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REJECTING EXCEPTIONALISM:

REINTERPRETING THE ASIAN FINANCIAL CRISES

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Rejecting exceptionalism: Reinterpreting the Asian financial crises

Abstract

Since the Mexican financial crisis of 1994-95, a large number of developing and newly industrialized countries have experienced financial crises. During 1997-8, the economies of many countries in South East Asia (e.g., Malaysia, Indonesia, the Philippines, South Korea and Thailand), and Russia and Brazil confronted serious declines in their currency and stock market values. This paper will develop a structural explanation of the causes of the crisis of 1997-8, examine the macroeconomic and political consequences of the crisis, and present measures designed to prevent the occurrence of similar crises elsewhere.

The conventional "exceptionalist" explanation of these crises contended that they were the outcome of political corruption, unsustainable economic policies (especially concerning government expenditures and exchange rate management) and malfeasance on the part of government officials who sought to present an inappropriately sanguine picture of the economy to foreign investors. Moreover, conventional wisdom contended that these crises would ultimately prove beneficial to afflicted economies in that the exit of global investors (and the entrance of the International Monetary Fund) forced governments to pursue radical, market-oriented economic restructuring.

In contradistinction to the conventional wisdom, the chapter will argue that the crisis of 1997-8 was principally an outcome of two factors: the private sector's excessive reliance on hard currency-denominated foreign loans, and the government's failure to control portfolio investment flows. By relying on these two types of private capital flows--in the absence of sufficient foreign exchange reserves--the economies involved in the crisis of 1997-8 were rendered vulnerable to the risks of

currency and investor exit. Once these risks were realized, governments found their ability to maneuver to be quite limited. In the context of the crisis, governments were compelled to implement neoliberal economic and social policies as a precondition for the return of private capital and, in some cases, as a precondition for IMF assistance. The paper will argue that the circumstances of the Mexican financial crisis of 1994-5 were markedly similar to those of the crisis of 1997-8.

The paper will also examine the efforts aimed at resolving the crisis of 1997-8. It will be argued that these efforts (whether government- or IMF-sponsored) in fact rendered economies more—rather than less—vulnerable to the recurrence of such crises in the future. In order to prevent history from repeating itself (again), developing and newly industrialized countries need to curtail the risks associated with foreign currency-denominated borrowing and portfolio investment and develop early warning signals of their vulnerability to currency and exit risk.

I. INTRODUCTION

The biggest financial news story of 1997 and 1998 was the series of crises that hit the stock, currency and banking markets in "emerging economies." The "crisis of 1997-8" began in Thailand in May 1997, and through the summer and fall swept through some of the most important and stable economies of Southeast Asia--Malaysia, Indonesia, the Philippines, and Singapore. In late October, the crisis reached Brazil and Russia, and by early December it reached South Korea. In January 1998, a new round of instability shook the South Korean and Indonesian financial markets. In its scope and depth, the crisis of 1997-8 proved to be far more disruptive and less tractable than its December 1994 Mexican predecessor.

The crisis of 1997-8 was notable for a number of reasons.

Since the first of these crises emerged in Thailand in May 1997, the year was marked by an unfolding contagion. These crises, especially in the SE Asian "miracle economies," took officials in multilateral institutions and investors by surprise. Up until the summer of 1997, IMF-World Bank reports and business press accounts on the SE Asian, Russian and Brazilian markets were uniformly bullish. As the data on net private capital flows in table one show, private investors and lenders were quite optimistic about prospects in these countries until their difficulties emerged.

<TABLE 1 HERE>

Indeed, as of year-end 1996, four of the countries headed for crisis were among the world's top six recipients of private foreign capital inflows. During 1996, Indonesia received the world's third largest share of private foreign capital inflows ($17.9b), Malaysia the fourth largest share ($16b), Brazil the fifth largest share ($14.7b), and Thailand the sixth largest share ($13.3b)

[WSJ, 11/7/97].

A second notable feature of the crisis of 1997-8 was the volume of the IMF bailouts that were negotiated. The December 1997 South Korean bailout of $57b dwarfed what was formerly the world's largest bailout of Mexico in February 1995 (valued at $50b). The other bailouts associated with the crisis were also not small in magnitude: the Thai bailout of August 1997 was valued at $17b, the Indonesian bailout of November 1997 was valued at $43b, and the Philippine bailout of July 1997 was valued at $4b.

Perhaps most notable about the crisis of 1997-8 was that it occurred *after* the IMF had implemented what was heralded as an important new set of safeguards embodied in the "Special Information Dissemination Standard." The Standard was adopted in April 1996 following the Mexican financial crisis. This new information system involves the development of a Dissemination Standards Bulletin Board in which accurate information on the conditions in a wide range of countries is available to investors worldwide [Fischer, 1997].

This chapter is motivated by the parallels in the conventional wisdom on the causes and consequences of the crisis of 1997-8 and the Mexican crisis of 1994-5. In the Mexican case, what I elsewhere termed the "Mexican exceptionalism thesis" contends that the Mexican experience was largely an aberration stemming from the country's "peculiarities" [Grabel, 1996]. Thus, rather than interrogate the Mexican crisis as evidence of generalizable problems related to financial openness in emerging economies, the experience was dismissed as a unique event [World Bank, 1995].

An interesting feature of the *general* crisis of 1997-8 was the ubiquitous claim of *exceptionalism* that was again invoked to explain these events. Especially in the SE Asian cases, much was made of the seemingly newly discovered--yet deeply rooted--patterns of corruption,

unsustainable real estate speculation, wasteful government spending, and misguided government policies [IMF Survey, 2/9/98; Safire, 1998]. In the Russian case, exceptionalist explanations focused on the problems of corruption, tax evasion and governmental mismanagement [WSJ, 11/3/97; DP, 12/6/97]. In the Brazilian case, exceptionalist explanations centered on investors' fears that the government would be unable to withstand political pressure to repudiate the neoliberal program it was pursuing [NYT, 11/11/97].

