

# CAPITAL LIBERALIZATION AND FALL OF EAST-ASIAN ECONOMIES

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The main factors identified for the collapse of East-Asian economies were capital liberalization, deregulation of the control of the domestic financial system, vast international inflows of financial assets, and the deep structure of domestic debt. Among these factors, capital liberalization without a framework of regulation was the root cause of their fall.

East-Asian economies were often considered as miracle economies because of a sustained high rate of economic growth during the last two decades. These countries enjoyed a high degree of trade orientation, high savings and investment rates and good macro-economic management. They adopted relatively free market, free trade, open capital account and other liberalized policies to attract foreign investment. Their manufacturing exports constituted a large proportion of their total exports. Their share of exports of GDP ranged between 30 per cent to 85 per cent, during 1991-1996.

The organization of the paper is that a brief review is given in section 2. Section 3 analyses financial reforms and capital liberalization and section 3 depicts the experience of East-Asian economies. India's classic example is narrated in section 4. Section 5 concludes the discussion.

## II

Edwards (1989, 1990), Edwards and Wijnberger (1983, 1986), Rodrik (1987), Corden (1987), Calvo (1987) emphasized that stabilization has to be preceded by capital liberalization. However, Krueger (1981, 1984, 1988) recommended reliance on foreign funds and strong multilateral assistance to tide over the transition period. He argued for reduction of barriers to capital movements before starting the stabilization programme.

There is widespread agreement that capital liberalization should be postponed till trade and banking sector reforms have been completed. Edwards (1990) argued that international capital controls should be lifted after the domestic financial market has been reformed and domestic interest rates have been raised. In turn, interest rates should be liberalized only after fiscal deficits are under control.

It is argued that opening up the capital account results in excessive capital inflows, consequently the real exchange rate (RER) appreciates, whereas trade reform would require a depreciated RER to give a boost to the export sector and neutralize the effect of reduction in tariffs on import. Opening up capital account makes exchange rate management difficult and it leads to excessive imports, which are financed by international sources if there is lack of credibility of reforms. However, the

experience of sequencing capital liberalization and financial reforms is somewhat mixed.

Edwards (1984), Edwards and Wijnbergen (1983, 86) and Caprio et al (1994) argued that slow gradual financial sector reforms would avoid short-term crises, whereas rapid liberalization would lead to short-term crises.

Further, there should be credibility of the reform process, otherwise the very reform process itself would be thwarted. If economic agents believed that trade liberalization would be reversed, they would import consumer durables immediately. This would be facilitated by free capital mobility, as agents could also resort to foreign credit to finance import. This would result in unsustainable current account deficits, falling reserves of the Central Bank and would finally force them to reverse the trade reform process.

### III

There is a close relationship between financial reforms and capital liberalization, and the success or failure of capital liberalization depends to a large extent on the financial reforms undertaken by a country. The success of financial reforms on the other hand depends on a country's basic financial structures and strong fundamentals.

Developing countries have adopted liberalized policies in the banking sector. But no institutional and operational framework exists to function the financial sector effectively under market conditions. There are shortcomings in legislation, prudential norms and accounting frameworks and a general lack of adequate supervision. Under banking sector reforms, specialized banks were commercialized and assigned new tasks. Private banks were allowed to enter. During the reforms period both old and new banks accumulated a significant amount of non-performing loans and they could not strengthen their banking skills to cope with the reforms. In many cases, the former specialized banks acted as the main channel in a subsidy chain from government and extended unrecoverable loans to loss-making enterprises at below market interest rates. New private banks engaged in aggressive lending to enterprises, with which they were associated through ownership or other ties. High real interest rates in the immediate aftermath of successful stabilization exacerbated banks' stocks (outstanding bad loans) and flow (operational inefficiencies) problems.

The absence of a well-functioning, market-based banking system and the persistence of prudential problems complicate the conduct of monetary policy, because banks that are less able to control their balance sheets are less responsive to changes in reserve money or interest rates. Moreover, banking problems may lead to pressure on the central bank to extend credit to bail out ailing banks, reduce the scope for tightening liquidity and credit conditions and raise interest rates and thereby undermine monetary control.

In addition, bad loan problems distort credit allocation and thereby impede structural adjustments, as well-run banks try to protect their assets by shifting their portfolios towards holdings of less risky government securities and by widening

spreads. Finally, dealing with problem banks usually entails significant government financial assistance, which has fiscal and, therefore, broader macro-economic implications. At the same time, fiscal policy is likely to need to compensate for monetary policy, incapacitated by banking sector problems from playing its role in stabilizing demand. Financial reforms are crucial pre-conditions for capital liberalization. The experiences of East-Asian countries are an example of the bitter consequences of capital liberalization without financial reforms.

