funds at reasonable rates.

Yet, it appears that conventional measures have worked quite well in Indonesia, South Korea and Thailand, just as unorthodox measures have in Malaysia. Nevertheless, it would be too premature to jump into any conclusion about the efficacy and effectiveness of such policy measures. The turnaround that we now detect in the crisis-hit countries may or may not have much to do with specific policy measures after all. Arguably, the recovery may be largely due to anonymous market forces adjusting themselves rationally and getting their bearings right at last after the irrational overshooting that led to the crisis.

Ironically as it may sound, a quick recovery may not be in the interest of East Asia, as it would ease the pressure on East Asian economies to undertake serious economic reforms. The danger is that too fast a recovery would lock-in inefficiencies, sowing the seeds for the next crisis, as it would amount to going back to business as usual. Should we fail to learn lessons from history, history may only repeat itself.

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Comment on "East Asian Response to the Instability of Financial Markets, with special reference to Malaysia," by Mohamed Ariff

György Szapáry[1]

Central European Reaction to the Financial Crises

The paper by Mohamed Ariff and Ong Gaik Ean gives an interesting description and analysis of the origin of the financial crises in East Asia and the policy responses of the countries involved. It points out the role of short-term speculative capital movements in triggering the crises and draws some important policy implications for preventing future crises, such as the proper sequencing of financial liberalisation, better supervision and regulation coupled with adequate disclosure requirements, and more flexible exchange rate regimes when the fundamentals do not support a fixed rate.

In my comments, I would like to complement the experience of the East Asian countries with that of the Czech Republic, Hungary and Poland, three countries which were not involved in causing any of the recent international financial crises, but were more or less seriously affected by them. There were three international crises in the past three years: the East Asian crisis of 1997,[2] the Russian crisis of August 1998 and the Brazilian devaluation of January 1999. By far the most serious impact on the economies of the three Central European countries was caused by the Russian crisis. This is not surprising given the geographic closeness of Russia to these countries. The important point to note is that "contagion" occurred even though these countries' trade with Russia is much less significant than they used to be. In 1996, exports to Russia accounted for 3%, 6% and 7% of the

[1] These comments are based on the findings and analysis of a study to be published later on the impact of the financial crises on five small open European economies (the Czech Republic, Hungary, Greece, Israel, Poland) prepared by Zsolt Darvas and György Szapáry.

[2] The contagion effects of the East Asian crises on the international financial markets started with the sharp drop of the Hong Kong stock prices in October 20-23, 1997. In the Charts, therefore, the East Asian crisis is pinpointed with the date of October 23, 1997.

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total exports of the Czech Republic, Hungary and Poland, respectively. Over 70% of the exports of Hungary and Poland and over 60% of the exports the Czech Republic go to the industrial countries. Clearly the fact that the three Central European countries were regarded as "emerging markets" and "transition economies" geographically close to Russia was the dominant factor leading to the contagion.

The main spill-over effects of the financial crises on the three countries under consideration were capital outflows accompanied by pressures on the exchange rates, fall in equity prices, and upward movements in interest rates. However, the magnitude and the duration of these effects varied among the countries. The three countries share similarities, but there are also significant differences between them. All three countries are small open economies with weak links to East Asia and Brazil and somewhat more important but nevertheless weak economic links to Russia. They are closer to the developed world than countries usually classified as emerging markets because of the important trade links and financial integration with Western Europe. All three countries are at an advanced stage of accession negotiations with the European Union and are among those transition countries which have made the most progress in reforms toward full-fledged market economies. However, they still have a long way to go to catch up with the developed world in terms of modernisation and standard of livings.

On the other hand, these countries exhibit diversity in the areas of macroeconomic situation, progress with structural reforms, and the monetary and exchange rate regimes adopted. Since the impact of the financial crises on the real economies of the Central European countries under review were far less dramatic than those on the East Asian economies, I will focus my remarks on the possible links between the different exchange rate regimes adopted and the effects of the crises. In the Czech Republic, the central bank has allowed the currency to float freely and has adopted inflation targeting since the fixed exchange rate regime was abandoned in May 1997. Hungary has adopted a preannounced crawling peg, with a narrow band of 2.25% since March 1995. Poland has had a preannounced crawling peg first with no band which was widened in steps to 15% currently.

Impact on Exchange Rates

Following each of the three financial crises, the nominal exchange rates depreciated in all three countries under review due to an outflow of capital (Chart 1). As expected, the depreciations were larger in the more flexible exchange rate regimes of the Czech Republic and Poland than in the

narrow band regime of Hungary. However, the depreciations proved to be temporary as all currencies strengthened after the crises. The East Asian crisis brought less depreciation than the Russian crisis, which underlines the significance of the regional aspect of market reactions. Following the Brazilian crisis, the Czech and Polish currencies depreciated almost as much as after the Russian events and the subsequent recovery was also much weaker. This coincided with a weakening of growth performance and the external positions of the Czech Republic and Poland and hence the depreciation of their currencies probably also reflects a change in market sentiment about the fundamentals of these economies.

In Hungary, with the exception of a couple of months following the East Asian crisis when the forint was slightly below the strong edge of the band, the forint remained at the strong edge almost throughout the entire period from the adoption of the crawling peg in March 1995 until the Russian events (Chart 2). During this period, the National Bank of Hungary engaged in sterilised intervention. Following the collapse of the ruble, the NBH had to intervene for a few weeks to defend the forint, but the net loss of reserves was relatively limited: reserves fell by $1.5 billion to $8.2 billion (4.3 months of imports) between end-July and end-October 1999. Subsequently, confidence gradually returned and the forint moved back to the strong edge of the band by the end of 1998. It weakened again after the Brazilian events and returned close to the strong edge of the band in May 1999.

The above movements in the exchange rate of the forint can be well traced through the movements in non-resident holdings of Hungarian government securities (Chart 3). After the East Asian crisis, these holdings fell by about $300 million, from a level just over $600 million. In the subsequent 10 months, these holdings jumped to almost $2 billion only to fall back to about $700 million after the Russian crisis. Then again they rose to reach $1.6 billion by early 1999, fell by $300 million in the wake of the Brazilian events and increased again to reach about $1.4 billion in June, 1999. These movements show that holdings of government securities constituted one of the main vehicles for speculative capital flows which triggered the fluctuations in the exchange rate. Large withdrawals from the equity markets and winding down of speculative open currency positions were the other main sources of the pressure on the exchange rate in the wake of the Russian crisis. The Hungarian authorities were aware that some of the capital inflows represented fickle capital and therefore engaged in sterilised intervention to mop up excess liquidity and build up reserves to cushion any sudden outflow of capital that could occur in response to international events.

Developments in the real exchange rates show the impact on competi-

tiveness of the different exchange rate regimes adopted (Chart 4). In the more flexible regimes of the Czech Republic and Poland, the real exchange rates were allowed to appreciate significantly in response to the capital inflows. In Hungary, the authorities have limited the appreciation through sterilised intervention. The Hungarian authorities placed special emphasis on maintaining competitiveness, due in part to the relatively high external indebtedness of the country, and therefore accepted a less rapid disinflation than would have been the case if they had let the currency to appreciate. Nevertheless, disinflation in Hungary has been approximately as fast as in Poland where the real exchange rate appreciated significantly. The crisis-induced depreciations of the real exchange rates were also more pronounced in the Czech Republic and Poland than in Hungary. Thus, the volatility of the real exchange rate has been less pronounced in Hungary than in the two other countries. Sterilisation in Hungary, of course, involved a budgetary cost, but that cost was relatively limited (estimated at 0.16% of GDP per year from March 1995 to end-1997)[3] compared to the benefits provided by the maintenance of competitiveness and the credibility of the exchange rate.

Impact on Interest Rates

The East Asian and Brazilian events had little or no effect on short-term nominal interest rates in the countries under consideration (Chart 5). The Russian crisis did not affect the nominal interest rates in the Czech Republic and Poland, but increased the nominal rates by about 5 percentage points (to 21%) in Hungary. Thus, one could argue that the less flexible exchange rate regime led to a jump in interest rates in Hungary; had the exchange rate been let to depreciate further, interest rates would not have increased. However, a more nuanced conclusion emerges if one looks at the evolution of interest rate premia (Chart 6), calculated as the difference between domestic and foreign interest rates adjusted for the preannounced exchange rate depreciation in Hungary and Poland (no such adjustment is made in the Czech Republic where a free float is in effect). From mid-1997 until the Russian crisis, the interest rate premium in Hungary was much lower than in the other two countries. This probably reflected the good fundamentals of the Hungarian economy (accelerating growth rate, falling inflation and declining fiscal and current account deficits), which strengthened the credibility of the narrow band exchange

[3] See György Szapáry and Zoltán M. Jakab (1998), "Exchange Rate Policy in Transition Economies: The Case of Hungary", In: *Journal of Comparative Economics*, December, pp. 691-717.

rate regime. However, following the Russian crisis, the fear of contagion generated more uncertainty regarding the Hungarian exchange rate regime, which caused the interest premium to increase, but only to the level of that of the Czech Republic and Poland. Therefore, a more valid argument is that a certain level of risk commands a certain level of premium and that following the Russian crisis, the risk of Hungary perceived by the markets increased to the level which had prevailed in the two other countries. As tensions in the international financial markets eased, the premia in all three countries declined, but the premium in Hungary remained at roughly the same level as in the other two countries. In other words, the regional effect became dominant and Hungary was no longer able to benefit from lower risk premium by distinguishing itself from the other countries by its economic performance. Developments in real interest rates show a similar picture: real interest rates in Hungary were lower prior to the Russian crisis, but after the crisis they rose approximately to the levels prevailing in the other two countries (Chart 7).

It is important to point out the regional effect, as it shows that at a time of a financial crisis in a region, markets suddenly reassess the risks attributed to those countries of that region which are regarded as emerging markets. That said, the deterioration of the Hungarian current account position, even though fully financed by non-debt creating capital inflows, has probably contributed to the perduring of the higher level of interest rate premium.

Stock Market Reactions

From end-1995 to the East Asian crisis, Hungarian stock prices tripled in dollar terms, while in the Czech Republic it rose by about 70% and in Poland it remained approximately unchanged (Chart 8). Several factors explain the Hungarian performance: the credibility of policies buttressed by the inflow of the FDI and the progress in privatisation and structural reforms, and the consequent good growth prospects; tax incentives for investments in equities; and the liquidity of the stock market. In addition, stock index futures and lombard stock buying reached relatively high levels in Hungary, while they were negligible in the two other countries. It is estimated that about half of the capitalisation of the Budapest Stock Exchange is on account of foreign investors. As a result, the Hungarian stock prices were much more affected by the financial crises than those in the Czech Republic and Poland. Following the Russian events, the Budapest Stock Exchange index fell by half and has only partly recovered since then. Nevertheless, it still is the double of its level of end-1995, while in the two other countries stock prices stand at about their 1995 levels in

dollar terms.

The sharp fall in equity prices following the Russian crisis caused losses in the financial sector in Hungary. Several banks had to infuse capital to their brokerage firms to cover losses due to the stock market crash, as well as due to the depreciation of the currency. The infusion of capital was relatively small, estimated at $30 million. Out of 87 brokerages firms, 12 firms not backed by banks went bankrupt. Before tax profits of commercial banks declined substantially in the second half of 1998, largely as a result of the above mentioned factors. However, no bank went down because of the crisis and the banking system as a whole has remained sound, with the average capital adequacy ratio staying at 17% at end-1998, the same as at end-1997.

Concluding Remarks

The most immediate impact of the international financial crises on the three Central European countries considered were capital outflows which led to depreciations of the currencies. These depreciations turned out to be mostly temporary and the exchange rates strengthened afterwards, although following the depreciations in the wake of the Brazilian crisis the Czech and Polish currencies did not recover. The crises had little lasting impact on real interest rates except in Hungary, where following the Russian events real interest rates rose to the higher level prevailing in the Czech Republic and Poland. The fall in equity prices was the sharpest in Hungary where they had increased the fastest earlier. GDP growth was not directly affected due to the weak trade links with the crisis areas. The most important effect on growth would be indirectly via slower growth in the EU to the extent that the crises have negatively impacted growth in that region. In addition, in Hungary growth would be affected, *ceteris paribus*, by the higher real interest rates and the sharp fall in equity prices to the extent that the latter affects the investment activity of firms. One conclusion that emerges from this experience is that Hungary, which was able to benefit from its good economic performance and progress in structural reforms prior to the Russian crisis, a benefit that manifested itself in lower interest rate premium and buoyant equity prices, seems to have lost at least part of this benefit after the Russian crisis as a result of the "regionalisation" of the risks perceived by the markets. It is difficult to assess at this point to what extent the weakening growth performance and external position of Hungary also played a role, since the same weakening has also occurred in the Czech Republic and Poland.

It is noteworthy that the more rigid exchange rate regime in place in Hungary performed well during the crises, without causing excessive loss

of reserves. At the same time, it protected competitiveness better than the more flexible exchange regimes in the two other countries, allowed as rapid disinflation as in Poland, and ensured for a non-negligible period of time lower interest rate premium. Of course, one cannot attribute these benefits to the exchange system *per se*, since that system could be maintained only with the support of other policies, namely the substantial fiscal adjustment that took place in Hungary during this period and the significant progress with structural reforms, including consolidation of the banking system and privatisation. A narrow-band exchange rate regime is sustainable only if other policies adequately support it. When this is the case, it can provide appreciable benefits and can perform well even under stress, but that also depends on the severity of the external shocks.