This chapter will present arguments against the exceptionalist explanations of the crisis of 1997-8. I argue that the crisis of 1997-8 was principally the result of two factors: the private sector's excessive reliance on hard currency-denominated foreign loans, and the government's failure to control portfolio investment flows. By relying on these two types of private capital flows--in the absence of sufficient foreign exchange reserves--the economies involved in the crisis of 1997-8 were rendered vulnerable to the self-reinforcing cycle of investor exit, currency depreciation and financial crisis. I will refer to the vulnerability to exit and currency risk as the "problem of increased risk potential." Once this increased risk potential was realized and the crisis emerged, governments found their ability to maneuver to be quite limited. In efforts to stem the crisis, governments were compelled (either on their own account or as a precondition for IMF assistance) to pursue the very macroeconomic policies that exacerbated their risk potential. I call this the problem of "constrained policy autonomy." The chapter rejects the measures that governments put in place in efforts to resolve the crisis, and proposes that emerging economies instead manage financial flows.

The chapter proceeds in the following manner. First, I briefly outline the stylized facts of the Mexican crisis and present a general theoretical explanation of the causes of that crisis. Then I turn to the crisis of 1997-8 and argue that the structural dynamics of that crisis are markedly

similar--though not identical--to those of the Mexican crisis. In this connection, I will also argue that the resolutions to the crisis of 1997-8 and the Mexican crisis were misguided insofar as they introduced problems of greater risk potential, constrained policy autonomy and recessionary tendencies to these economies. Finally, I offer some thoughts on the types of preventative measures that policymakers in emerging economies should consider lest history repeat itself (again).

II. THE MEXICAN CRISIS OF 1994-5: EXCEPTIONALISM EMERGES

In less than a decade after Mexico's threatened default on its international loans, private investors (though largely not private lenders) returned to Mexico (see table 2).[1]

<TABLE 2 HERE>

As early as 1989, Mexico was being marketed as the site of one of the world's most dynamic, emerging markets. Investor interest in Mexico was fueled by the government's gestures toward political democratization and economic liberalization, measures which received wide attention in the US. The signing of NAFTA also created new opportunities for investors, and offered them an implicit US guarantee on their investments.

The high returns offered on short-term Mexican government bonds were also extremely attractive to individual and institutional investors. Both the dollar-indexed and the peso-denominated short-term bonds (the *tesobono* and the *cete,* respectively) offered returns that far exceeded returns available elsewhere, especially in the US where lower interest rates during 1993 encouraged investors to look abroad. Attracted by these high returns, portfolio investment began in 1990 to flood Mexico's debt and equity markets (see Table 2). Partly as a consequence, the stock market index gained value every year after 1989 (except for 1994; see Table 2).

[1] This discussion of the Mexican crisis is drawn from Grabel [1996].

During this period of increased private capital inflows, the peso was fixed at a progressively overvalued rate (in nominal and real terms) by the government.

A. The Emergence of the Crisis

A tightening of US monetary policy beginning in February 1994 began to diminish the appeal of Mexican portfolio investment. By April 1994 the Mexican bubble began to lose steam, completely collapsing in December of that year. During 1994 the stock market lost 30% of its value and there were several speculative attacks on the peso. In efforts to stabilize the peso, the government depleted $10 billion dollars of foreign exchange reserves [Dornbusch and Werner, 1994]. The conjunction of this financial instability, the Chiapas revolt, and the assassination of the leading Presidential candidate led President Ernesto Zedillo to devalue the peso by 40% on December 20,1994 and to float the peso just two days later. Rather than stabilize Mexican financial markets, however, the depreciation triggered a cycle of portfolio investor exit and peso depreciation--the combined effect of which was financial crisis. Within the first month of 1995 alone the Mexican government depleted almost 50% of its foreign exchange reserves in efforts to stabilize the peso [Economist, 2/4/95].

With the peso and Mexican markets entering a free fall, the dismal state of Mexican financial markets triggered fears of global financial contagion. This contagion scenario involved what was seen as the Mexican government's near certain default on short-term bonds--the *cetes* and especially the *tesebonos*. In Ponzi fashion the Mexican government had been deficit financing its expenditures and obligations with short-term debt, rendering the government vulnerable to a shock from financial markets. The Mexican economy's vulnerability to a financial crisis was exacerbated by the fact that the government's foreign exchange reserves totaled $6b at the end of 1994 and that *tesebonos* worth $29b were due to mature in 1995

[Finance and development, 1997].

The Clinton administration and financial industry analysts argued aggressively that default on Mexican government bonds would trigger a general flight from Mexican financial markets and a further collapse of the peso. Not only did this conjure visions of disaster within Mexico, but it was also seen as the harbinger of significant problems within the US, given its deepening integration with Mexico. The Mexican crisis also led to predictions of systemic financial crisis in other emerging markets, as investors turned bearish on these markets. When this flight did indeed occur, it was termed the "tequila effect."

The Clinton administration responded to the crisis in February 1995 by pressing for a bailout. In exchange for a $20 billion US bailout and $28 billion in international loans, the Mexican government committed to further the 1980s reform agenda of privatization, stabilization, and liberalization. It also agreed to implement restrictive monetary policy, to reduce budget and current account deficits, and to increase the value-added tax and the prices of goods produced by the state. More controversial than the Mexican government's renewed commitment to neoliberalism were the requirements that the majority of the bailout funds be used to cover bond obligations, that the government be able to draw on a $10 billion portion of the bailout earmarked as an emergency fund only at the discretion of the US, that the government get permission from the US for major economic policy decisions, and that the receipts of Mexico's state-owned oil company, Pemex, be used as collateral for the US loans and guarantees.

Though Mexico suffered a severe recession from the fourth quarter of 1994 to the third quarter of 1995 (involving a collapse in output and employment and large increases in inflation, loan defaults, and bank distress), the Mexican economy was seen to have been rehabilitated by 1997 [Lopez, 1997]. The Mexican government repaid its bailout loans (with interest) ahead of

schedule, economic growth improved impressively in 1996-7, and portfolio and direct foreign investment returned to the country (see table 2). However, the return of private foreign capital was largely driven by foreign investors' purchases of Mexican assets and firms at vastly deflated prices. Thus, while increased openness stimulated the private capital inflows that boosted the economy in 1996-7, these same inflows also reintroduced the possibility that the economy could be destabilized by a new cycle of investor exit and currency depreciation. Moreover, the country's very success in attracting new private capital inflows caused the peso to appreciate. Because of the economy's increased growth in 1996-7 and because of the appreciation of the peso (as well as the decline in world oil prices in 1997), Mexico ran a current account deficit in 1997 (and a larger deficit was projected for 1998). Should the deterioration in the current account reignite investors' fears, the increased openness of the economy makes it more likely that the country could experience a new crisis.

