International Financial System Reform: Lessons From The 1997-8 East Asian Crises

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This paper seeks to offer a vision of alternative international financial institutions more conducive to and facilitative of late industrialization and development more generally by drawing upon the recent experience of East Asia, especially Southeast Asia. The next section will critically review the East Asian crises of 1997-8 as well as some aspects of the ensuing institutional and policy debate which led temporarily to some rhetoric on reforming the international financial architecture, the establishment of the Financial Stability Forum as well as other initiatives to address issu

m the 1997-8 East Asian Crisis

In the wake of the Mexican crisis in early 1995, even the IMF stepped back momentarily from its earlier post-Bretton Woods advocacy of virtually unfettered financial liberalization. Unfortunately, the short-termism of financial markets extends to human and institutional memories as well as to related policy making and advocacy. The recent crises[1] have also seen 'market corrections' 'overshooting' well in excess of alleged 'misalignments' many times over. Further evidence of market-induced anarchy can be found in the 'herd behaviour' underlying so-called 'contagion' or 'domino' effects. While affected government and economies have been badly affected by the crisis since mid-1997, there is little evidence that the private sector culprits have suffered most as a consequence.

Perceiving the Southeast Asian region as much more integrated than it actually is (e.g. in terms of trade links excluding Singapore, the regional entrepôt), the panicky investment decisions of fund managers, often based outside the region — e.g. in Wall Street or the City of London — have often been 'herd-like,'[2] causing 'contagion' or 'domino' effects throughout the region. The

s BoP) se s nd 2 5b a k king rise s during the period 1970-95, there were only three banking crises associated with the 25 balance of payments crises during 1970-79. However, there were 22 banking crises -- which coincided with 46 payments crises -- over 1980-95, which they attribute to financial liberalization from the 1980s, with private lending booms culminating in bank

very logic and magnitude of hedge fund operations[3] have tended to exacerbate these phenomena, with disastrous snowballing consequences for the region and beyond. Other international, regional and, increasingly, local currency speculators and hedgers

have also been responsible, but mainly by reacting in their own self-interest to perceived market trends[4].

There is little point in arguing that the crisis should not have happened since East Asian economic fundamentals were fine, even if that were true (for a nuanced contrarian position, see Jomo ed. 2001: chapter 2). In some instances, such denial exacerbated the problem as authorities did not recognize and respond to problems with any great sense of urgency. Unfortunately, as East Asia has painfully learnt, financial markets are driven by sentiments more than by fundamentals. Hence, although much more serious current account deficits elsewhere have not always resulted in crisis, it does not mean that an economy can maintain such deficits indefinitely without being vulnerable to speculative attacks or loss of confidence due to circumstantial factors.

One cannot, for example, liberalize the capital account, and then complain when short-term portfolio investors suddenly withdraw due to their whims and fancies. As is well known, even Chile, once the darling of the Chicago monetarists, has long made it difficult — and costly — to rapidly withdraw capital from its economy, and treats foreign direct investment very differently from portfolio investment. Some authorities try to distinguish between portfolio investments that are simply short-termist from, say, pension funds with a more medium-term orientation. Financial liberalization means investors have a choice as to when they come and go[5].

In the decade before 1997, the crisis-affected East Asian economies, especially those which sought and received IMF emergency credit, became excessively reliant on such short-term capital inflows to finance their current account deficits. This problem was exacerbated by excessive imports to make more non-exportables such as buildings and infrastructure. Ostensibly prudent financial institutions often preferred to lend for real property and stock purchases, and thus secure assets with rising values as collateral, rather than to provide credit for more productive purposes.

While foreign banks were happy to lend US dollars at higher interest rates than available elsewhere, Southeast Asian banks and businesses were keen to borrow at lower interest rates than available domestically. The costs of hedging — a hundred basis points or so for ringgit-dollar, a few hundred for baht-dollar or rupiah-dollar — now look cheap in hindsight, but were avoided by borrowers to maximize their rentier margins as they generally expected their central banks to defend their currencies' unofficial pegs to the US dollar. The existence of a well-developed swap market allowed some Southeast Asian companies to tap into foreign capital markets, at reasonable cost, by swapping away currency risk. Hence, the problem was ultimately one of greed: the combination of lower foreign interest rates and seemingly fixed exchange rates caused most foreign exchange borrowers to gamble without prudently hedging.

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[3] Hedge funds may, however, go in different directions, for instance, when one fund's currency sell-off provokes another fund to snap up bargain equities, e.g. foreigners were often persistent net buyers of Japanese stocks throughout the bursting of the bubble there in the 1990s.

[4] Rather than as part of some grand conspiracy.