Chart 1 Exchange Rate Movements 1997-99
(July 31, 1998 = 100)

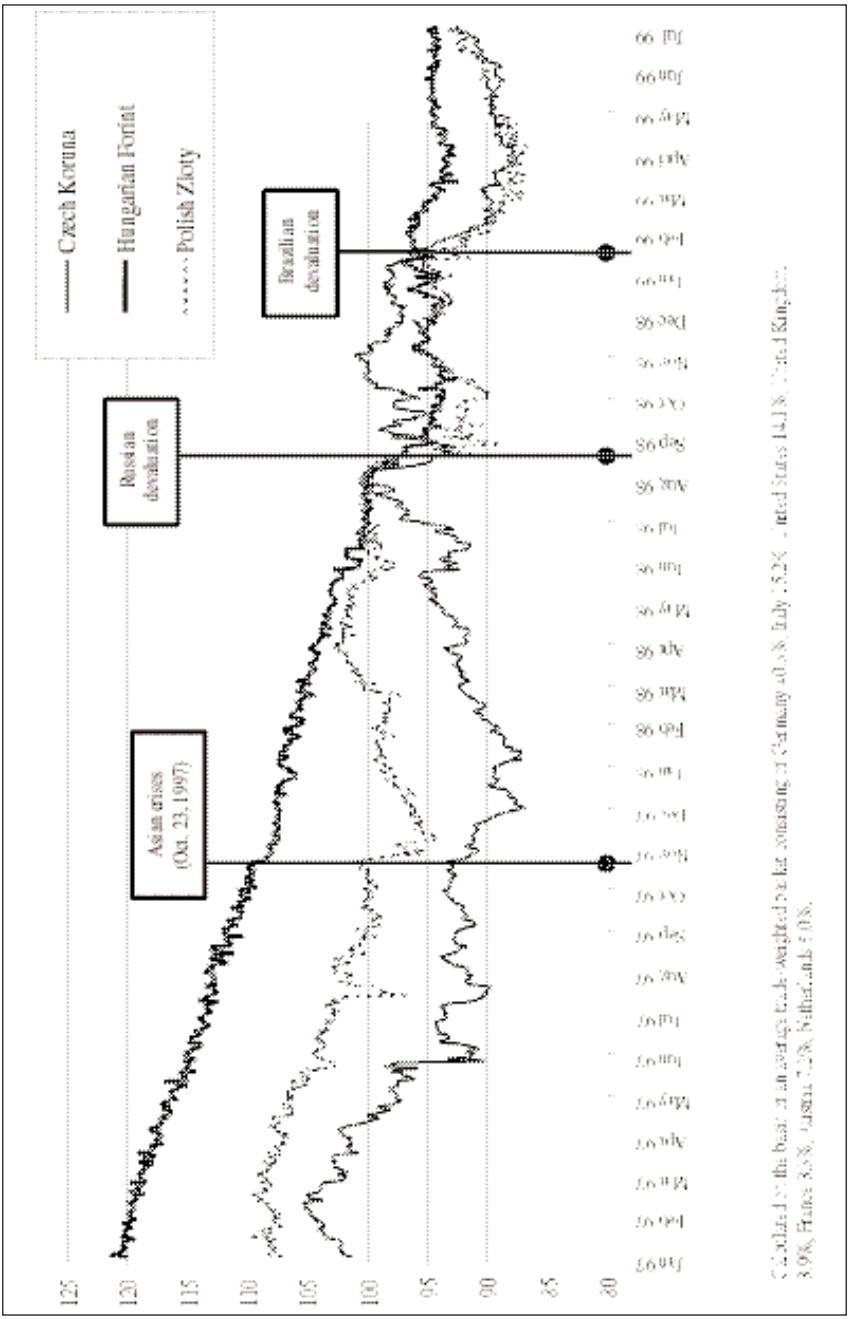

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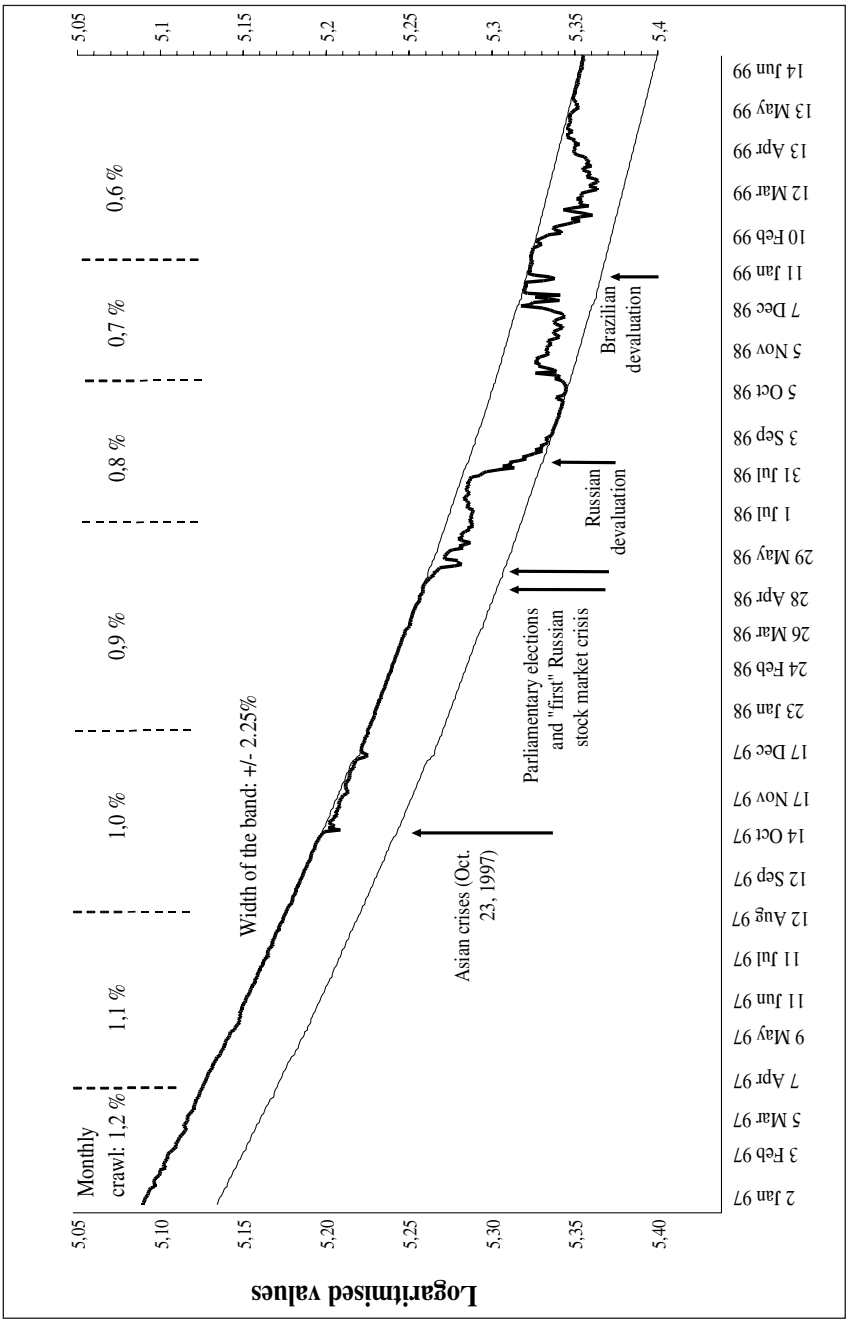
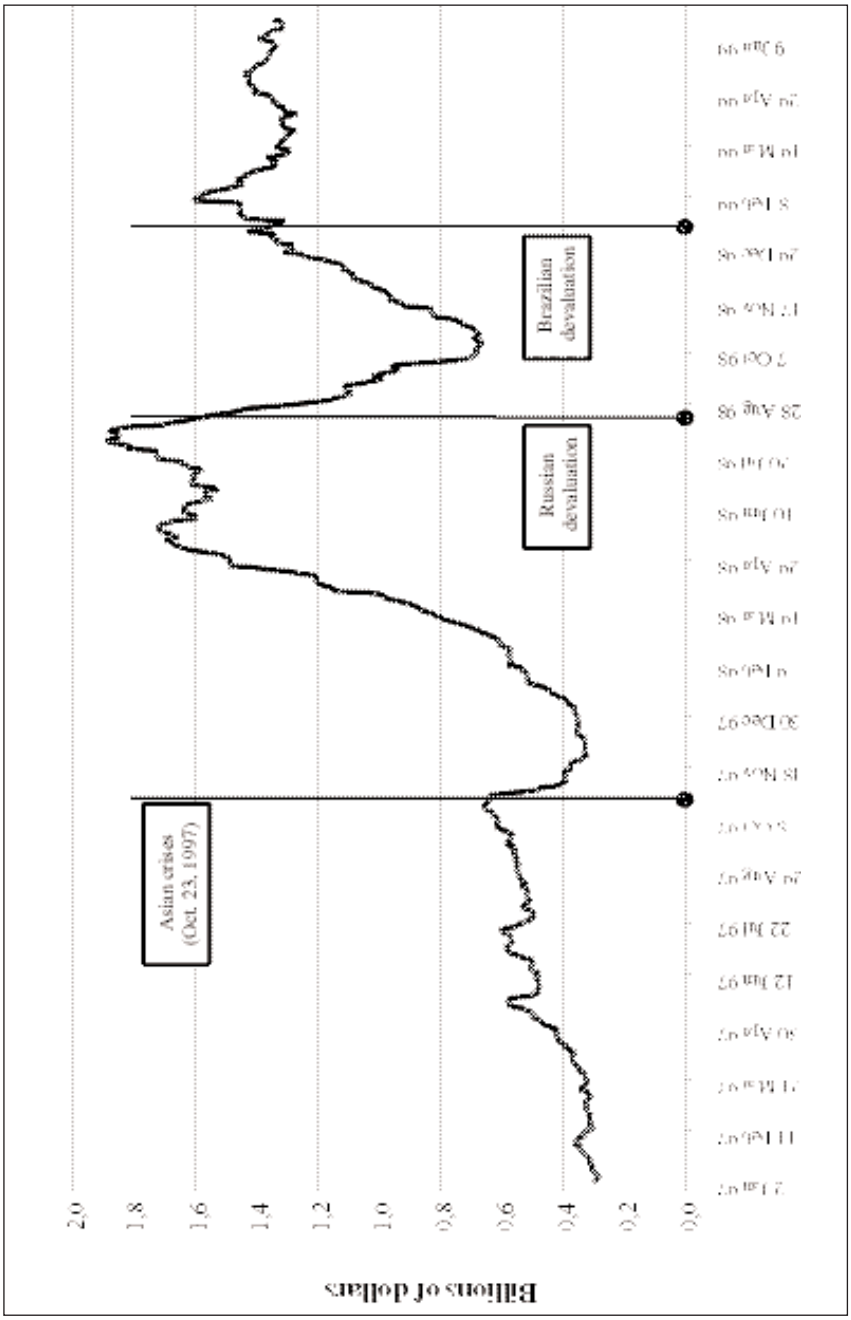
Chart 2 Exchange Rate of the Hungarian Forint within the Preannounced Crawling Band, 1997-1999



From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

Chart 3 Non-Resident Holdings of Government Securities in Hungary, 1997-1999



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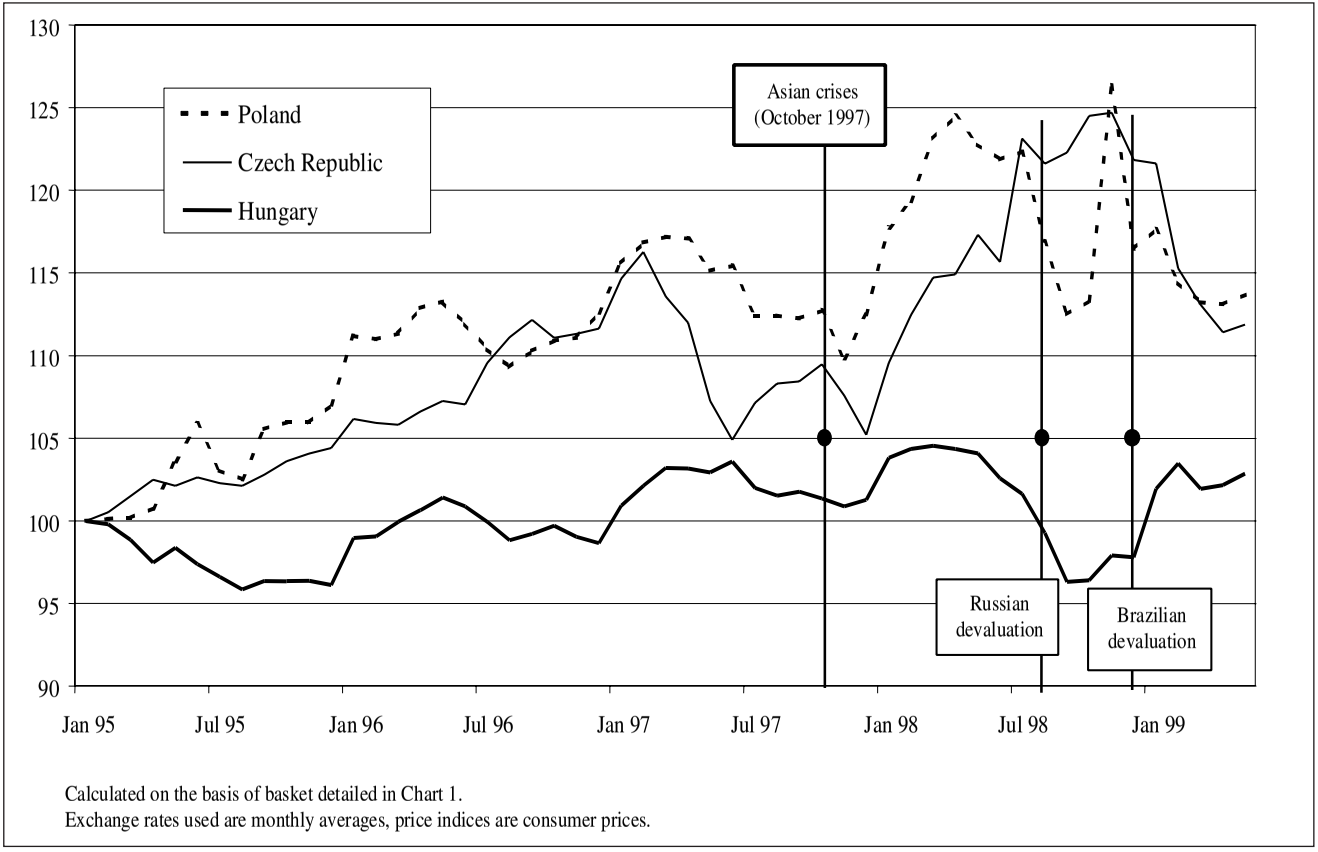
FONDAD, April 2000, www.fondad.org

Chart 4 Real Exchange Rate Movements, 1995-99
(January 1995 = 100)



Calculated on the basis of basket detailed in Chart 1.
Exchange rates used are monthly averages, price indices are consumer prices.