B. Increased Risk Potential and Constrained Autonomy in the Mexican Crisis

I now turn to a brief theoretical examination of the causes and consequence of the Mexican crisis. My principal argument is that the structural roots of the crisis were not based in the country's peculiar combination of political corruption, social-political instability and economic mismanagement. Rather the crisis in Mexico was principally a result of the government's failure to control portfolio investment flows.

Constrained policy autonomy

Prior to the crisis, an "ex-ante" constraint on policy autonomy was apparent in Mexico. The attraction of large inflows of portfolio investment after 1989 resulted from the neoliberal reforms proscribed by the Brady Plan. The need to attract high levels of portfolio investment inflows--given the low levels of foreign lending and aid and the low domestic savings rate--

meant that it was necessary for the Mexican government to orient macroeconomic policy toward the objectives of portfolio investors.

When the crisis occurred in 1994, an "ex-post" constraint on policy autonomy obtained. In this context, the government was compelled to try to stem the investor exit and stabilize the peso by tightening monetary policy and expending foreign exchange reserves. This strategy further destabilized financial markets as investors recognized that the government's resources were inadequate to meet bond obligations and to protect the value of the peso. Furthermore, the pursuit of contractionary monetary policy induced a serious recession and aggravated social dislocation in Mexico. The depletion of foreign exchange reserves also impaired the government's ability to ease the dislocation following the crisis and its aftermath.

The stringent bailout provisions were another instance of an ex-post constraint on policy autonomy. The influence of the US and the IMF over Mexican policy was increased by the bailout, and the entire import of policy in the post-crisis period has been aimed at restoring investor confidence via contractionary monetary and fiscal policies.

Increased risk potential

Increased risk potential, too, was in evidence. The portfolio investment inflows following 1989 provided the government and the private sector with resources to which they might not have otherwise had access. But the liquidity of this investment in the context of financial openness, meant that the December 1994 devaluation and the tightening of US monetary policy could further destabilize markets and trigger additional outflows and peso depreciations. Thus, the financial openness that is a precondition of portfolio inflows makes the threat of an investor stampede more apparent. In order to try to contain the crisis, the bailout provisions introduced greater foreign influence in economic decision making. By further

opening the economy to capital inflows as the neoliberal tenor of the bailout required, the vulnerability of the Mexican economy to future crises was exacerbated, possibly necessitating future bailouts and introducing further foreign intervention in the economy.

III. THE CRISIS OF 1997-8: EXCEPTIONALISM REDUX

The "Asian miracle"economies earned this designation because of their rapid industrialization and high rates of GDP and export growth in the 1980s and 90s. Given what seemed like the remarkable success of these economies, they were collectively taken by analysts—across the political spectrum—to represent a model that offered valuable lessons to countries seeking to overcome the challenges of late development.[2] Up until the first wave of crisis emerged in Thailand in May 1997, investment analysts remained optimistic on SE Asia, and more strikingly, the IMF-WB remained sanguine on the region's prospects. Indeed, as recently as a few months before the IMF bailouts of Thailand and South Korea, the Fund issued reports praising both countries for proper "macroeconomic management" [NYT, 1/4/98].

The rapid evolution of the SE Asian economies was the outcome of numerous factors, including a favorable world economic climate, the region's geopolitical significance during the Cold War which gave it access to much foreign aid, and the presence of highly effective illiberal "developmental states." Currencies were heavily managed by the state; in most cases the currency was pegged to the US dollar (and either fixed completely or allowed to fluctuate within

[2] The literature extolling the virtues of the "Asian model" is voluminous. The now classic World Bank [1993] study lauding the model was an embarrassment to Bank officials following the events of 1997-8. The IMF-WB continued to praise the Asian model in the 1996 *World Development Report*. Aspects of the Asian model were also lionized in the late 1980s and early 90s by mainstream policy analysts and liberal and left academics [see the review in DeMartino, 1996]. At the time of nearly universal enthusiasm for the Asian model, the work of a few dissenters is worthy of note [Bello and Rosenfeld, 1990; Hart-Landsberg; 1993; Burkett and Hart-Landsberg, 1996].

a narrow band). The currency peg (along with the state's general integration with the financial sector) contributed to the stability of SE Asian economies during the years of high growth. The currency peg was critical in two other respects as well. The general depreciation of the US dollar relative to the yen that followed the September 1985 Plaza Accord significantly enhanced the global competitiveness of SE Asian exports. At the same time, the general appreciation of the yen relative to the US dollar encouraged inward Japanese direct foreign investment.

As can be seen on table 1, the volume of inward portfolio investment to the SE Asian (and other emerging) economies began to increase dramatically in the late 1980s. These portfolio investment inflows helped fuel the boom in speculative activities across the region by providing firms with capital and governments with a means to finance their current account deficits. During this time, individual and especially institutional investors sought to capitalize on the high returns available in these booming economies. These economies became even more attractive to investors as they began to embark on programs of internal and external financial liberalization in the late 1980s and early 90s. Moreover, investors were drawn to SE Asian markets as conventional wisdom on investment prospects in the US soured in the face of its loss of industrial leadership in the late 1980s and following the stock market crash of 1987.