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Hence, most such loans remained un-hedged as the Southeast Asian currencies seemed pegged to the US dollar since the mid-eighties' devaluations despite official ficti

Although the financial systems in the region are quite varied (often reflecting colonial as well as post-colonial legacies and other influences) and are hardly clones of the Japanese 'main bank' system, as often wrongly alleged, they have nevertheless become prone to similar financial-property 'bubble' phenomena, albeit for somewhat different reasons. Arguably, the more bank-based systems of Thailand, Korea and Indonesia had stronger nexus of this sort compared to, say, Malaysia's much more stock market oriented financial system[7]. With the currency collapses, the assets acquired by short-term portfolio and other investors in the region depreciated sharply in value, precipitating an even greater sell-out and panic, causing herd behaviour and contagion to spread across national borders to the rest of the region. Further property market and stock market collapses followed due to earlier uncoordinated over-building and the property-finance nexus as well as the consequent liquidity squeeze. Thus, financial interests were generally badly hit by this 'triple whammy' from the currency, stock and property markets.

The higher interest rates demanded by the financial markets in 1998 added salt to the wound, but had limited success in attracting short-term capital inflows once again. But even when higher interest rates succeed in doing so, such flows can only be temporarily sustained and retained, at great and permanent cost to productive investments in the real economy so important for realizing economic growth and development. And when inflows are eventually reversed in the precipitous manner experienced by East Asia from the second half of 1997, much collateral damage to the real economy can be expected – as with the region-wide recession of 1998.

As a consequence of these developments associated with external financial liberalization, Southeast Asia has faced four major domestic policy reform challenges, namely greater exchange rate flexibility, the urgency of financial sector reform, as well as handling asset-price bubbles and current account deficits. Without the advanced economies stabilizing exchange rates with regards to one another, the virtual or quasi-pegging of a developing economy's foreign exchange rate had clearly become very dangerous, as the crisis demonstrated. The continued large movements among the US dollar, the Euro and the Japanese yen threaten the monetary stability desired by countries unofficially pegging their currencies against any one currency, invariably the US dollar except for most former French colonies.

Also, though short-term capital inflows may temporarily supplement domestic savings, the reversal of such flows can create severe disturbances. While such flows may be influenced by economic fundamentals in the long term, they are usually determined by speculative sentiments in the short term. Short-term exchange rate adjustments — with disruptive consequences for domestic prices and wages — are then deemed necessary to stem sudden outflows, but these, in turn, offer opportunities for currency speculators.

Financial sector reform has to be thought of, not primarily with a view towards further liberalization, as usually encouraged, if not insisted upon by international financial interests, but instead, in terms of the prudential regulation needed to anticipate and respond to new challenges. While the problems caused by excessive as well as inappropriate regulation are often emphasized by advocates of liberalization, liberal banking policies have resulted in weak domestic banking sectors[8] unable to withstand competition from abroad, and even the collapse or costly bail-out of weak banks. For most developing economies, policies of 'financial restraint' are still needed to

[7] Rapid growth, on the basis of export-oriented industrialization from the late 1980s, gave rise to unregulated financial expansion, which contributed to a property boom and asset price bubbles, both in the more market-oriented or 'Anglo-Saxon' Malaysia as well as the more bank-oriented Thailand.

[8] As in Chile in the early 1980s.

‘direct’ credit[9] to finance productive investments, especially in priority areas — instead of, say, asset acquisition or consumption purchases (Chin and Jomo 2001).

Recent trends involving greater capital account convertibility, innovative financial

The currency and financial crises in Southeast Asia suggest that the region's economic miracl

a) the absence of the usual sources of currency stress, whether fiscal deficits or macroeconomic indiscipline:[14]
b) the governments did not have any incentive to abandon their pegged exchange rates, e.g. to reduce unemployment;
c) the pronounced boom-bust cycles in asset prices (real property and stock markets) preceded the currency crisis, especially in Thailand, where the crisis began;

more than forty times the value of all international trade (including 'invisibles' or services).[16] Viewed from a historical perspective then, such currency trading is hardly natural, inevitable or even desirable[17].

An explosion of international financial flows has followed the substitution of the Bretton Woods system of fixed exchange rates with a new system of flexible exchange rates. Strong speculative motives can generally be ascribed to most such international capital flows. However, the abandonment of fixed exchange rates has also been associated with a retreat from capital controls -- which was the international norm before the seventies -- permitting many investors to diversify to their advantage. In any case, the trend picked up momentum from the 1980s, leading to a US$1250 billion daily foreign exchange market by 1997, and the proliferation of new financial instruments.