Chart 5 Short-Term (3-Months) Interest Rates, 1995-99

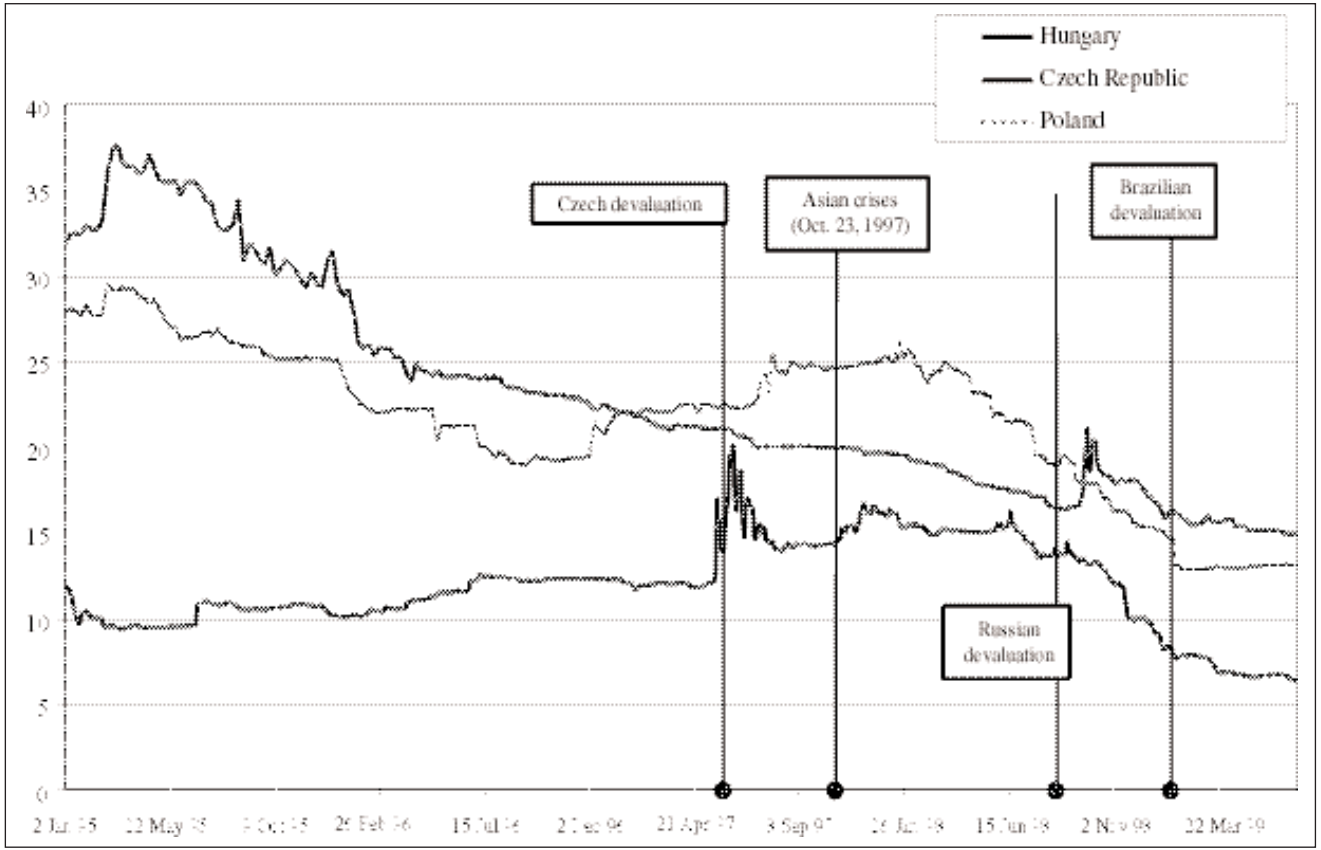


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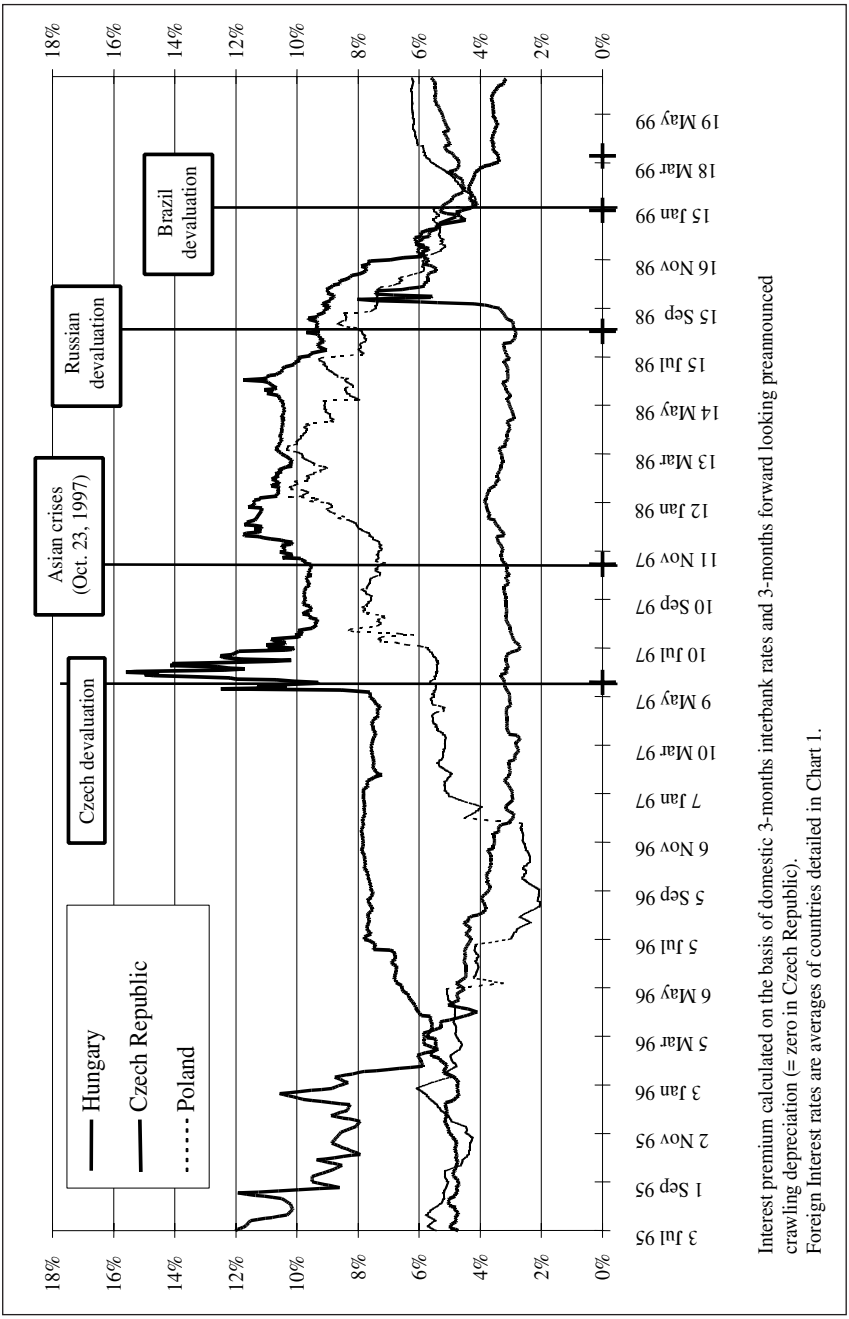
Chart 6 Interest Premia, 1995-99



Interest premium calculated on the basis of domestic 3-months interbank rates and 3-months forward looking preannounced crawling depreciation (= zero in Czech Republic).
Foreign Interest rates are averages of countries detailed in Chart 1.

Chart 7 Real 3-Months Interest Rates (Calculated with Past Inflation), 1995-99

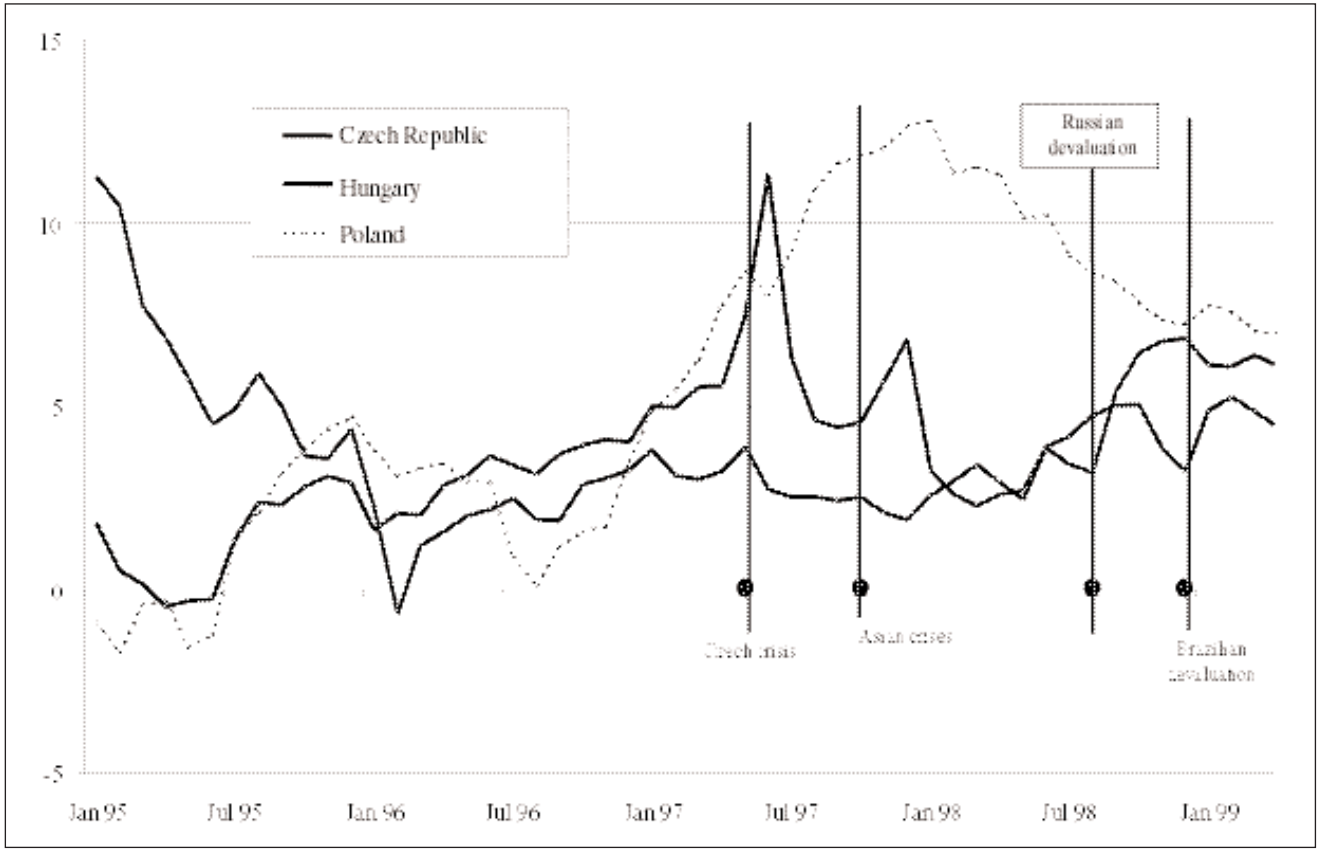


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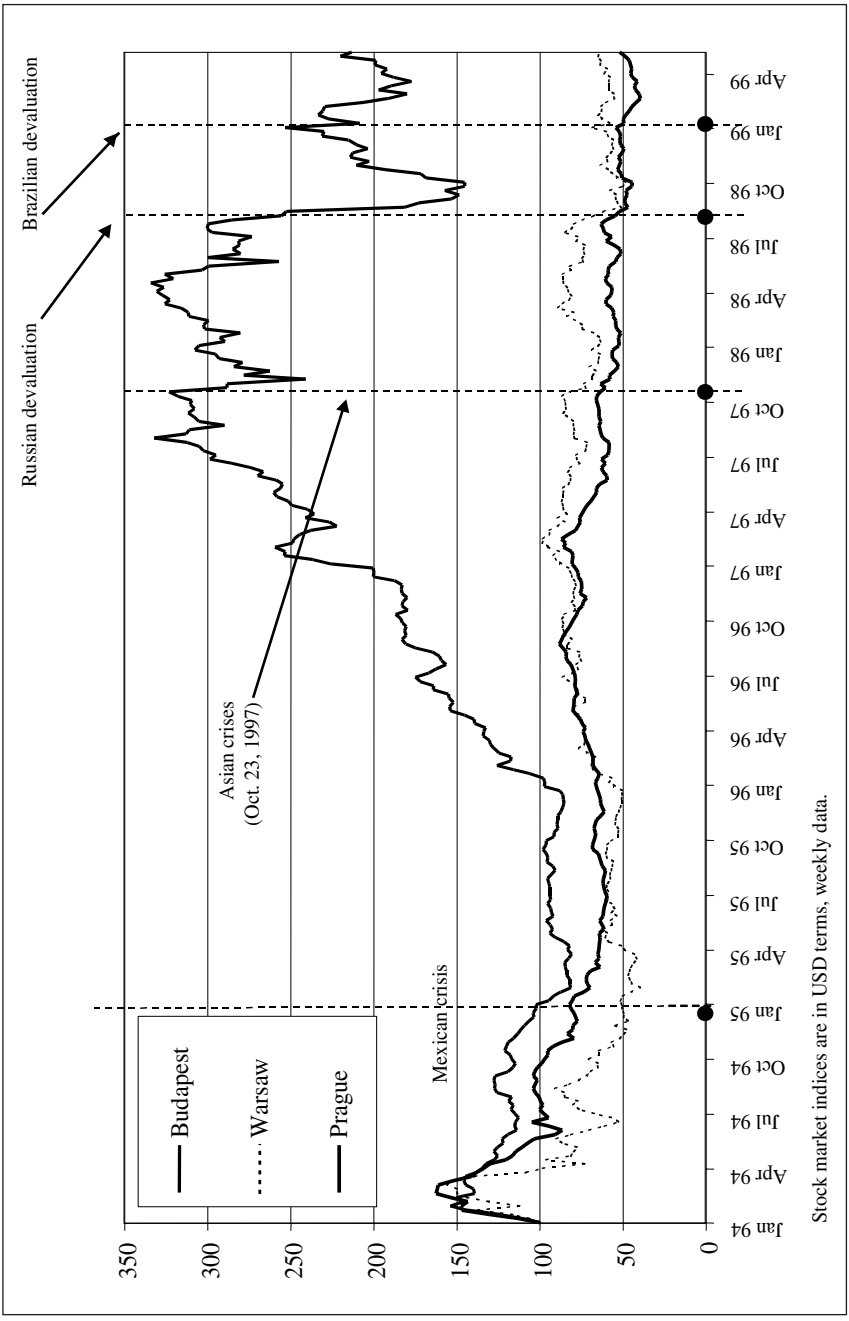
Chart 8 Stock Prices, 1994-99
(January 7, 1994 = 100)