Private lending to and within SE Asia also grew dramatically during the boom years of the late 1980s and 90s. This high degree of leveraging was made possible by a number of circumstances. Rampant real estate speculation throughout the region resulted in property value inflation, and hence induced a general inflation in the value of loan collateral. In the context of rising collateral values, domestic and international lenders were eager to make available low-cost loans to the private sector. A January 29, 1998 study by the Institute for International Finance reports that "foreign banks fell over themselves to lend [the region] more money year after year"

[NYT, 1/30/98]. The total private sector debt held by SE borrowers rose to dramatic heights through the mid-1990s. According to the Bank for International Settlements (BIS), the total private sector debt held by SE borrowers (excluding Singapore and Hong Kong) was $307b in December 1995, $367b in December 1996, and $389b in June 1997 [NYT, 1/28/98]. The same BIS study reports that the largest proportion of the $389b in foreign loans made to the region (again excluding Singapore and Hong Kong) by June 1997 was made by Japanese lenders (32% of the loans), followed by German and French lenders (respectively, 12% and 10% of the loans), and US and UK lenders (each accounting for 8% of the loans) [NYT, 1/28/98].

In many cases, the ability of domestic banks to extend credit was enhanced by direct and indirect governmental support for lending to targeted sectors and firms. The lending base of domestic banks was substantially enhanced by international financial integration which gave domestic banks and borrowers access to low-cost yen- and US dollar-denominated loans. When both US and Japanese interest rates were relatively low, banks in these countries lent vast sums in dollars and yen directly to SE Asian firms, while also extending dollar- and yen-denominated loans to banks in the region (which, in turn, lent these funds to domestic firms). As table 3 shows, SE Asian borrowers held a large percentage of hard-currency denominated loans during the late 1980s and 90s.

<TABLE 3 HERE>

As the boom in SE Asian economies unfolded in the mid-1990s a regional division of labor emerged. Wage costs in the "older tigers" like South Korea started rising; these cost pressures led to production shifts to new low-wage centers in the region. In this context, the "younger tiger" economies of the Philippines, Thailand and Indonesia began to experience rapid growth along with many other aspects of the earlier SE Asian boom.

A Crises in the Asian "miracle economies"

However, by mid 1996 the region began to encounter a number of difficulties. The real estate boom began to lose steam. The decline in property and hence collateral values was highly problematic for the domestic banking industry, given that it was so heavily involved in real estate. Moreover, as the Japanese economy itself began to experience serious problems, Japanese foreign direct investment to SE Asia began to slow. Lending from US banks to the region also began to slow during the first six months of 1997. At the same time as US banks were beginning to exit the region, a recent BIS study reports that some Japanese, German, French and British banks—faced with slow growth and sluggish profits at home--began to capitalize on the growing demand for loans by Asian borrowers and began to increase their lending to the region [NYT, 1/28/98]. However, by the fall of 1997 even these banks began a dramatic curtailment of lending to the region [NYT, 1/28/98; NYT 1/30/98].

By late 1996 the region was also beginning to confront other difficulties as well. The cost advantages of low-wage production in SE Asia were not sufficient to counter the decline in export competitiveness brought about by the appreciation of the US dollar following the 1995 US-Japanese agreement to appreciate the dollar and depreciate the yen. The dollar's appreciation after 1995 also made it more expensive for SE Asian borrowers to repay their dollar-denominated loans. Finally, as investors once again became bullish on the US economy in the context of the US stock markets' ascent and rising levels of economic growth, portfolio investors turned their attentions away from emerging economies in general (and SE Asia, in particular) and towards the booming US economy. And once the first signs of trouble emerged in Thailand on May 7, 1997, investor skittishness on the region only intensified. It is to these events that we now turn.

Thailand

The Thai economy had been experiencing a speculative boom since the early 1990s. Increases in share and real estate prices and commercial construction activity were particularly important components of the boom. As elsewhere in the region, the stock market's performance was fed by inflows of foreign portfolio investment (see table 1). Foreign portfolio investors were very much attracted to the high returns available on Thai markets following the deregulation that began in 1990. Real estate and commercial construction activity were fueled by the abundance of relatively low-cost short-term loans made available by Japanese and US lenders and by Thai banks (themselves relying on short-term loans from foreign lenders). Foreign lenders were eager to extend these loans because of the perceived strong growth prospects of the economy and the region. These expectations of continued growth were maintained even though Thailand had $60b in foreign debt and only $40b in foreign exchange reserves [NYT, 8/1/97].

News of problems in the Thai economy emerged on May 7, 1997. On that day, the Thai currency—the baht—began to come under pressure by speculators who began selling off their holdings of the currency. This sell-off followed the release of adverse economic news about the Thai economy (that suggested that the boom was ending) and predictions that the Japanese central bank was poised to raise interest rates [Finance and development, 1997]. The predicted rise in Japanese interest rates was problematic for Thailand's highly-leveraged private sector which held a large portfolio of both yen- (and dollar-) denominated loans (see table 3). In the context of these (feared) adverse developments, investors began to predict that the Thai government would be unable to maintain the baht's fixity, and hence would be forced to devalue the currency. Throughout May 1997 investors exited baht and baht-denominated investments (the latter circumstance caused precipitous declines in Thai share prices).

The government tried in May 1997 to stem speculation against the baht by increasing interest rates (and hence raising the cost of borrowing funds to purchase baht), implementing selective capital controls aimed at making it prohibitively expensive for foreigners to purchase baht off-shore, and buying baht with its own foreign currency reserves [NYT, 10/24/97]. Investors were not calmed by these measures however. Indeed, as Thai interest rates rose, stock and land prices fell because borrowing became more costly [WSJ, 11/26/97]. As the sell-off of baht and baht-denominated investments continued through the spring and early summer of 1997, investors in other emerging markets (such as Malaysia, Indonesia, and the Philippines) began a general exit from these markets as well. This contagion effect (termed the "Asian flu") paralleled the events that followed the investor exit from Mexico.

Rather than devalue the baht, the Thai central bank on July 2, 1997 ended its efforts to defend the currency's fixity, and announced that the baht would henceforth float with market forces. The currency immediately fell by 20%. Fearing further sales of baht and baht-denominated assets, the central bank and the government took action to try to stem speculation by raising the discount rate by 2% to 12.5% and restricting sales by foreigners of Thai stocks [Economist, 7/12/97]. Following pressure from the government, private banks refused to provide short-term credit to speculators [Finance and development, 1997]. Given the intense demand for funds to borrow baht and given the government's efforts to curb such borrowing, offshore interest rates rose to 1300% per annum. The rise in Thai and foreign interest rates and the collapse in property values led to loan defaults and losses for Thai banks. The bhat's depreciation compounded debt and bank distress as Thai borrowers faced dramatic increases in the domestic currency value of their hard-currency repayment obligations.