With foreign exchange spot transactions now worth so much more than the total value of international commodity trade transactions, the financial sector has become increasingly divorced from the real economy. With the recent proliferation of new financial instruments and markets, the financial sector has an even greater potential to inflict damage on the real economy. Ever since Lord Keynes advocated 'throwing sand' into the financial system to check the potentially disastrous consequences of unfettered liberalization, Keynesians — and others — have been wary of the financial liberalization advocated by ideological neo-liberals and their often naïve allies. But the lobby for financial liberalization remains much stronger and far more influential, dominating most of the business media and the key financial institutions internationally, especially in the US. More importantly, many of the alleged benefits of financial liberalization have not been realized, as the following summary of findings by Eatwell (1997) shows.

a) Financial liberalization was expected to move resources from capital-rich to capital-poor countries,[18] when, in fact, net flows of finance — and of real resources — have been very modest, and mainly toward the capital-rich.[19] Of course, until the 1997 crises, most net flows to the 'capital-poor' were mainly to 'emerging markets' in East Asia – which, arguably, contributed to

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[16] Since trade-related currency trading is greatly exceeded by 'investment'-related currency trading, it is not surprising that the volume of currency trading is so large. One key question is how much of those investment-related trades are 'healthy', 'appropriate', or 'desirable', which is hard to determine. International investors want to hedge their personal income and wealth by spreading their investments across many countries and adjusting them quite frequently as conditions change, thus contributing to market volatility. e

asset price bubbles and, eventually, to financial panic as well as currency and stock market collapse.

b) While liberalization was expected to enhance opportunities for savers and lower costs to borrowers, savers have benefited most from higher real interest rates.[20]

c) The new financial derivatives — expected to improve risk management — have actually generated new systemic risks, especially vulnerable to sudden changes in sentiment.[21]

d) Improved macro-economic performance — with greater investment and growth expected from better allocative efficiency — has not been realized; in fact, overall macroeconomic performance has been worse than before liberalization.[22]

e) Financial liberalization has introduced a persistent deflationary bias on economic policy as governments try to gain credibility to avert destabilizing capital flows, instead of the supposedly 'healthy discipline' on governments which was expected to improve macroeconomic stability.

Financial markets seem to function in such a way as to impose their own 'expectations' on the real economy, thus defining their own 'fundamentals' and logic, which in turn become self-fulfilling prophecies. In other words, they do not just process information in order to efficiently allocate resources. Since financial markets operate like Keynes' 'beauty contests' and the real economy has no automatic tendency to converge to full-employment growth, the presumptions of market participants are imposed on the economy.

The threat of instability in the now massive capital market forces both government and private investors to pursue risk-averse strategies, resulting in lower growth and employment creation. A deflationary bias in government policy and the private sector emerges in response to the costly risks of violating the rules of the game. This is exacerbated by the high costs of debt due to high real interest rates owing to efforts to maintain financial stability in a potentially volatile world. Thus, 'long term price stability' supersedes a 'high and stable level of employment' as the policy priorit(em)Tj10.98 0 0 10.9e policn sT(em)Tj10.98 0 0 dj10.98 0 0 10.98 245.1679

The benefits that the deregulation of financial controls have brought to 'emerging markets' must therefore be weighed against increased instability due to enhanced ease of exit. While increased flows of (real) foreign direct investment generally require agreement to unrestricted profit repatriation, this is quite different – with different implications -- from the 'instant exit' conditions demanded by financial markets.[24]

There is considerable evidence that, in the longer term, most post-war economic development has been associated with developmental states. Also, the post-war Golden Age — which saw high levels of output and employment as well as short-run efficiency — was premised on active macroeconomic management under the Bretton Woods system. Post-war European reconstruction was achieved with tight capital controls. On the other hand, the recent rush to convertibility and capital control deregulation in Eastern Europe has resulted in Russia becoming a significant net capital exporter![25]

Some dangers associated with financial liberalization have now become quite evident, but most are not sufficiently recognized in the public discourse surrounding the subject, let alone debated and addressed. Most initiatives in this regard cannot be undertaken unilaterally without great cost[26]. The very few options available for unilateral initiatives need to be carefully considered, and only implemented if deemed desirable on balance. Selectively invoking instances of bad or incompetent policy making or implementation does not justify leaving things to liberalized markets that render systematic policy-making impossible. Instead, such instances emphasize the importance of creating an environment and developing the capability for good and competent policy to be effective.