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The Role of Domestic Policies in Stabilising Capital Flows in Latin America

Ricardo Ffrench-Davis[1]

I Introduction

Latin American countries (LACs) have been strongly affected by the changes that have occurred in capital flows over the last quarter of a century. During the 1970s, a large supply of funds was made available to the region; then, during the 1980s, there was a generalised severe binding shortage of financing, and the region became a net exporter of funds. Between 1991 and 1994, it received a large capital surge again, only to experience another sharp reduction focused in Mexico and Argentina, and a generalised drop of portfolio flows in late 1994 and early 1995. The so-called "tequila" crisis was followed by a renewed access in 1996-97. In 1998-99, Latin America has been experiencing a new shortage of external financing, aggravated by a worsening of the terms of trade. The crisis centred in Asian countries has now been the origin of a new recessive macroeconomic adjustment in the region. It appears impossible to hide the significant financial instability. Another matter is where the instability originates and what are the effects and dynamics involved.

On all occasions, the changes that were first expansive and then contractionary, began on the international markets and had a strong impact on the national economies. Up to 1996, the successful emerging economies of Asia appeared to be immune to the instability associated with capital surges. The recent events, however, have shown that this is not so anymore. Some of the causes are common with those of Latin America. The new crisis provides a renewed opportunity to significantly reform the architecture of the international financial system, and to improve the domestic response so as to achieve sustainable macroeconomic equilibrium and growth. Here we concentrate on some features of policies in emerging economies and suggest reforms needed.

[1] The author is Principal Regional Adviser of ECLAC. The views expressed herein are the sole responsibility of the author.

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In Section II we sketch the three capital surges experienced by LACs, since the 1970s, focusing on the 1990s. In Section III we review main macroeconomic effects generated by capital inflows, emphasising the analytical bases. In Section IV we compare the contrasting experiences of Mexico and Chile in the 1990s. In Section V we outline features of Asian emerging economies common with Latin American previous crises. Section VI summarises some policy lessons.

II Capital Flows to Latin America

Although the growth of international capital markets since the mid-1960s is partly a reflection of the growth of the world economy, including international trade, and the globalisation of production, it is also associated with purely financial factors, in which changes have occurred at a much faster pace. During the 1970s and the 1980s, many countries began to liberalise their financial sectors and to relax or eliminate foreign exchange regulations (Díaz-Alejandro, 1985; Devlin, 1989). This, together with the revolutionary advances that have taken place in data management and telecommunications technology, and the emergence of increasingly sophisticated financial techniques, contributed to a boom of national and international financial flows.

Table 1 Indices of Stock Exchange Prices, 1990-98[1]

	Dec. 1990	Aug-Oct. 1994	Dec. 1994	March 1995	Dec. 1995	Dec. 1996	June 1997	Dec. 1997	Dec. 1998
Argentina	17.3	100.0	77.5	63.4	84.2	100.1	121.9	117.3	84.0
Brazil	11.7	100.0	91.6	67.4	71.3	93.1	143.2	112.1	64.3
Chile	25.9	100.0	100.8	94.9	97.9	81.0	105.3	83.8	58.6
Colombia	15.0	100.0	93.4	88.6	69.6	72.7	90.3	90.2	50.9
Mexico	30.0	100.0	62.6	32.7	45.7	53.7	68.7	78.4	47.8
Peru	-	100.0	104.8	87.4	114.6	115.4	156.8	131.4	79.2
Venezuela	170.8	100.0	91.6	75.0	62.6	145.2	191.8	179.0	86.2
Latin America[2]	24.1	100.0	80.9	58.6	66.4	76.9	106.2	96.2	59.4

Notes:
[1] Values at end of each period, expressed in current US dollars.
[2] Average of the seven countries considered, weighted by amount of transactions. These countries include the overwhelming majority of transactions.

Source:
Indices based on series in International Finance Corporation, *Monthly Review of Emerging Stock Markets*, several issues.

Table 2 Real Exchange Rate Indices, 1983-98[1]
(percentages, 1987-90 = 100)

	1983-86	1987-90	1991	1992	1993	1994	1995	1996	1997	1998
Argentina	78.5	100.0	66.1	61.5	58.1	60.3	66.5	67.9	65.4	63.6
Brazil	117.2	100.0	97.2	104.8	96.8	85.5	69.5	64.6	63.2	64.5
Chile	68.8	100.0	100.1	96.5	98.1	97.2	92.7	88.0	80.7	81.3
Colombia	65.1	100.0	111.6	98.8	95.6	82.5	82.6	78.3	73.5	76.8
Mexico	96.0	100.0	81.0	74.6	70.9	72.7	107.2	96.7	84.2	83.4
Peru	136.4	100.0	55.4	55.4	57.3	56.6	57.0	55.0	53.7	53.4
LACs average (18)	97.4	100.0	88.5	87.9	83.3	79.2	82.5	79.2	74.7	74.5
Weighted Simple	85.8	100.0	97.5	96.4	95.0	93.4	95.0	93.4	88.1	87.0

Note:
[1] Annual averages of real exchange rate indices (main official) for each country with respect to the currencies of their main trading partners, weighted by the share of exports to those countries; inflated by external CPI and deflated by domestic CPI; for Brazil we weighted the Rio CPI index ($^2/_3$) and the new official series of inflation ($^1/_3$).

Source:
Calculations by the author, based on official figures processed by ECLAC for 18 countries.

Net capital inflows to Latin America averaged nearly 5% of GDP in both 1977-81, 1991-94, and 1996-97. In all three periods, the deficit on current account rose sharply, and exchange rates appreciated (see Tables 1 and 2; and ECLAC, 1995; 1998); naturally, imports grew more rapidly than exports, and external liabilities rose steadily. Indeed, all these variables reflected a growing macroeconomic imbalance after a while,[2] in many cases anchored to one dominant "balance"; that of a falling CPI associated to real exchange rate appreciation and climbing external deficits. Those recipient countries which had larger deficits on current account, heavily financed with short-term liabilities, and exhibiting stronger appreciating exchange rates, tended to become increasingly more vulnerable to external creditors;[3] the outstanding case was that of Mexico in 1991-94. Creditors, given the high exposure of financial assets placed in the region, subsequently became more sensitive to any "bad news".

The dramatic increase of the flow of international financial resources in recent years has been more diversified during the current decade than it was during the 1970s. But the situation is potentially more unstable, inas-

[2] The presence of significant disequilibria, in a framework of repeated statements regarding the need to maintain macroeconomic equilibria, reveals either a too narrow definition or an inadequate understanding of how to achieve those equilibria in order to make them sustainable and consistent with development. See Ffrench-Davis (1999, ch. VI).
[3] See our advise, as early as in mid-1992, published in Teunissen (1992).

much as the trend has been to move from medium-term bank credit to investments in liquid stocks, bonds and deposits; a very high percentage of this supply of financing is of a short-term and highly liquid nature. Paradoxically, there has been a diversification toward volatility in the 1990s; the relative improvement after the "tequila crisis", with a rising share of FDI, still included a significant proportion of volatile flows.

There is well-documented evidence showing that these changes have originated, to a large extent, in the sources of supply. The boom of the early 1990s occurred mainly in the US (see Calvo, Leiderman and Reinhart, 1993; Culpeper, 1995; Griffith-Jones, 1995). Institutional changes allowed and encouraged outflows; domestic recession in the US, a limited demand for funds, and very low interest rates pushed US investors to seek other markets.[4] Then followed the long process of building a market for portfolio investment in emerging economies, with large flows in the process. Latin America was a receptive destination, and offered the expectation of high rates of return.

Why the high rates of return? Naturally the rate should tend to be higher in the "productive" economy of capital-scarce regions, like Latin America. But that was reinforced by several conjunctural factors. Initially, prices of stocks and real estate were highly depressed. That allowed a 300% average rate of return (in current US dollars) in the stock markets of Latin America between late 1990 and September 1994 (see Table 1), with fast rising price/earnings ratios. After a sharp drop around the tequila crisis, with contagion to all Latin American stock markets, between March 1995 and June 1997 average prices nearly duplicated, being pushed up directly by portfolio inflows. Domestic interest rates were high as well, reflecting the binding external restriction predominating in 1990 and the repressive monetary policy in place (plus the nature of financial reform implemented). Finally, in a non-exhaustive list, the recovered supply of external financing generated a gradual exchange rate appreciation (see Table 2) that encouraged short-term or liquid inflows; that is, for dealers operating with maturity terms within the horizon of expected continued appreciation of the domestic currency.

The yearly deficits on current account rose, as shown in Table 3, but also accumulated through time. By 1994 Mexico and the region had accumulated 4 years of large flows of external liabilities. While in 1991 the actual stock of assets of the new investors in Latin America was evidently below the "desired" stock, in 1994 it was notably large. We had entered a

[4] Between 1989 and 1993, the LIBOR rate in dollars, at 180 days, fell from 9.3% to 3.4%; rates for the same term on the US monetary market fell from 9.2% to 3% (IMF, *International Financial Statistics*, Washington, DC, various issues). Background on interest rates in Latin America can be found in ECLAC (1995, ch. IX).

Table 3 Deficit on Current Account, 1983-98
(in millions of dollars)

	1983-90	1991	1992	1993	1994	1995	1996	1997	1998
Argentina	1,413	647	5,462	7,672	10,118	2,768	3,787	9,454	12,200
Brazil	1,564	1,450	-6,089	-20	1,153	17,972	24,347	33,484	32,450
Chile	999	99	958	2,554	1,585	1,398	3,744	4,058	5,160
Colombia	671	-2,347	-876	2,219	3,113	4,366	4,946	5,683	6,060
Mexico	241	14,888	24,442	23,400	29,418	1,576	2,330	7,449	15,500
Peru	1,030	1,509	2,101	2,302	2,662	4,298	3,619	3,408	4,120
Latin America (19)	6,967	17,426	34,350	44,920	49,566	34,449	36,659	63,669	83,905
L.A.-Venezuela (18)	8,642	19,162	30,601	42,927	52,107	36,463	45,573	68,353	82,345

Source:
Calculations by the author, on the basis of official figures processed by ECLAC. The balance on current account includes private and public unrequited transfers as current income. In 1994, private transfers amounted to $9.5 billion and public transfers totaled $2.5 billion.

vulnerability zone (Ffrench-Davis, Ocampo and Tovar, 1999), with the economy growingly sensitive to bad political or economic news.

III The Effects of Inflows

During the 1990s, capital inflows contributed to a recovery of economic activity, after the recession that still prevailed around 1990 in most LACs. Argentina and Peru were two outstanding cases of underutilisation of capacity; Chile and Mexico were the exceptions in the other corner.

Table 4 Gross Domestic Product, 1970-98
(percentage of annual growth rates)

	1970-80	1981-90	1991-94	1995	1996	1997	1998
Argentina	2.8	-0.7	8.2	-5.0	3.6	8.4	4.2
Brazil	8.6	1.6	2.8	4.2	2.8	3.0	0.2
Chile	2.5	3.0	7.9	10.1	7.3	6.9	3.4
Colombia	5.4	3.7	4.3	6.2	2.2	3.2	0.6
Mexico	6.7	1.9	3.7	-6.6	5.3	7.3	4.8
Peru	3.9	-1.2	5.3	7.7	2.4	7.7	0.7
Uruguay	3.0	0.0	5.2	-2.1	5.3	5.1	4.5
Latin America (19)	5.6	1.2	4.1	0.4	3.5	5.3	2.3

Source:
Calculations by the author, based on official figures for 19 countries processed by ECLAC; figures expressed in 1980 US dollars for 1970-80, in 1990 US dollars for 1980-97 and in 1995 US dollars for 1998.

Annual GDP growth rose from 1.2% in the 1980s, to 4.1% between 1991 and 1994 and to 2.9% in 1995-98 (Table 4). This growth was meagre, however. On the one hand, the comparison with the previous golden age is shocking. Along the three decades spanning between 1950 and 1980, Latin America had averaged a GDP growth of 5.5% per annum; domestic investment had been rising fast, as a source of that vigorous growth. Subsequently, in the 1980s there was a sharp drop of the investment ratio, of 7 points of GDP, with only a mild recovery in the 1990s. In fact, investment grew much less during this decade than did capital inflows; thus, a significant part of the external flows financed increased consumption, and consequently crowded-out domestic savings.