Discussions of a Thai bailout began in the summer of 1997. Following the US rejection

of Japan's offer to finance a regional assistance fund, an IMF bailout of $17 billion dollars was finalized on August 11, 1997 [NYT, 10/24/97]. The bailout stipulated that the Thai government was to reduce public spending, to end public and quasi-public support for failing firms and banks (the government suspended operations of 42 firms and 58 of the country's 91 finance companies) [FT, 10/8/97], to raise taxes (the VAT was raised to 10% from 7%), and to remove the capital controls imposed in May 1997 [Economist, 7/12/97; NYT, 8/12/97]. Thai interest rates also continued to rise as the central bank attempted to stem portfolio investment outflows and attract new inflows.

Following the crisis and the bailout, living conditions in Thailand worsened as unemployment, prices and interest rates rose (as numerous banks and factories closed, while still others consolidated operations). Bank lending fell (stalling production) and loan arrears and bankruptcies rose [NYT, 9/21/97]. Social protest against the government and political instability emerged as well: on Oct. 21, 1997, 2,000 business and office workers protested in the streets of Bangkok [NYT, 10/2/97]; and the Thai government witnessed numerous personnel changes [NYT, 10/24/97].

In searching for answers as to what went wrong in Thailand, the conventional wisdom that quickly emerged among analysts was that they were misled by a corrupt Thai government and by cronyist Thai banks. The government, it was asserted, misled investors by failing to reveal that nearly all of its $40 billion in official reserves were committed to supporting the baht's fixity [NYT, 12/14/97; Economist, 8/9/97]. Similarly, it was asserted that foreign lenders were simultaneously unaware of the extent of banks' and borrowers' involvement in real estate speculation, of the poor performance of Thai banks (although as early as 1996 13% of all loans were non-performing)[FT, 10/8/97], of the links between Thai banks and failing firms, of the

extent of the country's foreign indebtedness (valued at $60 billion) and its large current account deficit (equal to 8% of GDP in 1996) [NYT, 8/1/97; Economist, 7/12/97].

Malaysia

In a region marked by high levels of real estate and construction activity, Malaysia's commercial building boom was notable. Prior to the crisis, Malaysia was embarked on plans to build airports and dams, to add to its already impressive landscape of skyscrapers, and to situate itself as a regional center for high technology development. Like Thailand, Malaysia's rapid growth was highly attractive to portfolio and direct foreign investors and to foreign lenders until the crisis emerged (see table 1). Following the exit of these same investors and lenders, analysts devoted much attention to the role of pervasive corruption in bringing about the economy's collapse [BW, 9/22/97].

Pressure against the Malaysian currency, the ringgit, began almost immediately following the floating (and concomitant depreciation) of the Thai baht on July 2, 1997 [Finance and development, 1997]. Following the fall in the value of the ringgit, investors exited ringgit-denominated investment (triggering a fall in stock prices) and the banking system began to experience serious difficulties as foreign credit became both expensive and scarce and as deteriorating real estate market conditions undermined the value of collateral [NYT, 9/22/97].

In efforts to reverse the outflow of portfolio investment and to discourage further speculation against the ringgit, the Central Bank and the government of Prime Minister Mohamad Mahathir in July 1997 introduced a number of measures. Overnight interest rates were increased to 50% on July 10 in order to slow the pace of borrowing by domestic and foreign investors seeking to hedge and/or speculate on the ringgit's further decline [Economist, 7/12/97]. As in Thailand, the central bank introduced targeted, informal capital controls (which

mandated that local banks not provide funds to foreign speculators) in efforts to stem foreign speculation against the currency. The government also ordered restrictions on stock transactions that rewarded investors for declines in stock prices ("short trades") and moved to prop up stock prices for domestic investors. These actions, in conjunction with the growing crisis in Thailand and Indonesia, triggered further portfolio investor flight from Malaysia. The Prime Minister's widely publicized denouncement of foreign currency traders (giving special mention to trader George Soros) at the annual meeting of the IMF-WB on September 21, 1997, exacerbated the flight from the Malaysian stock market as well [NYT, 9/22/97].

In the face of the fall 1997 round of portfolio investor flight, currency depreciation and stock market decline, the Prime Minister ultimately ceded to pressure to reverse the controls implemented in July of that year. Though Malaysia's banking system was not on as shaky a footing as was that of Thailand[3], the government responded to the crisis by closing 50 finance companies [FT, 10/8/97]. Moody's predicted that 5 of the country's 15 commercial banks would be allowed to fail by the end of 1998 [FT, 10/8/97]. Note that Malaysia was one of the few countries in the region not to have requested an international bailout.

Indonesia

During the 1990s, international portfolio and direct foreign investors and foreign lenders alike were quite taken with the rapidly growing economy of Indonesia (see table 1). Its currency, the rupiah, was pegged to the dollar (and allowed to fluctuate relative to the dollar within a 12% band) [WJS, 8/15/97].[4] And as elsewhere, following the crisis analysts focused much attention

[3] In 1996 the ratio of non-performing to total loans was 4% in Malaysia, compared to 13% in Thailand [FT, 10/8/97].

[4] The Indonesian Central Bank had for many years a policy of depreciating the rupiah by about 4% a year [NYT, 7/22/97].

on the wasteful and corrupt diversion of resources to the expensive "show projects" with which Indonesian President Suharto and his family were very much preoccupied [WSJ, 10/13/97]. Local banks—which were significantly controlled by the government—were heavily leveraged as key participants in these show projects and in real estate speculation. As early as 1996, the Indonesian banking sector was experiencing difficulties (bad loans/total loans were 9%) [FT, 10/8/97], but it was not until the crisis emerged that widespread bank failures began to occur. As elsewhere in the region, the Indonesian private sector accumulated a large percentage of dollar- and yen-denominated loans throughout the 1990s (see table 3)—indeed as of February 1998, the Indonesian private sector had $65b in dollar-denominated debt [NYT, 1/27/98].