Many need to be actively pursued through multilateral initiatives, for which governments usually need the support of regional neighbours and others sympathetic. Given the power of the dominant ideology about the international financial system, it is virtually impossible to assert control over the financial system without a fundamental change in priorities and thinking by the major governments involved. The currencies of a small number of major governments — the US, Japan, Germany and the UK — were involved in over three-quarters of currency transactions in 1995. Thus, acting together, they have the capability to control capital flows.

International Reform?

Liberalization should not be allowed to frustrate the sound development of the financial system and improvements in the productivity of investment. As we have seen, sound macroeconomic fundamentals do not guarantee immunity from contagion and crisis. The scope for monetary independence partly depends on the soundness of macroeconomic management as well as political will.

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24 Of course, liquidity is one of the features that induces otherwise risk averse investors to buy into a situation. Furthermore, in any transaction, there is a buyer for every seller.

25 Of course, capital flight is not an inevitable consequence of financial liberalization, but may reflect the fears and consequent hedging behaviour of locals.

26 As market and other reactions to Malaysian Prime Minister Mahathir's critical remarks about the international financial system made clear.

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countries via 24 ministers — gave the IMF a mandate to alter its Articles of Association so that it would have additional 'jurisdiction' over th

also to stem, let alone reverse the situation despite interventions in Thailand, Indonesia and Korea — have certainly not inspired much confidence. Nor has the fact that though the Philippines had long been under an IMF programme, it was not spared the contagion.[28]

The Fund did not seem to be sufficiently cognizant of the subjective elements contributing

US banks and other investors to take advantage of the situation seem to have influenced this change of stance.

Almost in tandem with financial liberalization, IMF intervention is generally recognized to undermine and limit national economic sovereignty.[30] Particularly damning is the clear abuse of imposed IMF conditionalities in the Korean aid package to resolve outstanding bilateral issues in favour of the US and Japanese interests (Cho.78(inCLs.7T/TT3 1 T6 304.2602 632.dowskrticularly)Tj10.98 0

Korean economy to do with the crisis or its immediate causes — were forced

institutional features that had ma possible the Korean econom miracle since the 1960s.

International Financial Arch ture[31]

Current proposals for reform of international financial governance include the call for a new international institution such as a World Financial Organization (WFO) proposed by he UN's Economic and Social Committee (ECOSOC) a World Financial Authority (WFA) proposed by nce Tay Such a proposal would need to revisit ma ng considerations and rationale for Keynes' original Bretton Woods proposals in 1944 as well as the many portant lessons from subsequent post-war experience as well as the new challenges raised by recent and proposed measures for further international financial liberalization.

establish a permanent United Nations Conference on Finance and Development in conjunction with the 2002 UN conference on 'Financing for Develop ent' to be held in Mexico. A comp m se proposal woul rrent mandate of UNCTAD to include finance issues more sy atically already ng some logistical and other support for the increasingly and marginalized Washington-based G24 on International Monetary d Financial Issues. To be more eff e, however, UNCTAD's earlier greater role and infl d supporting the developing countries has to be restored. An even weaker option would be a forum on the same theme comparabl to the Financial Stability um set up after l financial crises in 1997-8.

Related to the WFO/WFA proposal, but not necessarily under the same roof, is the need to establish a new international bankruptcy nsolvency echanism. For guidance, most current suggestions refer to the US Bankruptcy corporations, though others point to the greater appropriateness of the chapter for municipal authorities. There have also been calls for some new arbitration mechanism outside of existing institutions to resolve the range of new problems

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[30] However, invoking 'national economic sovereignty' may become very dubious when it is clearly hijacked by

Taking advantage of Korean vulnerability anese banks also insisted that the Korean

emerging. Most such calls expect these new institutions to be representative and transparent.

The capacity of the Bretton Woods institutions to respond effectively and appropriately to developmental needs and emergency financing requirements has been subject to much criticism. One important criticism has been a tendency of these institutions to adopt universalistic criteria and solutions in their dealings. Hence, there is now a greater appreciation of and desire for similar institutions at the regional and sub-regional levels. While such arrangements and institutions will undoubtedly bring about some duplication, if not ambiguity, they will also introduce some desirable competition. The IMF, in particular, seems to have resisted such plurality, e.g. the Japanese government's Asian monetary facility proposal of the third quarter of 1997.

New institutional initiatives and roles in crisis management have been increasingly

with developing country claims for better representation. Since then, however, the issue has received little attention. Jadhav (2000) has shown how the origins of the Bretton Woods institutions as well as the quota system as well as various historical accidents have resulted in a heavily biased system of voting rights which are unlikely to serve developing country interests unless radically restructured to, among other things, significantly increase developing country seats on the Board besides fundamental quota reform, which is likely to be very difficult to achieve. ha1 Tl accidents

Managing Director announced that countries would no longer be subject to policy conditionalities. Instead, governments would be presented by the IMF staff with various policy options to choose from. One might add that program design should also include discussion of the likely socio-economic implications of different policy options. However, there is no evidence that this has become IMF policy and cynics suspect that this was a sop to defuse protests.