Actually, the new supply of financial flows initially had a positive effect on Latin America: thanks to a larger utilisation of installed capacity, production increased, beyond the expansion of the production frontier by some $70 billion in 1994 in comparison with 1990 (Ffrench-Davis and Reisen, 1998). That is, about one third of the 4% rate of annual growth in GDP in 1991-94 corresponded to an increased use of installed capacity. The phenomenon was particularly intense in countries such as Argentina and Peru. Subsequently, the strong recovery of Argentina and Mexico in 1996-97 rested to a significant degree on the underutilisation created in 1995. And, again, recovery was short-lived, giving way to slower growth since mid-1998, and open recession in Argentina in 1999. Any serious research should control for the huge swings in the rate of utilisation of capacity, when measuring performance of policies, reform or productivity.

The increased availability of external financing removed the binding external constraints that had been responsible for the one-decade recession of the region. However, beyond contributing to overcome that constraint and to move toward macroeconomic equilibria, after a while it led to an overshooting. Gradually, effective output approached the production frontier; depreciated exchange rates rose and at some point started to become "appreciated".

In fact, the renewed access to external capital posed challenges in regard to the stability and sustainability of macroeconomic equilibria. Indeed, the affluence of capital had an adverse effect on the evolution of exchange rates,[5] the money supply and domestic credit, the accumulation of external liabilities (mostly with short-term maturities), and thus made the economy more vulnerable to future negative external shocks.[6] Tables 1 to 3 show a

[5] It should be recalled that several LACs were implementing sharp liberalisation of import regimes *pari passu* with exchange rate appreciation. See Ffrench-Davis (1999, ch. III) and ECLAC (1995, ch. V).

[6] The process has been similar to that in East Asia, with a capital surge and financial liberalisation since early 1990s. See Ariff and Ean (1999).

similar story in 1991-94 and 1995-97, reproducing the desequilibrating macroeconomic adjustments of 1976-81 (Devlin and Ffrench-Davis, 1995).

What happens? Why do debtors not stop inflows before a crisis? Why don't creditors take up that task if debtors fail?

Among debtor countries we will distinguish three cases. The first are those with nominal pegs, the outstanding case being Argentina since 1991 with a currency board system. Macroeconomic policy is passive and the conjuncture is determined by the external supply of finance. In an economy with huge underutilisation of capacity and a capital surge, as was the case in 1991, passivity works well, until capacity approaches exhaustion or the surge softens or reverts; both did coincide in late 1994. The outcome tends to be intrinsically pro-cyclical.

A second case is that of a flexible exchange rate. Mexico had flexibility within an asymmetric band, and allowed all the flexibility to operate under the capital surge. The actual rate remained at the most appreciated extreme of the band.[7] The outcome of Mexico shared with Argentina a significant real appreciation, but Mexico had no underutilisation of capacity, so the capital surge leaked to a much larger degree to imports and deficit on current account (Ros, 1999). The outcome is again pro-cyclical. The standard assertion that "flexibility" can avoid disequilibria is at least misleading.

The third case corresponds to comprehensively active macroeconomic policies, of which Chile was the paradigmatic case in the first half of the 1990s (Section IV, and Agosin and Ffrench-Davis, 1999), with an anti-cyclical outcome.

In the majority of cases, authorities allowed the capital surges to move into their domestic economies, as illustrated by the data in Tables 1 to 3.[8] Most of them thought they should do nothing or could do nothing, or preferred to "benefit a little longer" from the anchoring of the domestic CPI to international inflation.

Ex post, the consensus of observers tended to be that disequilibria had been built. For a voluntary flow to take place there is need of willingness on both debtors and creditors. Then, why did creditors not act in due time to curb flows? The specific nature of agents prevailing in the creditor side is crucial. The conflictive segment of flows, that was predominant in the surges and busts, naturally works with short horizons.

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[7] The higher border of the band was constant in nominal terms while the lower border was partially indexed to net inflation.

[8] Lax or poor prudential supervision of banks obviously feeds disequilibria. But a strong supervision does not avoid *per se* the problem. Actually, a significant share of inflows is usually not intermediated by banks. As well, in the booms, prices of guarantees are biased upward.

When creditors discover an emerging market, they start out with non-existent exposure. Then they generate a series of consecutive flows which accumulate in rapidly increasing stocks. As said, the creditor's sensitivity with regard to bad news increases remarkably with the level of stocks placed in a country (or region), and with the degree of dependence of the debtor on additional flows (current account deficit plus refinancing of maturing liabilities). Additionally, the most relevant feature is that after a significant increase in asset prices and exchange rates, accompanied with rising stocks of external liabilities, the probability of reversal of expectations grows steeply.

The accumulation of stocks and a subsequent reversal of flows can be considered to be a "rational" behaviour, given the nature of predominant agents. Investors with short horizons are not concerned whether (long-term) fundamentals are being worsened with capital surges while they continue to bring inflows. What is relevant for them is that the crucial indicators – real estate prices and stock, exchange rates – can continue providing profits in the near term; thus, they will continue pouring money until expectations of near reversal start to build.

The most relevant issue is that myopic agents in microfinance have become to determine the macroeconomy. The outcome, unsurprisingly, is unsustainable macroeconomic imbalances, "wrong" or outlier macroprices, and undermined environment for productive investment. Then what appears to be "irrational" is that the domestic macroeconomy has been increasingly influenced by experts in microfinance. There is a need for macroeconomic authorities to take over their responsibility of making fundamentals to prevail so as to achieve macroeconomic balances both sustainable and suitable for growth. That requires that they avoid entering vulnerability zones during economic booms accompanied by capital surges.

IV The Contrasting Cases of Mexico and Chile in 1990-95

External financing is obviously a vital ingredient of development; however, it also tends to be very volatile, and to fluctuate between excessive surpluses and shortages. Consequently, it is important to design economic policies that will attract resources, but which will ensure that they flow in a fashion and quantities that are sustainable and are directed more towards long-term investment rather than to consumption.

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The Tequila Crisis[9]

The Mexican crisis which exploded in 1994 is a good example of the harm that can be caused when a country absorbs an excessive volume of capital inflows, giving way to a large stock of external liabilities, especially when the composition of such financing makes it volatile. Producers and consumers adjusted to a level of overall expenditure that was much higher than potential GDP, and after a while the amounts involved became unsustainable. Recessive adjustment inevitably followed. A 6.6% drop in GDP and a nearly 30% drop in capital formation occurred in Mexico in 1995. They were closely associated, first, with a persistent appreciation in the exchange rate and a growing deficit on current account, and subsequently with a sharp cutback in financing on the part of creditors. Then the country was forced into a highly recessive adjustment and a huge devaluation, despite the large package of international support it received in 1995 (Lustig, 1997).

It is wrong to say, as it is said surprisingly often, that the Mexican crisis of 1994 could not have been foreseen because of the concealment of information. While it is true that official information on international reserves was provided only sporadically, the key data concerning the exchange rate appreciation, the high current account deficit, and the fact that it was financed with volatile resources, were available on a regular basis. Notwithstanding this, by 1993 praise of Mexican policies was generalised in financial institutions and media.

As said, the seeds of the crisis date back to the period between 1992 and 1994, when there was a massive capital inflow, mostly short-term. Aggregate demand grew rapidly, leaving far behind the potential GDP; it leaned increasingly towards tradables, especially encouraged by exchange rate appreciation.[10] Thus, in those years, there was a maladjustment that would most likely have to be reversed in the future. What is extremely important is that disequilibrium was led and encouraged by capital inflows. Since the public sector was balanced, the disequilibrium was located in the private sector. Money expansion was associated to foreign exchange operations and *ex post* multiplication.

However, the crucial problem was that neither those on the supply side nor those on the demand side paid enough attention to the available infor-

[9] There is a mounting literature on the tequila crisis. For a recent comprehensive analysis, see Ros (1999).

[10] Despite the fact that expenditure exceeded GDP, production capacity was probably larger than actual GDP, with an underutilisation of the production capacity of importables and of potentially exportable goods under a less appreciated exchange rate. This might explain the subsequent sizeable response of the output of tradables to the real devaluation in 1995.

mation until after the crisis erupted. Indeed, we must emphasise, the most influential financial operators usually act with a very limited (though now becoming more comprehensive) set of data, particularly dealing with a short horizon. Their more relevant variables are not related to the (long-term) fundamentals but to short-term profitability. This explains why they may suddenly change their minds radically about the economic situation of a country or of a firm.

In 1995, the Mexican crisis did not have a widespread effect throughout the region, as it had in 1982. The Argentine economy, however, was seriously affected by the contagion. Although this did not lead to a currency crisis in the sense of a sharp exchange rate devaluation, as many operators had feared in 1995, Argentinean GDP fell by 5% and investment diminished by 16%. The overall growth rate of Latin America went down sharply, to a figure below the population increase, while the regional investment ratio also fell substantially. During 1995, in various countries, negative flows had been observed in several segments of the supply of funds (especially bonds, deposits and to stock markets). By early 1996, given a lag in the response of the real economy, several countries showed GDP drops in various quarters. In fact, average growth in Latin America was negative in the four quarters included between March 1995 and 1996.

Subsequently, the flow of funds was reactivated once again, exceeding $80 billion in 1997. The resulting economic reactivation was particularly significant that year. However, some of the same problems displayed in the 1991-94 recovery reappeared in 1996-97, and actually collected a bill in 1998-99. Nevertheless, the bill has been moderate for the following reasons. First, the new financial boom period was short-lived; it lasted only a couple of years. Second, there was a tendency to increment the share of FDI inflows, which are most steadfast than flows to the stock market or short-term credits. Third, owing to a sharp reduction in 1995 of the current account deficits (and a significant exchange rate depreciation, particularly in the case of Mexico), a high deficit was recorded only in one year (1997). Fourth, taking into consideration the banking crisis of Mexico and Argentina, following the "tequilazo", these and other countries introduced reforms to their financial reforms which strengthened the prudential regulation and supervision of their banking systems.

Consequently, the required adjustment in 1998 took place in economies with a more moderate stock of external liabilities than in 1995, with healthier banking portfolios, and with less overheated economies. However, in all, the Asian crisis caught Latin America after most LACs had appreciated their exchange rates (see Table 2) and their deficit on current account had risen sharply. The same old story was returning to the

scene, in circumstances that the international scenario was recessive, with worsened terms of trade, declining trade and access to finance, and rising spreads.

Reducing Vulnerability in Chile

Chile displayed a performance opposite to that of Mexico in 1995-96, regardless of numerous similarities during the years prior to 1994. However, there was a most pronounced divergence in macroeconomic policies, related to the external sector. In 1991-94, Chile and Mexico chose divergent roads with respect to capital movements regulation, exchange rate policy, and prudential supervision of the financial system.

Both the Mexican crisis and Chile's strength were built up over time. Towards the end of the 1980s, both countries had already opened up their trade considerably, their budgets had improved substantially, privatisation was well under way, annual inflation was around 20%, and the two countries had similar domestic savings rates. The reason why Chile performed better in 1995 is that, faced with an abundance of external funds in 1990-94, it deliberately followed a cautious policy (Agosin and Ffrench-Davis, 1999; Stiglitz, 1998). Instead of taking and spending all the large supply of external resources available, which would have led to a significant appreciation of the peso and to a rising deficit on the current account, it chose to discourage short-term capital inflows. In 1991 a tax was imposed, and substantial non-interest-bearing reserves for external credit were required; the reserve requirement was subsequently extended to deposits in foreign currencies and investment in second-hand stocks, while primary issues and venture FDI capital were exempted;[11] FDI had to be held in Chile for one year at least; the financial system was subject to relatively strict prudential regulation, including a selective supervision of assets and required provisioning, as well as restrictions and drastic penalties on operations with related parties. The set of measures adopted effectively discouraged speculative capital inflows (Agosin, 1998; Agosin and Ffrench-Davis, 1999; Larraín, Labán and Chumacero, 1997).

This is one of the main reasons why, in late 1994, Chile had a moderate external deficit, high international reserves, a modest and manageable short-term debt, a domestic savings rate that was rising instead of falling (the latter being the case in Mexico and Argentina), a level of domestic investment that since 1993 has been the highest recorded in history, and

[11] The rate of the reserve requirement, that had to be kept at the Central Bank for one full year, was reduced from 30% to 10% by the end of June 1998 and to zero in September, in order to accommodate to the new shortage of external financing associated to the Asian crisis.

the exchange rate in 1990-94 was comparatively closer to equilibrium (see Table 2) than that of most of the countries of the continent, as reflected by a moderate deficit on current account (Table 3).

Policy has been effective in achieving its targets in most part of the 1990s. However, in 1996-97 this policy mix and the intensity with which it was applied remained unchanged, in spite of a new vigorous surge in capital flows to most countries in the region, but particularly to Chile, a country immune to the tequila contagion. This surge should have been met with increased restrictions on rising inflows. Being a market-based mechanism, that alters relative prices of capital flows. What happened was that inflows came in paying the cost of the reserve requirement, with no evidence of significant fading power. The fact is that, in general, the intensity of policy was kept rather unchanged in face of a stronger capital surge.

As a consequence of such lack of action on capital inflows during 1996-97, despite heavy intervention in foreign exchange markets, the Central Bank was unable to prevent a sharp real exchange rate appreciation and rise of the deficit on current account. Evidently, as said, the new surge should have been met with an increased reserve requirement or other equivalent measures. Nonetheless, the benefits of the active regulation implemented in previous years, had left large international reserves, a low stock of foreign liabilities and a small share of volatile flows. Unfortunately, those strengths were partially undermined by the excessive exchange rate appreciation and high deficit on current account recorded in 1997.