Following the difficulties that emerged in Thailand on July 2, 1997, investors began exiting Malaysian, Philippine and Indonesian currency and stockholdings because of the view that all of these economies confronted similar problems. In contradistinction to the Malaysian and the Thai cases, the government did not respond to these pressures by attempting to restrict market transactions. Rather, the Indonesian central bank responded to pressure against its currency by widening the rupiah's trading range on July 11, 1997 and by spending about $500m to maintain the wider band [WSJ, 8/15/97]. When the currency continued to come under speculative pressure (falling to the bottom of its new band on July 21, 1997), the central bank on August 14, 1997 revoked the trading band entirely. The decision to float the currency triggered a new round of investor exit from the currency and stock markets.

In the context of these developments, the Indonesian government in late October 1997 approached the IMF and the US for assistance. By November 5, 1997 agreement was reached on a $40b bailout package. In exchange for the bailout, the Indonesian government was required to implement a comprehensive program of reform involving privatization, reductions in

government subsidies and spending, financial liberalization and the closure of distressed financial institutions (on November 2, 1997, 16 distressed banks were closed) [NYT, 11/2/97; WSJ, 11/3/97]. These measures had the same immediate political, economic and social effects as had similar plans throughout the region.

Circumstances took a second negative turn early in January 1998. On January 8, the rupiah plunged after President Suharto unveiled large new spending projects, and hence seemed to be repudiating the spirit of the austerity mandated by the November 1997 bailout. The IMF responded to these events by threatening to terminate the $40b bailout package. Predictably, investors immediately exited the country, causing the currency and share prices to decline further. By January 15, President Suharto announced a new comprehensive reform program involving liberalization of the economy, an end to the special privileges granted to politically-favored projects and the rehabilitation of the banking sector [IMF Survey, 2/9/98]. The banking reforms include measures to guarantee deposits, to end curbs on foreign ownership of banks, and to create a special agency that would rehabilitate failing banks [NYT, 1/27/98]. This new commitment to austerity and reform calmed investors and led to a stabilization of the currency. In this context, the IMF renewed its support package on January 26, 1998 [IMF survey, 2/9/98].

Indonesia continued to face severe economic and political instability following Suharto's January 1998 recommitment to reform and austerity. On January 29, 1998, the government initiated a "temporary pause" in payments on billions of dollars in private debt to overseas lenders [NYT, 1/28/98]. Throughout February 1998 and again in May of that year, the country was wracked by riots, looting and violence over price increases. These developments took a particularly ugly racial turn, as the violence and looting focused on ethnic Chinese merchants [NYT, 2/15/98]. The government also continued to spar with the IMF over monetary reform—

indeed on February 15, 1998 the government announced that it was planning to implement a currency board, a plan which was soundly rejected by the IMF [NYT, 2/15/98; NYT, 2/10/98]. Following (successful) efforts at ousting President Suharto, the new Indonesian administration in May 1998 committed to accelerate the pace of reform.

The Philippines

As was the case in Malaysia and Indonesia, the outward signs of difficulty in the Philippine economy emerged almost immediately following the decision to float the Thai baht on July 2, 1997 [NYT, 8/12/97]. Within a few days after the Thai decision, investors began to exit the Philippine peso and liquidate Philippine portfolio investments (as well as Indonesian and Malaysian investments). Overnight interest rates rose to 30% in efforts to protect the currency and to stem further outflows. These efforts were ultimately futile, however. The pace of investor exit accelerated further on July 7, 1997 following the release of a press report that indicated that the Philippine Finance Minister was considering devaluing the peso[5] [Economist, 7/12/97]. Faced with this unfolding crisis, the Philippine Central Bank followed the route of its neighbors and allowed the peso to float beginning on July 11, 1997.

Investor exit and the depreciation of the peso had similar social, economic and political consequences as elsewhere in the region. One important consequence of the depreciation was its effect on borrower and bank distress. Insofar as 25% of all foreign loans held by Philippine banks in 1997 were dollar-denominated (down from 30.4% in 1993; see table 3), the depreciation introduced significant repayment difficulties [WSJ, 10/6/97]. These difficulties exacerbated those introduced by the higher cost of peso-denominated loans.

[5] It was widely held that that the Philippine government aggressively managed the value of the peso despite its claims to the contrary [Economist, 7/12/97].

In mid-July 1997, the Philippine government also approached the IMF for assistance. On July 18, the IMF agreed (with similar conditions and consequences as elsewhere) to provide the government with a $4b assistance package [NYT, 8/12/97]. In contrast to elsewhere in the region, bank closures were not a part of the Philippine bailout plan. This is because high loan loss rates had not been as significant a problem in the Philippines as elsewhere in SE Asia (in 1996 the ratio of bad loans to total loans was only 3%) [FT, 10/8/97]. However, banking distress began to emerge in mid 1998 as the peso's depreciation increased the cost of foreign loan obligations.

South Korea

The most startling development in SE Asia was the collapse of the region's prototypical "miracle economy," South Korea. The conventional wisdom on the collapse was that the regional crisis exposed the failure of an economy whose strength was based on the corrupt and opaque business practices of family-owned financial-industrial conglomerates (the *chaebols*).[6] Analysts also devoted much attention to exposing the duplicity of the Korean government which, it claimed, misled foreign investors and multilateral institutions by secretly bailing out banks with large portfolios of failed loans that stemmed from domestic and international misadventures [NYT, 11/21/97].