Crisis Prevention

As noted above, recent trends in the IMF and the WTO after the East Asian crises began are unlikely to make prevention of future crises any easier. By insisting on opening the capital account and allowing unrestricted freedom for trans-border movements of funds, it becomes difficult not only to have measures to prevent financial crises, but also to introduce effective financial safety nets at the national level.

Soon after the East Asian crises, there seemed to be widespread agreement that *short-term capital flows need to be regulated.* But while developing countries currently have the right to control short-term capital flows, the lack of international endorsement for such measures serves as a major deterrent for those considering their introduction.

Developing countries are currently being encouraged to either fix (through a currency board system or even dollarization[36]) or freely float their currencies, but are being discouraged from considering intermediate alternatives. However, studies have shown that a float system is associated with the same degree of volatility as a fixed system (Akyuz 2000a; 2000b), with the principal difference between the two being that of how external shocks work themselves out. Countries should be allowed to choose their own exchange rate regime, which should not be imposed as an IMF conditionality, for instance.

Since the East Asian crisis, the international discussion on international financial reform to prevent future crises has emphasized questions of transparency and greater supply of

for the stability of their own currencies as well as other currencies in the world today. Despite frequent G7 meetings, existing arrangements leave much to be desired. Consequently, there are fluctuations of up to 20 per cent within a week. The effects of such huge swings on smaller open economies are not well understood, though they are expected to simp

of capital controls, which may be introduced for various reasons. The effects of specific controls may change over time and could become quite different from what may have been intended. The major reasons advanced for the introduction of capital controls have included the following:

1. Achieve greater leeway for monetary policy, e.g. to reflate the economy.
2. Enhance macroeconomic stability by limiting potentially volatile capital inflows.
3. Secure exchange rate stability, e. g. protect a fixed exchange rate or peg.
4. Correct international payments imbalances, both deficits and surpluses.
5. Avoid inflation due to excessive inflows.
6. Avoid real currency appreciation due to monetary expansion.
7. Reduce financial instability by changing the composition of -- or limiting -- capital inflows.
8. Restrict foreign ownership of domestic assets, which might cause nationalistic resentment.
9. Ensure the domestic utilization of national savings by restricting outflows.
10. Enable governments to allocate credit domestically without risking capital flight.
11. Enable domestic financial houses to attain scale economies in order to better compete internationally.
12. Facilitate revenue generation, particularly taxation of wealth and interest income; by allowing higher inflation, more revenue can be generated.

Capital controls may well be the most acceptable alternative to the destabilizing effects of capital flows on inadequately regulated financial systems characteristic of developing economies. Effective regulation may be comprom

1. Taxes versus quantitative controls: Taxes rely on price or market mechanisms to deter certain types of flows. Such taxes may be on certain types of transactions or returns to foreign investment, or may even involve mandatory reserve requirements, which raise the cost

James Tobin has called for a tax on foreign exchange spot transactions to enable more independent national monetary policy, discourage speculative capital movements, and increase the relative weight of long-term economic fundamentals against more short-termist and speculative considerations. As a bonus, the tax collected would also more than adequately fund the United Nations system and programmes, not leaving it hostage to the whims of US leadership, as has long been the case. Another Nobel Laureate, Lawrence Klein has mentioned two other options to be considered besides *the Tobin tax, namely regional monetary arrangements* as well as the introduction of *'circuit-breakers'* into the system — a suggestion also made by the World Bank's then Senior Vice President and Chief Economist, Joseph Stiglitz.

likely to get better terms in a bankruptcy court.
The new finance went to the creditors, instead of supporting the debtor.

Unlike the seventies, when developing country solidarity ensured effective voice and a number of reforms which promised to advance their interests such as the New International Economic Order, the Global Common Funds and so on, their increasingly divergent interests – real as well as imagined – have been a major stumbling block to more effective collective action to reprioritize development and its implications for the international financial architecture debate. Some major sources of divisions include:

- conditionalities: middle-income countries have been much less willing to accept and more i899e 0 0 10.98 389.89k

adequate counter-cyclical financing, e.g. for social safety nets during crises[41] (Ocampo 2000). Instead of current arrangements which tend to privilege foreign creditors, new procedures and mechanisms are needed to ensure that they too share responsibility for the consequences of their lending practices.

Third, the agenda for international financial reform needs to go be 396.1456 684.5401 Tm

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