The Asian crisis has been felt principally through trade. The fact is that the terms of trade of Chile worsened in the equivalent to 5% of GDP, with reduced access to external markets, in a country that was selling one-third of its highly commodity-intensive exports in Asia.

V Emerging Asia: the New Casualty of Financial Instability

During 1995 there were negligible effects of the Mexican crisis over the Asian region. This was so even in economies with large deficits on current account. As a consequence, the year 1996 saw many outstanding researchers and observers asserting that those deficits were not relevant if investment ratios and economic growth were high. Thailand and Malaysia were two of those cases.

A few Asian countries had rather free capital flows, but several of them had regulated capital inflows and exchange markets successfully for long periods (Helleiner, 1997; see the cases of Malaysia, Indonesia and Thailand, in Sachs, Tornell and Velasco, 1996; Korea and Taiwan, in

Agosin, 1999). Growth was actually sustained and extremely high. In 1980-95 GDP yearly growth averaged between 6% and 8% in Korea, Indonesia, Malaysia and Thailand; the investment ratio exceeded 33%, with domestic savings ratios close to that notable level; inflation was low (in the 5% annual range) and fiscal budgets were generally balanced or in surplus. In the meantime, the average GDP growth in Latin America was 2% and the investment ratio fluctuated around 20%.

What explains the sudden inverted comparative perceptions of Asia and Latin America in 1997?

First, what works for some time might see its efficacy reduced after a while. A relevant feature relates to exports performance. In fact, recently the exports of several Asian economies were experiencing problems. What until then had been products with a notably dynamic demand appeared to be reaching maturity, facing tightening markets (Sachs and Radelet, 1998).

Second, even if exports perform well, a disequilibrium can emerge if imports experience a boom. In both Korea and Thailand imports rose sharply in 1995-96. This boom was related to expanded aggregate demand and to cheaper imports (due to some import liberalisation together with relaxation of liquidity constraints to consumers and exchange rate appreciation, a recent Latin Americanisation of some Asian economies). Rising capital inflows were behind those factors.

Third, good sustained policies can be reversed under exogenous pressures. The strong drive towards financial liberalisation prevailing in the world today had also permeated several Asian economies in the 1990s (Agosin, 1999; Ariff and Ean, 1999; Jomo, 1998); China and Taiwan were two outstanding exceptions. Actually the deficits on current account increased substantially in Korea and Thailand since 1993. Data shows that they were not led by public deficits and did not imply losses of international reserves. Neither were they due to an exogenous increase of private expenditure. On the contrary, the cause was a private expenditure rise led by mostly short-term capital inflows (IMF, 1998; Sachs and Radelet, 1998). In Korea, Indonesia, Malaysia and Thailand international reserves were accumulating persistently between 1992 and early 1997, fed by capital inflows, pressing local authorities to purchase foreign currency. Consequently, international reserves more than doubled in those countries in that period.

Inflows contributed to a domestic lending boom, with bubbles in real estate and stock market prices. Weaknesses in prudential supervision of the financial system, not so relevant in the previously repressed domestic markets, became evident. But it is also evident that poor supervision was not the main cause, but just a reinforcing factor in the macroeconomic disequilibria which were built in just three years, in a region that had exhibited a

spectacular performance for a long time.[12]

It was a phenomenon of worsening macroeconomic fundamentals, led by capital inflows, which sustained appreciating exchange rates (though a moderate trend) and a strongly increased aggregate demand (with a significant enlargement of the deficit in current account of 5 points of GDP in Korea, 2 points in Indonesia and 3 points in Thailand). The disequilibrium was only recognised by financial markets in 1997 and charged a high bill in 1998. The policy failure was an error shared with the rather similar financial reforms of Chile in the 1970s and of Mexico in the 1990s.

The East and Southeast Asian countries experienced deep recessions in 1998. Subsequent to two or three decades of a solid annual growth of 6 to 8%, many of them experienced in 1998 significant drops. Indonesia presented a 14% contraction in 1998, similar to the spectacular drop of Chile in 1982. For Korea, Malaysia and Thailand reductions of 5 to 8% were recorded. Korea has been recovering during 1999 faster than the other countries of the region. Notwithstanding that Korea exhibits an impressive external surplus and a GDP growth in 1999, the costs have been significant: in 1998 a GDP nearly 14% below the historical trend and a drop of 10 points in the investment ratio. These recessions are comparable to those of Latin America in 1982-83, with drops in productive investment, banking crises and social decline.[13]

VI Policy Lessons

Optimism regarding Latin America returned to the international financial markets in 1996-97. The current net capital inflow climbed to the pre-crisis levels. Composition improved, with a larger share of FDI. GDP decline in various LACs was reversed. In fact, a dynamic growth for the region as a whole was observed since mid-1996 until mid-1998.

Nevertheless, it should be noted that GDP increase comprised a large recovery share; that is, effective GDP was once again close to the production frontier. However, the frontier moved upward slowly, because productive investment was still low, while real exchange rates were retaking an appreciation path. Consequently, as long as productive investment does not increase substantially, that rate of growth was not sustainable. In effect,

[12] Actually, a significant share of inflows was not intermediated directly by financial firms. In the 1970s also about half of bank loans had arrived to Chile to non-financial firms, notwithstanding the lax regulation of domestic banks.

[13] See various interpretations of the Asian crisis in Krugman (1998); Perry and Lederman (1998); Sachs and Radelet (1998); Stiglitz (1998); Wyplosz (1998).

at the beginning of 1998 it was foreseen that the 5.3% growth of 1997 would moderate to around 4%. With the intensification of the Asian crisis and its contagious effects, the effective growth contracted to 2.3% in 1998 (ECLAC, 1999b) and is expected to close near or below zero in 1999.

Additionally, the Asian crisis worsened the terms of trade and the access of Latin American exports. Then the region is experiencing a new significant adjustment. The future will depend on whether the region and the most influential people (i.e. the IFIs and the US) have learned the lesson. There are very mixed signals.

GDP recovery in Argentina and Mexico was particularly vigorous, although after the sharp decline in both countries with the "tequila" effect in 1995, there was a large gap between effective GDP and productive capacity. This enabled a significant reactivation to take place. Nevertheless, in both countries GDP per capita was approaching the levels achieved in 1994 only during 1997, while average wages were still lower in 1998, with Mexico 22% lower than in 1994. Rather than being a consequence of policies adopted in 1995-96, this is the result mostly of policies implemented before the crisis. The following lessons can be derived from them.

1. Level, Composition and Sustainable Uses of Capital Flows

It is important to ensure that inflows are directed to productive investment; allowing too much to drain off into "investment" on the stock exchange and consumption of imported goods will create bubbles and imbalances that would be unsustainable. Additionally, fast rising stocks of external financial liabilities tend to be increasingly dangerous.

Opening up the capital account indiscriminately can be very detrimental to productive development and to the welfare of the majority of people and firms, inasmuch as externalities and other imperfections of international capital markets give rise to frequent cycles of abundance and shortage of external financing (Rodrik, 1998; Wyplosz, 1998). The instability of real interest and exchange rates and of other macroeconomic indicators, that is usually associated with unrestricted openness and capital surges, is always very costly in terms of production and equity. Effective, efficient regulation is possible. By efficient we mean that the allocation of resources via enlarged volume of productive investment and enhanced quality contributes to higher and sustained GDP growth; Chile proved this from 1991 onwards, and Colombia did so during the 1970s as well as in recent years (Urrutia, 1996; Ffrench-Davis and Reisen, 1998).

2. Avoiding Outlier Prices and Ratios

Governments must ensure that capital flows do not generate atypical (outlier) prices or significant distortions of basic macroeconomic indicators, such as interest rates and real exchange rates, the composition of expenditure in terms of consumption and investment, and the production of tradables.

Capital inflows should not be used for achieving an extreme objective related to a single domestic economic variable, such as to anchor inflation, by appreciating the real exchange rate. This tends to throw other major variables off balance. It is risky to remain bound to a fixed nominal rate, and worst to fully dollarise except if our economy is an optimum currency area with the US. Is there anyone in the region? The methods of regulating the exchange rate can be extremely diverse; several of them involve some form of a crawling-band, with some type of intra-marginal intervention (Williamson, 1996).

The recent experience of Latin America has shown dramatically that allowing the market, dominated by agents with short horizons, to determine the volume and composition of capital flows can have a very high cost for the recipient country. This is why the use of regulations on capital inflows should not be neglected *a priori*. On the contrary, the microeconomic costs associated with the use of such instruments should be balanced against the social benefits in terms of macroeconomic stability, investment and growth (Ffrench-Davis and Reisen, 1998; Williamson, 1993; Zahler, 1998).

3. Consistent Sequencing

It is generally agreed that across-the-board opening-up of the capital account has been premature and should have been postponed, moving only in a selective way, until a long-term process in which other major reforms had been consolidated and new equilibrium prices had been established. The lesson to be learned from this experience is that during structural adjustment, with open capital accounts (especially when international financing is abundant), the capital flows can increase too fast and have destabilising macroeconomic and sectoral effects (Edwards, 1989; McKinnon, 1991; Williamson, 1993; Wyplosz, 1998).

In the first place, in the particular case of Latin America, many countries conducted deep trade reforms in the 1990s *pari passu* with exchange rate appreciation. Second, if productive investment capacity reacts slowly and/or with a lag and domestic financial markets remain incomplete and poorly supervised, additional external resources cannot be absorbed effi-

ciently in the domestic economy, and thus they threaten the future stability of the flows themselves. In the third place, fiscal parameters need to be consolidated, since in the absence of a sound tax base and flexible fiscal mechanisms the authorities will have to depend excessively on monetary policy to regulate aggregate demand. Finally, since part of the aggregate demand generated by capital flows is inevitably spent on non-tradable goods, when actual demand comes close to the production frontier, the relative price of non-tradables tends to rise. This in turn is reflected in a higher current account deficit. A real revaluation of the currency can obviously distort the allocation of resources and investment, seriously weakening the structural mid-term objective of penetrating external markets with new exports (ECLAC, 1995; Ffrench-Davis, 1999, ch. III; World Bank, 1998).

4. Flexible Selective Regulation

It is not wise to make an inflexible commitment to indiscriminately keeping the capital account open, particularly in light of the crucial importance of macroeconomic stability, along with the disproportionate volume of the international capital markets compared with the small size of LACs markets, and the serious shortcomings of both markets. As long as market movements depend to a significant extent on short-term transactions and domestic securities markets remain shallow, there will be a risk of great instability in this new modality of linkages with the international economy. In fact, Mexico's, Korea's and Thailand's recent critical experiences attest to the wisdom of discouraging both large financial inflows and the accumulation of short-term external liabilities. There is growing evidence that the greater the instability of flows (or deviation from the trend), the lesser the share directed to productive investment (Uthoff and Titelman, 1998).

Understanding better the working of domestic and international financial markets is at the core of the future of the world economy. More pragmatism and more systematic efforts should be at work.

5. The International Environment

A common factor in recent crises has been the great volatility of the most rapidly growing segment of international financial markets: short-term and speculative funds. Successive waves of over-expansion, followed by financial panic, indicate that the market tends first to overshoot and then to contract more than is justified by the economic fundamentals. These deficiencies are inconsistent with a balanced and efficient globalisation process. More energy is being spent on resolving crises than on avoiding them. It is

to be stressed that while there has been an obvious lack of appropriate prudential regulation of domestic financial markets in most of the Asian and Latin American countries affected by the crises, there has been an even more notorious lack of appropriate international institutions to monitor such a sophisticated, but unstable, financial market.

In times of booming flows, it has been the predominant practice for recipient countries to be encouraged and praised by the international financial institutions and financial specialists to accept all the resources offered. Even, the typical situation has been that gradually the cost of financing has fallen during the boom period; then, actually, the market has operated with a negative sloping mid-term supply of funding. The recriminations concerning the resulting excessive indebtedness have come later, partly from these same sources of praise, in the periods of massive outflows. There is an obvious contradiction between these two attitudes.

The financial operators evidently fulfil a useful microeconomic function as intermediaries between savers and users of funds, as hedgers of risk, and as providers of liquidity. However, in practice, and perhaps without wishing to do so, they have come to play a role that has significant macroeconomic implications. With their ratings (in the case of the agencies) and their expectations made widely known in the economic press (in the case of financial operators), they have contributed to intensify the financial flows towards "successful" countries, thus facilitating continuous rises in financial assets and real estate prices, and sharp exchange rate appreciation in the recipient markets. Apart from the quality exhibited by prudential supervision in these markets, these macroeconomic signals contribute to prolonging a process that appears, wrongly, to be very efficient and sustainable (with good profits and loan guarantees supported by high prices on stock exchanges and low value in domestic currency of debt denominated in dollars). But in reality bubbles are being generated, which sooner or later must burst. When that happens all these signals and the risk ratings are reversed, in a sharp pro-cyclical fashion.

It is a good time to reconsider the international financial order. Contrariwise, it is a bad time to impose additional liberalisation on financial markets, an issue that was being debated in the context of changing the IMF statutes to grant it a mandate in the area of capital account convertibility and of approving a Multilateral Agreement on Investment at the OECD. This would be a grave error. How quickly the harsh lessons of the Mexican crisis were being overlooked and the costly adjustments in the wake of financial upsets viewed with complacency.

In closing this paper, we would like to emphasise that the focus of attention should be the management of booms, rather than the crises, since the latter are, in many respects, the inevitable consequence of badly managed

booms (ECLAC, 1999a). This approach is of the utmost importance, given that the existing institutions and instruments have not been effective in warning of impending turbulence and rather have tended to encourage unsustainable booms. In that framework it becomes particularly relevant to design an appropriate regulatory framework at the domestic level and to adopt national measures aimed at controlling booms before they become unsustainable. Noteworthy among such measures are the reserve requirements on financial inflows that Chile has been using with success in times of capital surges.