In the spate of "post-mortems" on the South Korean economy, relatively little attention was paid to the obvious problems engendered by the dependence of Korean industry and banks (both inside and outside of the chaebol) on direct foreign investment from Japan and on portfolio

[6] In the aftermath of the crisis, the chaebols (like their Japanese counterparts, the *keiretsu*) became the institution that analysts loved to hate [Safire, 1997]. Prior to the crisis, these same institutions were held in high regard by the legion of policy analysts and business consultants that were seeking to solve the US' economic slide by looking east.

investment inflows and loans from foreign banks.[7] While the South Korean economy was growing rapidly, US, Japanese and European lenders were eager to extend short-term low-cost dollar- and yen-denominated loans directly to South Korea's highly leveraged industrial and financial firms (the latter, in turn, then extended loans to local industry) (see table 3). As of February 1998, South Korean banks owed foreign banks $153b ($23.4b of which was short term until the January 1998 restructuring of some foreign debt) [NYT, 2/10/98]. As Chang [1998a] noted, the 30 new South Korean merchant banks (these banks are less than two years old) were among the most aggressive borrowers of short-term funds on foreign markets, accounting for $20b of the $153b owed to foreign lenders.[8] Domestic indebtedness was also startlingly high: as of February 1998, South Korean firms had $300b in outstanding short-term obligations to local banks (with 50-75% of this debt coming due in three to six months) [NYT, 2/10/98]. As of February 1998, at least 20% ($60-65b) of domestic loans were in default [NYT, 2/10/98].

Once the decline in the South Korean won began (itself triggered by the flight of portfolio investors, foreign lenders and Japanese direct foreign investors, as well as the regional crisis), the currency and the Seoul stock market steadily began to lose value during November 1997-January 1998. When the sell-off of the won began in early November 1997, the government initially vowed that it would not let the won fall below the rate of 1000 won to one US dollar [IMF Survey, 2/9/98]. As the exit from the won intensified, the government tried to calm investors by expanding the won's daily band of flexibility to 10% (up from its daily band of 2 ¼%) and by spending $10b (which amounted to over 1/3) of its foreign exchange reserves in

[7] Important exceptions to this are Chang [1998a, 1998b, 1997] and Crotty [1998] who have to date developed the best analyses of the causes of the crisis in South Korea.

[8] In contradistinction to elsewhere in the region, these foreign loans financed investment in the export sector (rather than in real estate) [Chang, 1997].

efforts to protect the currency [DP, 12/16/97]. But as elsewhere in the region, the government's gesture toward greater currency flexibility only heightened investors' fears about an eventual devaluation of the won. When even this wider band proved untenable, the government on November 17, 1997 let the won float. As investor exit and the won's depreciation continued through November 1997, it became increasingly difficult for Korean banks and industry to meet their foreign currency-denominated loan obligations [DP, 12/16/97].

Following ten consecutive days of declining prices on the Seoul stock market and a 24% loss in value of the won against the US dollar (since late October 1997), the government and the IMF on December 3, 1997 reached agreement on a record $57b bailout. The bailout funds were primarily intended to supplement the foreign currency reserves of the Korean Central Bank (Bank of Korea). These reserves were to be used to aid Korean industry's efforts to refinance their foreign loans [DP, 12/4/97].

The bailout required South Korea to liquidate and/or restructure its banking system, to open its economy immediately to foreign products, to open its economy to foreign investment by raising the limit on foreign ownership of stock in South Korean companies to 55%, to reduce drastically government spending, and to raise taxes [DP, 12/4/97]. In order to draw foreign investment back to Korea, the government announced on December 16, 1997 that it would abolish all remaining controls on its currency, that it would issue $10b of state bonds overseas, and that it was willing to allow foreigners to purchase domestic commercial banks [DP, 12/16/97].

After signing the bailout, the South Korean economy continued to decline. By December 21, 1997 it became clear that large-scale defaults on the private sector's $100-$110b in

obligations (in hard currency) to foreign creditors were imminent.[9] On December 23, the South Korean government began negotiating with foreign banks to defer the private sector's loan payments. In order to preclude these defaults, the World Bank and the Asian Development Bank immediately announced that they had respectively extended to South Korea emergency loans of $3b and $2b. That same week, the Clinton administration announced that it would join with other industrial countries in supplying the country with additional emergency aid of $10b [DP, 12/24/97]. A group of the world's major commercial and investment banks announced on December 29 that they would rollover $15b in South Korean obligations until the end of January 1998. Following these announcements--and the passage by Korea's National Assembly on December 29 of a financial reform program involving further liberalization and opening of financial sector--the IMF on December 30, 1997 approved an early disbursement of a $2b portion of the bailout funds to the government [IMF Survey, 1/12/98]. When in January 1998, it became apparent that it would be difficult—if not impossible—for South Korean firms to meet their foreign repayment obligations, a coalition of thirteen international banks agreed on January 29 to restructure $24b of the short-term debt scheduled to come due during 1998 [IMF Survey, 2/9/98]. The restructuring involved swapping these short-term loans for new debt that would come due in one to three years.

As elsewhere in the region, the economic restructuring necessitated by the bailout was associated with serious economic, social and political dislocation. As the availability of credit diminished and its cost rose, corporate bankruptcies and unemployment increased. The February 1998 changes in laws governing the country's lifetime employment policies resulted in further

[9]In a much publicized speech, President-elect Kim Dae-jung announced that "national bankruptcy was imminent" [DP, 12/24/97]

increases in unemployment.

Singapore and Hong Kong: The SE Asian crises that never were

It is notable that the economies of Singapore and Hong Kong were ultimately not destabilized by the events that affected their neighbors. In general, these economies were distinguished from those of their neighbors by their low levels of hard-currency foreign indebtedness and by the fact that their monetary authorities had very large holdings of hard currency reserves. For these reasons, the initial investor exit from Singapore and Hong Kong (in August 1997 and September-October 1997, respectively) never escalated into a full-fledged panic because investors had little reason to fear loan defaults and or significant currency depreciations.

Singapore

In the context of the unfolding regional crisis, investors began to exit investments in Singapore's stock market and began to sell their holdings of the Singapore dollar late in the summer of 1997. Since the Singapore dollar was among the region's only freely floating currency, the wave of investor exit that began on August 12, 1997 induced a dramatic depreciation of the currency. Indeed, the currency fell to a three-year low against the US dollar during August 1997. The Singapore Monetary Authority did not make any effort to intervene in currency markets in order to stabilize the currency. However, it did take steps to stem portfolio investment outflow and reverse the wave of currency sales by raising interest rates and by letting it be known that it had hard currency reserves sufficient to finance up to six months of imports [BW, 8/11/97]. These measures were successful and the flight ended shortly after it began.