Over the 1990's, East-Asian economies went through radical financial deregulation including near-removal of restrictions on the inflow and outflow of capital. But little attention was paid to the new kinds of regulation that would now be required. The deregulation was carried out on a thin base of financial skills. Banks and finance companies even today operate in East Asia as family business with management structures unable to cope with the complexity of present-day finance. The deregulated financial system enabled inexperienced private domestic banks and firms to take out large dollar-denominated loans from foreign lenders and on-lend with generous spreads. High profits for those with access to much cheaper foreign credit was the reason why firms and banks, both national and international, urged their governments to undertake financial deregulation. This converged with pressures from the IMF and the World bank.

### **Overvaluation of Currency**

In Korea, President Kim Young Sam proclaimed financial deregulation as an important policy objective. Korea liberalized capital flows and relaxed monitoring of external borrowings. Such relaxation was more than required and there was inadequate supervision of the financial institutions involved in such borrowings. The Kim government sanctioned new licenses for 20 merchant banks and there was virtually no supervision on these banks. Korea's external debt increased to \$150 billion in 1996. The exchange rate was used to contain inflation, which caused overvaluation of the currency, adversely affecting exports.

Under radical capital liberalization and financial deregulation, Thailand undertook heavy private borrowings from Japan, Europe and the United States. Their investment rate was between 40-44 per cent during 1990-96. Many investments were based on money borrowed abroad. Due to high interest rates and a fixed exchange-rate policy, foreign investors were eager to place their money in Thailand. In 1992, the Bangkok International Banking Facilities (BIBF) were established to attract more foreign funds to cover increasing current account deficits. The BIBF enabled local and foreign commercial banks take deposits or borrow in foreign currencies from abroad and lend the money both in Thailand and abroad. External debt increased from \$40 billion in 1992 to \$80 billion in 1997. The total outstanding debts as a share of GDP was 51 per cent in 1996. Of the total debt stock, 80 per cent was private debt and almost 36 per cent short term. In 1997, of the total foreign debt of \$90 billion, \$73 billion belonged to private companies, and \$20 billion were due for repayment by the end of the year.

The massive inflow of money tripled the amount of loans in the financial system.

As the scope for productive investment was inadequate, there was a misallocation of investments. A substantial part of the money was channelled into already inflated assets in the real estate sector. During 1992-96, a total of 7,55,000 housing units were built in Bangkok. By 1996 the supply of housing outstripped effective demand and in the following year Thailand had a residential vacancy rate of 25-30 per cent and the vacancy rate for officers in Bangkok stood at 14 per cent. Moreover, many property owners artificially inflated the value of their assets and kept borrowing against them and most real estate companies had a poor cash flow. When the economic recession started in 1996 and the buying power of the middle and upper classes began declining, the property bubble burst and left substantial bad debts on the balance sheets of the financial companies, which had financed their investments by borrowings from abroad.

The underlying factor behind the East-Asian crisis is institutional failures in the context of financial sector stabilization. Mature free market economies function on the basis of institutions that minimize informational imperfections and transaction costs and facilitate a high degree of transparency and accountability of government regulatory agents. When the institutional conditions fail to hold or are incomplete, it results in adverse selection and creates moral hazards in behaviour in the principal and agency relations, which are highly relevant to the functioning of financial markets. The prevailing institutional conditions in East-Asian countries are inconsistent with and inadequate for an efficient functioning of the free market mechanism.

### **Evaporation of Savings of the Public**

In the case of the East-Asian economies, borrowed capital was channelled to unproductive and highly risky assets, such as real estate (non-tradeable), creating an asset bubble. Borrowing and lending in financial markets are based on principals (savers) and agency relations (intermediaries). Informational imperfection or engineered misinformation results in adverse selection and moral hazard in behaviour. Informational imperfection in these countries was the result of the corrupt and mismanaged banking system and highly inefficient and non-transparent corporate governance, under insider relations between the government agents and large banks and industrialists. The price of these practices was the evaporation of savings of the public without any accountable and compensatory mechanism.

Capital liberalization was the root cause of the Asian collapse. It was the removal of restrictions, which allowed foreign capital to enter these countries with ease and just as quickly flee when trouble surfaced. This freedom of entry and exit to global capital provided a few long-term benefits, but it also caused enormous harm to the developing countries. Jagdish Bhagavati of Columbia University agrees that making currencies of the developing countries fully convertible is of benefit only to the Wall Street-US Treasury Complex. Liberalized capital inflow crushed South America in 1982; Mexico suffered its currency crisis in 1994, and in 1997 there was the collapse in East Asia.