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Comment on "The Role of Domestic Policies in Stabilising Capital Flows in Latin America," by Ricardo Ffrench-Davis

Zdeněk Drábek

Let me start with a small observation on Ricardo's paper, which is that neither in the paper nor in his presentation he mentions anything about the recent measures adopted by Chile. I am talking about the lifting of the restrictions on short-term capital movements and certain fiscal policy measures. These measures in fact might be interpreted as measures going very much against the spirit of what has happened in Chile before. So I wonder what your reaction to that is.

My comments concern Ricardo's policy recommendations at the end of the paper, which are rather interesting. Although I am not an expert on Latin America, I am very sympathetic to all of the recommendations with the exception of one: his suggestion that countries should not make inflexible commitments to indiscriminately keeping the capital account open. In other words, the country should be free to move to capital inflow restrictions, if necessary. I have a problem, because conventional wisdom tells us that this is one thing you must avoid in situations where you have already liberalised the capital account, because of the credibility issue. I would therefore only consider the situation of countries that are in the early phases of reform and are considering the liberalisation of the capital account. That I think is the issue for us. And here I come to the basic question: how are countries positioned to do that kind of liberalisation of the capital account? My argument would be that the emerging economies are vulnerable to short-term capital movements and must pay attention to the dangers and risks that emerge in this process. There are at least four risks.

First of all there is a risk of growing a strong debt exposure, which could become excessive, for various reasons. The first reason is that if you have an open capital account there are strong incentives to borrow externally, as we have seen in the Czech Republic. This is because you are normally starting from a situation of higher inflation, which means higher interest rates. Therefore companies are motivated to borrow abroad. The second reason that this risk becomes particularly strong in emerging economies is

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that in the context of stabilisation programmes we normally recommend pegging or some kind of fixing of the exchange rate, which means that the foreign exchange risk to companies becomes very limited. I think the mistake that was committed in the Czech Republic was that the pegging remained just a little bit too long. The third reason is that the emerging countries often find themselves in a situation of competitiveness problems, requiring structural reforms, which take time to implement, whereas capital often doesn't think long-term. If it doesn't see that things are being done, there are strong incentives for capital flight and we have seen that in Russia. The fourth argument why the external debt exposure can increase excessively is, obviously, that there are real needs. Ricardo talked about imports that grow faster than exports; the resulting current account deficits are a normal feature in the case of transition countries.

The second risk is contagion. We have seen that the emerging economies are more vulnerable to problems of contagion. Why does this happen? One factor is the herd instinct of bankers, which means that the Czech Republic is put in the same basket of countries as Hungary and Poland. Another factor is the question of timing. I again take the example of the Czech Republic. The Czech Republic was running into serious difficulties on the external account, starting from 1994, but obviously the investors did not react until 1996, 1997, at a time when other things already happened elsewhere. So in my view, it was again an issue of contagion: a reaction to external events.

A third risk, which is quite self-evident, is that many emerging market economies are macroeconomically more unstable. In many of these countries inflation rates have been higher, balance of payment positions have been weaker, there have been jumps up and down in inflation and there is this question of external debt that should not be forgotten.

The fourth risk which needs attention when countries are considering to open up the capital account is the issue of how it constrains governments to pursue their own macroeconomic policies. For example, some observers are making comments concerning the policies in the Czech Republic and in Hungary, arguing that the convergence towards the European Union is going faster than it should. That is something that policymakers may want to consider as well.

One of Ricardo's recommendations concerns the sequencing of policy items. Proper sequencing is a very important issue which, in my view, has not been adequately considered at a time when many countries were opening capital accounts. Ricardo makes the point that the liberalisation of the capital account should be preceded by a number of policy measures and by institution building. He argues that these are vital requirements for sustainable liberal capital account policies, and I agree. There is a list in

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Ricardo's paper that deserves strong consideration by policymakers. I remember that in the 1980s there was a study at the World Bank on trade liberalisation and one conclusion that came out very strongly was that the capital account liberalisation, judging from the experience of other countries, should come last in the sequence of liberalisation. Unfortunately, this recommendation was largely bypassed.

Let me just conclude by making a footnote. I very much agree with the thrust of Ricardo's policy recommendations, but they concern countries that are already subject to strong pressures of foreign capital inflows. When I talk to officials from Tanzania or anywhere in Africa, their first question always is: 'How do we protect ourselves against excessive capital inflows?'. To me, quite frankly, I find it almost bizarre that African countries and other developing countries are talking about how to control the surges of capital inflows when they hardly have access to foreign capital. It seems to me that the policies suggested in Ricardo's paper are specific to a particular set of circumstances and it would be interesting to know exactly what these circumstances are.

In my view, privatisation in the Czech Republic would never have taken place on the scale that it has without opening of the capital account. Probably in Russia the officials would argue the same. So there are also these circumstances that need to be taken into account. What are the safeguards under those circumstances? I don't know. Similarly, and again somebody already made this point, it may be that foreign direct investments are tied to portfolio investment in some form. Either in the form of confidence building or that portfolio investments become foreign direct investments if investors take larger and longer-term positions.

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Floor Discussion of "National and Regional Responses to the Instability of Financial Markets"

Malaysian Capital Controls

Age Bakker wondered whether Malaysia had taken the necessary reform measures during the period of capital controls. "We have had considerable experience with capital controls in Europe. The argument for these restrictive policies was that they could provide breathing space to implement the necessary reforms. Our experience showed that if you were successful in reforming, the capital inflows increased again when you lifted the controls, because the lifting of controls was viewed as a sign of strength. But when Malaysia lifted capital controls, the outside world did not view it as a sign of strength. Why not?"

Mohamed Ariff responded that Malaysia did not effectively use the period of capital controls to reform. "Unfortunately, the capital controls were seen as an alternative rather than as an opportunity to reform. Some changes have been made, but they were insufficient. Countries under IMF surveillance have done much more in this regard than Malaysia has."

Age Bakker thought it curious that foreign direct investment more or less ceased in Malaysia during the capital controls. "The short-term controls should not affect long-term investments, because the remittance of dividends and equity was still permitted. Does the fact that FDI flows essentially stopped mean that foreign direct investment needs free short-term – as well as long-term – flows, or was the imposition of capital controls seen as a sign of an unattractive investment climate?"

Mohamed Ariff responded that it was not yet clear whether the short-term capital controls had had any effect on long-term investments. "We are not absolutely sure whether short-term capital controls and FDI inflows are totally unrelated. Foreign direct investors said that exchange controls were effective because prior to the exchange controls, they were faced with exchange rate risks. Furthermore, the peg made their products more competitive in the export market. Nonetheless, manufacturing has declined in Malaysia. Manufacturing has also declined in other countries in the region while FDI has gone up. FDI has expanded in Thailand, Indonesia and Korea because certain sectors that used to be closed have been opened, especially the banking sector. So, we are not yet in a position to disentangle the implications of short-term capital controls for long-term

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investments – even though the government says that these two things are very different, and that short-term controls should not affect long-term investments. It will probably take some time before we find some meaningful answers to this."

Export-Led Growth

Mohamed Ariff reacted to Warren Mosler's observation that a discrepancy between a 'good' financial situation and a 'bad' real economy forces us to redefine the performance of the finance. "In Malaysia, there seemed to be virtually no relationship between developments in the real and the financial sphere. The financial sector is doing well and the real sector is not, so something is wrong. For example, stock market performance bears little relation to the behaviour in the real sector. In the second half of 1997, after the crisis, the stock market collapsed by 60 percent while the real sector expanded by 7 percent. Likewise, in the first quarter of 1999, the stock market has appreciated more than threefold, yet the real sector continues to contract. So we need to use caution in interpreting these financial sector indicators as a parameter of the health of the real sector of the economy."

Warren Mosler was critical of Mohammed Ariff's statement that Malaysia needs foreign capital and FDI. "Why do you need these nominal transfers if you are a net exporter of a country, unless you need real imports in order to make your country work? Perhaps you have everything you need internally and it can be organised internally through domestic policy, through local currency policy. Perhaps the need for dollars really is not there. When you borrow external currency, it doesn't matter who the lender country is, you are setting up a short position in that currency. So when Malaysia borrows dollars, it is placing itself in a position of risk because it is getting short of dollars. You have to be sure you have a good reason to do this."

Mosler also criticised the idea that a country should export its way out of a recession. "Recession means a reduction of growth. Exporting your way out of a recession means all of your people are creating products to give to somebody else, while getting nothing in return in terms of the real standard of living. In the case of Malaysia as an exporter of resources, it means that your own resources are being transformed into a product that is sent to foreigners for their material benefit. So when you export your way out of a recession, you have decided to put your people to work for someone else. In a sense, you have become the world's slaves and this is a serious condition."

Mohamed Ariff disagreed and explained why it makes sense for Malaysia to export its way out of the recession. "We need to do this because there is

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an excess capacity of about 30 percent in the manufacturing sector. Most of the industries are producing at 70 percent of their capacity. The domestic economy cannot absorb this excess capacity in the system without additional demand. In fact, in case of the domestic sector, we found that all the sales have picked up in the first quarter, but production is not rising, because they are simply running down the inventories. We must use this excess capacity, and we can do that with an increase in external demand."

John Williamson basically agreed with Warren Mosler's critique of the idea to export your way out of a recession and gave the example of China. "Exporting your way out of a recession depends on the strength of your foreign position. If sending all of your resources abroad is not bringing the necessary liquidity to the country, then it is better to expand at home. China still has a large current account surplus, which does not seem to be eroding, and its exports continue to expand. It has a high level of reserves which yield a modest level of interest income, so why on earth would they pile up more reserves in order to get out of a recession when they appear to have policy instruments that enable them to expand domestic demand?"

Zdeněk Drábek, on the other hand, agreed with Mohamed Ariff that export-led growth would be a sensible policy to follow for both Malaysia and China. "John Williamson made me think about Warren Mosler's earlier comment that free trade is bad under certain circumstances. John, you now seem to argue along with Warren that export-led growth is not good. In the context of Malaysia, it seems to me export-led growth is sensible. I agree that since China is building up current account surpluses, it might make more sense for them to stimulate domestic demand. But this is not a wise policy given the major agenda for economic policy reforms, particularly in the state-enterprise sector. I am not sure that inducing growth of domestic demand would be that helpful in China, and perhaps export-led growth remains a good strategy."

The Asian Miracle

András Hernádi suggested that the high growth rates would not return to the Asian region. "Part of the cause of the crisis was the bubble effect which was closely tied to the bad debts, real estate speculation and other related issues. And since these should be avoided in the future, I believe that prospective growth rates will be lower."

Ariff responded that high growth might return but that double-digit growth figures was neither desirable nor feasible. "Krugman was correct in stating that the high growth was made possible because of an increase of input and not because of productivity improvement, especially in Malaysia. Whenever we were short on capital, we imported capital and the same goes

for labour. We had two million foreign workers in the country working side by side with nine million domestic workers. We simply added more input, and productivity actually declined. In 1997, the total factor productivity was negative, just as it was in 1985. At the Malaysian Institute of Economic Research, we estimated that the optimal growth rate, without straining the balance of payments and resources and without bringing in foreign workers, is about 6 percent. That is a growth that is sustainable in the long run. The nine or ten percent growth that we had in 1995 is probably neither desirable nor feasible."

Barry Herman wondered how to explain the fact that East Asia is a high saving region and nevertheless has a debt problem. "In 1997, gross domestic savings in East Asia were 32 percent of GDP. It appears that the savings go out and then return as capital inflows because the net transfer is not all that large. They go out and then in, rather than being intermediated domestically or within the region."

Ariff explained that the East Asian countries not only have high savings – up to 40 percent of GNP – but even higher investments, reaching 45 percent of GNP. "There is a lot of over-investment going on in the region and the incremental capital output ratio has increased enormously which means that there is a lot of capital inefficiency in the system. This is true for all countries including Korea but especially Malaysia. This is why they borrow. There are additional reasons why Korea borrowed: they preferred to borrow rather than have foreign equity."

Stephany Griffith-Jones said she was somewhat shocked at Mohamed Ariff's comment that the financial crisis came as a blessing in disguise to East Asia. "It sounds a bit Darwinian. Why not do it the Hungarian way, why not have good policies and restructure as György has just told us and implement any changes that may be necessary? These Asian countries had dramatically good performance, particularly South Korea but the others as well, for thirty years. When they did open up, and obviously they did not open the capital account up very well, the problems started. We should be more cautious in suggesting that financial crises are good.

There seems to be a link between the limits that Malaysia placed on outflows and decreases in FDI. In Chile, short-term flows were discouraged on the inflow side, and it has not negatively affected FDI. In fact, FDI has increased in Chile quite significantly – also for other reasons. So maybe it matters whether you control inflows or outflows."

Martin Mayer believed a strong case could be made that the three Asian crises were unrelated. "In Thailand, there was a classic real estate boom plus a lot of banking problems because of the BIBF, which was an undesirable institution in many ways. The Korean crisis was the result of leveraging by the *chaebol* system. The *chaebols* were in fact losing money, but they

did not go bankrupt until everything rapidly deteriorated. In Indonesia there was a heavy element of just plain crookedness. I know of a couple of energy contracts in which there was a take-or-pay provision that was three or four times as much as the market was paying for energy. To the extent that these contracts were spread throughout the society for the benefit of very rich individuals, that country was going to fall of its own weight. Finally, we have Paul Krugman's argument that there was no Asian miracle; it was all a matter of increasing labour inputs and it looked more impressive than it really was."

Mohamed Ariff agreed that the crisis presented itself in different forms. "One had real estate problems, another one had *chaebols* and in the other it was corruption. But all of these point to one thing and that is poor governance: poor corporate governance and poor economic governance."