The basic problem is that global financial markets are prone to vulnerability and

crises. One reason for the crises is that mismatch between short-term liabilities and long-term assets makes intermediaries prone to panic.

The argument for capital liberalization has been built on the premise that it will promote a more efficient allocation of capital across the world. Domestic firms facing high interest rates can access inexpensive funds in the global market. Capital liberalization broadens the channels through which trade and investments can be financed and income increased. It gives more opportunities for portfolio diversification and hence a potential higher risk-adjusted rate of return. It also increases the efficiency of the domestic financial system. However, capital liberalization is highly sensitive to the conduct of macro-economic policies and perceived soundness of domestic banking. It leads to excessive capital inflows and outflows and a possible attack on the currency, as happened in Mexico and the East-Asian countries. It does not permit the monetary policy to take on an excessive burden of adjustment. However, it enhances the effectiveness of fiscal policy by: reducing real interest rates applicable to public sector borrowing, bringing about an optimum combination of taxes to international levels with a beneficial effect on tax revenues and reducing the crowding-out effect in access to funds.

Dani Rodrik of Harvard University has analysed the experience of 100 developed and developing countries between 1975 and 1989, some of which had control on capital movements while others did not. The conclusion, was 'There is no evidence in the data that countries without capital controls have grown faster, invested more or experienced lower inflation. Capital controls are essentially uncorrelated with long-term performance.'

McKinan argues that trade reforms, strong balance of payment positions, fiscal disciplines, financial sector reforms, banking reforms, inflation control, good foreign reserve position, strengthening of prudential regulation, etc., are pre-requisites to capital account convertibility.

India could survive the contagion effect of the currency crises because of the following reasons:

- Adoption of a gradual reform strategy.
- Slow financial sector reforms. Banks have not been denationalized. There are still controls on the allocation of credit. Thus, bankers are not free to decide their portfolio allocations. There are high reserve requirements, and interest rates are yet to be fully deregulated.
- Exchange rate was floated within two years of the introduction of reforms.
- Trade-policy reform was calibrated with a gradual reduction of import duties, rapid removal of quotas on intermediate goods and quantitative restrictions on consumer goods.
- India maintained moderate restrictions on FDI flows and very high restrictions on short-term capital flows, especially portfolio investment flows. It adopted minimal and gradual liberalization of capital flows.

Gradual reforms adopted by India have helped a smooth transition to a market-based economy. It would be unrealistic to assume that firms would be able to reorient their management skills to the liberalized environment overnight. In the banking

sector, India has adopted a slow liberalization process. In the case of the East-Asian economies, rapid liberalization of the banking sector resulted in building up a bad portfolio of assets (high yielding but highly risky) in their urge to increase profits. This enhanced opportunities for raising prices of stocks and real estate, demands for consumer goods, etc.

India's gradual liberalization policies have resulted in new private sector banks competing with vastly deregulated public sector banks. The stock market crash of 1992 could be restricted due to belated supervision by the central bank. The soaring stock market in 1992 could be restricted due to belated supervision by the central bank. The soaring stock market in 1992 was because of illegal flows of funds from banks to the stock market. When the news broke the stock prices collapsed by over 40 per cent in a short span of time. India did not face any major internal shock due to the currency crises in East Asia, mainly due to capital controls. India's domestic financial market was not linked to the world financial market in a big way and international interest rates did not have a major impact on the Indian economy. However, India could have proceeded much faster on the liberalization of the domestic financial sector. It could have facilitated speedier lifting of capital controls than what is possible now. Control on FDI could have also been faster and tied up with export commitment. This could help India manage its balance of payments.

It is necessary to avoid appreciation of RER, by allowing the rate to be market determined early in the reform process. Capital liberalization, particularly liberalization of short-term capital flows could wait till trade reform and domestic financial sector reforms have been effectively carried out.

The single most irresponsible action resulting in the crises in the East-Asian economies was capital account liberalization without a framework of regulation. As these economies operate on the basis of long-term relationships and patient capital, foreign capital is at a disadvantage. The basic problem in international capital is the vulnerability of global financial markets. There is no evidence that countries without capital controls have grown faster, invested more or experienced lower inflation. Capital controls are essentially uncorrelated with long-term performance. Many countries have grown without capital liberalization. India is a classic example.

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