Hungarian Policies and Contagion

Warren Mosler shifted the discussion to György Szapáry's comment. "When you talk about short-term interest rates jumping in Hungary, it is more a technical than a political question. When you are floating within the band, the interest rate is something that the central bank has to decide on in all cases. For example, when you have excess clearing balances in the banking system, which is a somewhat normal situation, the clearing balances have nowhere to go. Sitting with excess clearing balances is a zero-interest condition in the interbank market, so the central bank will act to offset the operating factors that have led to the excess clearing balances. In the process, an interest rate for money market intervention has to be determined, whatever form that takes. Once you hit the lower band – and if you look at the chart, the jumping of the rates is coincident with hitting the lower band – the clearing balances have a second alternative. The Treasury securities have to compete with the option to convert at the central bank, and the interest rate goes from being determined exogenously by individuals making a decision, to becoming an endogenous function of the market. The spot rate and forward rate differential become the interest rate and a market-driven interest rate results, based on the notion that the market wanted the currency to go down a little further – which is impossible because of the band. So the forward rate goes down to where the market wants it. I am not criticising the policy, my point is that the jump in interest rates was a purely technical issue.

You also talked about 'sterilised intervention'. On the same technical level, I want to oppose this to 'unsterilised intervention', of which I am not sure whether it actually exists. When you are in a floating situation and want to intervene, you might buy a certain quantity of foreign currency in

the market, which I know is not Hungary's policy now. When you buy the foreign currency, you add clearing balances to your member banks' accounts, and if you don't offer some alternative to clearing balances, the interest rate would go to zero. So *unsterilised* intervention would be effectively a zero-interest rate in the money market. If you want to support your interest rate target, be it 15 percent or whatever, any intervention implies sterilisation. So I would suggest that because you don't generally want a zero-interest rate, all intervention is going to be *sterilised* intervention. There really is no distinction between sterilised and unsterilised intervention, apart from the zero-interest rate condition which was obviously not what you were trying to do.

You also argued that the sterilised intervention was to keep the excess liquidity from creating inflation. Again, I think the situation here is a technical and not an economic event. The difference in liquidity is the point. You have given the clearing balance an alternative, by offering a repo or a government security or some place to park a separate account. A repo is a interest bearing separate account at the central bank rather than a clearing balance which is not interest bearing. The asset remains, the agent that had the clearing balance now has a clearing balance that pays interest, which you can call a repo or a Treasury bill or whatever you want to call it. His net worth has not changed, his ability to spend has not changed, so there is no economic effect."

Bill White strongly disagreed with Warren Mosler. "When you get capital inflows of this sort, and the central bank intervenes and builds up excess reserves in the domestic banking system, the interest rate does not automatically go to zero. There is an increase in the supply function and there is a demand function for excess reserves. That demand function for excess reserves may or may not be interest elastic. The real worry that we face at that moment, if we go back to a Keynesian view of the world, is that the demand function for excess reserves may be highly inelastic and you cannot get the interest rates down at all. This is essentially what is going on in Japan where they continue to pump reserves into the system and the banks are prepared to sit on them. When the interest rate does go down, it makes them even more willing to sit on them because the opportunity costs are very low."

John Williamson said he was delighted about the good performance of the Hungarian crawling peg. "It is interesting to hear that the crawling peg resulted in lower interest rates for a long period of time, while the movement towards a floating rate resulted in interest rates getting higher and higher. This is not what the conventional wisdom is at the moment. But the qualifications György sets are absolutely right. This system is fairly

demanding in terms of the policy decisions that go along with it. Simply adopting an exchange rate regime of this type, without doing the other things, gets you nowhere at all.

I also found the examples of contagion quite striking. Anyone who thinks that there is no such thing as contagion should try to explain what caused the Hungarian stock market to fall by 40 percent when Russia got into trouble, when there is only six percent of trade with Russia. What is that if not contagion! However, I would be interested to hear your insights on the domestic causes of the decline in the stock market. If there was no domestic cause, one might have expected it to have recovered, which it has not done."

Elemér Terták related that before the Russian crisis, he and other Hungarian bankers believed that fundamentals would have a much larger impact on price development in the stock exchange than actually occurred. "But the figures that Mr. Szapáry presented clearly show that outside effects were more influential than we thought. The Russian shock made some feel that Hungary could be harmed much more than it was in reality.

Another reason why Hungarian stock market prices fell is that the Hungarian stock exchange was much more liquid than the Czech and the Polish markets. In the Czech Republic and Poland, it was more difficult to close the position and sell the shares. This is why price fluctuations in the stock exchanges of these two countries were not so great."

In his reply, György Szapáry agreed with Warren Mosler that sterilised intervention kept interest rates higher – "that was the policy because we did not want domestic demand to increase" – but stressed that it was interesting that after the Russian crisis, interest rates went up to the level of Poland and Czech Republic and remained there. "And that brings in John's question which is that it is not like conventional wisdom that you have a fixed exchange rate together with lower interest rates, and a floating exchange rate together with higher real interest rates. Well, this is the nature, I believe, of fickle capital. Such capital comes in for a short period of time, even if investors buy long-term paper, because with the repos it is short-term from one week to maybe nine months or so. And since there is less risk that the exchange rate would depreciate with a fixed rate or narrow band than with free floating, a smaller risk premium is required. So this fickle capital came in. Now, why did it then go back to Poland and remain there after the Russian crisis? It is like the Kosovo crisis and tourism in Hungary. The war is in Kosovo and thousands of Western tourists cancel their tours to Hungary. It's contagion.

On the stock exchanges, Mr. Terták mentioned that large price fluctuations arose because Hungary was more liquid, it was easier to sell. But after

the Russian crisis there were withdrawals all over the world. In the United States, fund managers told me that their final investors wanted cash and that when they started to sell, they first sold in the more dangerous markets, like Hungary. Also, the Hungarian investors had become more cautious. They only had seen stock prices going up and they suddenly realised that they could also go down. So some of that money did not return, and we saw deposits in the banking system rise very sharply. Some of these people went back to more conservative forms of saving.

The interesting thing that emerges from this experience is that contagion exists. In other words, you are far away from all these crisis countries, or you have weak trade links, like Hungary has with Russia, but you still get all of these ups and downs. We even had the same impact when Brazil depreciated – it was not as strong as in the Russian case, but it happened all the same."

Chilean Capital Controls

Discussing Ricardo Ffrench-Davis' paper, Stephany Griffith-Jones wondered why short-term capital flows were more successfully discouraged in Chile than in Hungary and the Czech Republic. "They have tried to discourage short-term flows, but the central banks say that they are not very successful because these flows feed upon each other. This does not seem to happen in Chile and I wonder why. Is it because the mechanisms were applied better in Chile, or were there certain peculiarities that made it possible?"

Roger Nord questioned the success of Chilean capital controls and referred to econometric studies claiming that these controls were not effective. "There has been a growing body of literature suggesting that the Chilean controls were ineffective in doing what they were set out to do. If you submit the impact on the size of capital flows, the impact on interest rates and the impact on the current account to rigorous econometrics, you find very little support for their effectiveness.

Since Chile didn't have a crisis while the rest of Latin America did, you start to look at what was different in Chile. When you find that they had controls on short-term capital, *ergo* they must have been effective. But in fact, it is quite possible that there are many other reasons why Chile did not have a crisis, and the strength of the banking system is certainly one of them. The clean-up that they were able to undertake in the 1980s in the banking system gave Chile a very strong starting position. So were the capital controls in Chile as effective as they are often touted to be? It is rather interesting that Chile actually abandoned these controls last year by setting them to zero."

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John Williamson was unimpressed by research claiming that the Chilean controls were ineffective. "So far I have only seen one of these papers claiming that Chilean capital controls didn't work, and it was one of the worst papers I have read for a long time. The authors made three fundamental errors. One was that capital controls don't work because Chile has had a higher interest rate because of its capital controls. This is preposterous since that was the purpose of those controls. The second was that because Chile did not have a lower interest rate, it did not get more investment, so it had lower growth. The authors never faced the question of where these resources were supposed to come from to permit this extra investment. They suggested that Chile would have had extra growth if only it had not choked off this investment. This is nonsense because they did not look at the macroeconomic situation. The third error is that there was no determined impact of the capital controls on the capital inflow because there was no capital inflow in the earlier period, and as a result the Chileans were paying less debt service. This tended to strengthen their current account through a lower stock of foreign investment and so they argued that the impact was theoretically undetermined. But even if this is true, it is not really relevant because the question is: can you keep the exchange rate depreciated relative to its fundamental equilibrium level? To say that the fundamental level may be a bit more appreciated because of this stock accumulation effect seems to me irrelevant. In short, I was profoundly unimpressed by this paper from a recent World Bank, IMF, WTO conference."

Ricardo Ffrench-Davis stressed that a policy tool like the regulation of short-term capital flows should be used in a flexible manner. "It is a bad signal to say, 'Now everything is free', and after two or three years to reintroduce restrictions. It is better to tell the market, 'We will reintroduce them when it is necessary'. The management of capital flows in Chile has been effective because it has been clear and friendly for the markets."

Jack Boorman shared John Williamson's position on the Chilean capital controls. "There seems to be some body of evidence that it reduced the short end and lengthened the maturity overall of a flow of resources. Maybe that wasn't any different than it would have been otherwise, but it was more stable."

John Williamson asked Jack Boorman whether the Fund would be likely to use its power to encourage other countries to adopt the same kind of controls that Chile has adopted.

Boorman responded that attitudes on capital controls are changing, also within the Fund. "The community broadly has learned an awful lot over the last five years about what is sensible in capital controls. But most importantly the policy community, and perhaps the economic profession,

is learning what was unlearned in the 1950s and 1960s when historians and institutional social scientists got relegated down to the small offices at the end of the hallway in universities, and the mathematicians and the econometricians, which I confess I was one, took over. We are currently witnessing a reassessment of the institutional requirements of a capitalist market economy, and that is really to the good. That is what this work on standards is about. The conclusion is that if you are going to liberalise your financial markets, you had better have a domestic financial system that is up to the confrontation with those international markets. Because if you don't, you are going to have problems similar to those of Asia. The combination of Chile's experience with capital controls, and just as important, the need for an absolutely robust domestic financial system, suggests that individuals pressing for liberalisation in a country's capital markets are under some burden to prove that these institutional prerequisites are in place. The Fund is a good place to do that under a jurisdictional authority with an amendment to its Articles."

Peru, Mexico and the Lessons from Asia's Crisis

John Williamson wondered why the performances of Chile and Peru were so different. "Ricardo set himself an easy task in contrasting Chile with Mexico because we know that Mexico made big mistakes and performed terribly. A much more interesting comparison that I would like to see him make in his next paper is between Chile and its neighbour Peru. They are quite similar economies: dependence on mineral exports, contiguous, similar in size. And in the developing world, it is perhaps the best example of a country which has now been operating a floating exchange rate for long enough to start drawing some conclusions.

Around 1995-96 I remember hearing that Peru was guaranteed a ten percent growth rate for the rest of the decade and it has not happened. Is it because its tradable sector didn't get the investment it needed in order to sustain a balanced growth rate? If so, that would be a story worth telling. And if not, let us know about it. If it turns out after all that a floating exchange rate is just as good and that all my worries about the impossibility of sustaining a high growth rate with a floating exchange rate for a long period are wrong, than I'd better know it."

Ricardo Ffrench-Davis agreed that Peru would be interesting. "Peru hasn't been examined much. Stephany has taken an initial look at capital flows in Peru. Capital formation is intensive in real estate and low in the non-real estate, non-building component. It is not a capital goods producing country and the import of capital goods is notably small. If it is true that productivity changes are associated with the import of capital goods,

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there is no basis for sustainable economic growth. Over the last twelve years, actual economic growth in Peru has shown ups and downs with a moderate average. But Peru's exchange rate experience is indeed interesting. It is important to manage flexibility and they have moved in that direction in Peru."

Ariel Buira agreed with the thrust of the recommendations made by Ricardo Ffrench-Davis in his paper and added a footnote on the Mexican case. "It is not my intention to defend the Mexican policies. It was a risky bet, we put ourselves into what Ricardo calls a 'vulnerability zone', and it went wrong. But, it went wrong mostly for non-economic reasons, and the mistake was making ourselves vulnerable. Now, on the obvious mistake that appears from the paper, I would make a little qualification. There is absolutely no question that there was a very significant appreciation of the exchange rate in the early 1990s. In the paper it is compared with the period 1987-90 and that gives an appreciation of thirty percent or so in the nominal exchange rate. But I would like to point out one or two things about the 1987-90 period.

In 1986 we had an oil shock and we lost about 5 or 6 percent of GDP and the government lost something like 40 percent of its tax revenues. This led the central bank to devalue so fast that despite the loss in terms of trade, we ended the year with higher reserves than we started with – we over-devalued. The following year, there was a stock market crash and we devalued again, having a surplus on the current account. So we started with a very substantially over-depreciated currency. The reference point is such that the labour costs in the following years lagged behind because there was a period of inflation and unit labour costs rose marginally. So I don't think this was a very clear case of overvaluation. All kinds of other things went wrong, but I don't think this was the main one.

If the currency appreciates and you have a large current account deficit, there is a tendency to say that you are overvalued. But I don't think it is that simple. You can have a large current account deficit without being overvalued. This is the case in the US for instance. If you look at relative prices, by and large the prices in the US are lower than in Western Europe. But this basically reflects an imbalance between savings and investment. As a first approximation it is best to look at it in these terms, though you can elaborate it and go beyond this.

In Mexico, we clearly ran into all kinds of other problems. By all accounts, the restructuring of the foreign debt in 1989 was – in arithmetic terms – insufficient to provide the required debt relief, but the psychological impact generated huge inflows. Confidence was the name of the game, also with NAFTA. And this game of confidence was expected to insure the soft landing. We had an administration that made several high risk bets

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and succeeded. In the end, confidence burst as a result of a number of political shocks. Of course, in retrospect it is clear that you should not have taken such risks, because they were devastating ."

Ricardo Ffrench-Davis observed that in 1997, with the outbreak of crisis in Asia, the world was in a very dangerous position. "The world was being pushed in what we now believe to be the wrong direction. The events in Asia at least have one positive by-product, which is that they introduced pragmatism. Or as Jack Boorman says, there has been a lot of learning about proper economic policies, so that the world now moves more cautiously in these very sensitive areas which can lead to crises."

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