Hong Kong

Investor flight from the Hong Kong stock market (the *Hang Seng*) began on September 2,

1997 [NYT, 9/2/97]. Investor exit continued through the fall of 1997 and accelerated rapidly following a wave of speculation against the Hong Kong dollar in early and mid-October 1997. By October 23-4, 1997 investors were betting heavily that the Hong Kong government would be forced to devalue the currency (which has been pegged at 7.75 Hong Kong dollars to the US dollar since 1984) [NYT, 10/24/97]. This investor exit resulted in the single largest one-day drop in the Hong Kong stock market since the Tiananamen Square events of 1989 (when stocks fell by 10.4% on October 24, 1997) [NYT, 10/24/97]. Faced with these circumstances the Hong Kong government vowed to defend the fixed value of the currency. To do so, the government raised interest rates quite dramatically—overnight interest rates were raised to 300%--and spent about $1 billion of its $88b in foreign exchange reserves defending the currency's value [WSJ, 11/26/97; NYT, 10/24/97]. The government's actions, however, did not have the intended effect of calming investors. This was because Hong Kong stock prices and property values (both of which are at the heart of the economy) fell in response to the dramatic increase in interest rates [NYT, 10/24/97]. Stock prices continued to drop throughout October 1997 following further sales by investors. Just a few days after the government tried to stabilize markets, stocks again fell by another 6% (on October 28, 1997) [NYT, 10/28/97].

The investor exit finally ended once it became clear to investors that the Hong Kong government would not renounce the peg and that it was prepared to use its $88b of foreign currency reserves to maintain it. Although the investor exit from Hong Kong ended, clearly the country's high interest rates proved damaging to the economy as stock and property market activity and consumer spending contracted in 1998 [NYT, 2/2/98].

B. Crises Elsewhere in 1997-8

Brazil

In the last few years, the rapidly growing economy of Brazil was an important site of foreign direct and portfolio investment (see table 1). Foreign investors were attracted to the economy because of the opportunities presented by privatization and by the attractive returns available on government bonds. These private capital inflows were made available to the country despite the fact that they served as a principal source of finance for the country's large fiscal and current account deficits (respectively, 5% of GDP and 4.4% of GDP), despite the widely perceived overvaluation of the currency (the real), and despite the potential for social unrest created by the country's notable levels of income and wealth inequality [WSJ 11/7/97; NYT, 10/24/97].

In the fall of 1997, signs of the "Asian flu" appeared in Brazil. As investors began exiting the Hong Kong market, a similar exit from Brazilian markets and the currency began on October 23. On that day, the Brazilian stock market index fell by 8%, only to be followed by another dramatic drop five days later. In all, in the three weeks that followed portfolio investor flight from Hong Kong, the Brazilian stock market lost 40% of its value (in US dollar terms) [BW, 12/29/97]. The Brazilian Central Bank tried to stem portfolio investment outflows by quickly doubling the official interest rate to 40% (on October 30, 1997) and by expending approximately $8 billion in foreign currency reserves in efforts to protect the value of the real [NYT, 11/11/97].

In the context of the unfolding Asian and domestic crisis, the President, Fernando Henrique Cardoso, announced on November 11, 1997 a severe austerity program that was designed to boost foreign investors' confidence in the economy (and in the currency) by cutting the budget deficit and raising $15b in revenue [NYT, 2/8/98]. The program involved the usual measures of fiscal austerity (coupled with the existing monetary austerity). The program aimed

to reduce the budget deficit (to 2-3% of GDP) by raising personal taxes by 10%, increasing taxes on air travel, gasoline and liquor, and reducing government spending on social security, pensions and public employment [NYT, 2/8/98]. Since the local stock market index rose after the plan was implemented, it seemed that fiscal and monetary austerity had the intended effect on investor confidence despite (or because of) the economic slowdown these measures induced.

Russia

In the two years leading up to October 1997, the Russian stock market was deemed by investment analysts to be one of the "hottest" emerging markets in the world [BW, 3/24/97]. A number of the largest emerging market mutual funds were investing from 2-7% of their assets in the Russian market [BW, 3/24/97]. Led by portfolio investor interest in petroleum, telephone and utility stocks, the Russian stock index tripled during the eighteen months prior to October 1997 [NYT, 10/29/97]. As in Brazil, portfolio investment continued to flow into Russia despite its well-publicized economic and political problems (e.g., severe tax collection difficulties, payroll arrears involving government employees, business corruption and organized crime).

By late October 1997 an investor flight from Russia emerged (as it was occurring in Brazil, Hong Kong and elsewhere in SE Asia). The stock market index fell sharply through late October to early December 1997. Following a particularly dramatic market decline on October 29, the government of President Boris Yeltsin halted trading for several hours and purchased rubles on the open market in efforts to stabilize its value [NYT, 10/29/97]. The government also increased interest rates on government bonds to 28% in efforts to prevent further portfolio investment flight and to attract new inflows [DP, 12/6/97]. These high interest rates placed increased pressure on the already strained resources of the Russian government.

In view of these circumstances, the Russian government approached the IMF for

additional assistance. The IMF agreed to provide Russia with $1.7 billion in exchange for a commitment by the government that it would improve tax collection and lower its spending. However, on November 2, 1997 the IMF decided to suspend the quarterly disbursement of $700m on its loan to Russia because of continued dissatisfaction with the government's tax collection (only about 46% of taxes due were being collected) and the large volume of wages in arrears to government employees (arrears payments of $9.3b) [DP, 12/6/97]. Faced with these continuing difficulties and continued investor exit, the Russian government raised interest rates on government bonds to 42% on February 2, 1998 [NYT, 2/2/98]. The interest rate increase introduced additional burdens to the economy as interest costs on government debt rose.[10]

C. Rejecting Exceptionalism

In the aftermath of the crisis of 1997-8, something of an "Asian (or Russian or Brazilian) exceptionalism"--that paralleled the earlier "Mexican exceptionalism"--emerged among policy analysts. Like Mexican exceptionalism [Grabel, 1996], the new exceptionalism thesis was also without merit.

Proponents of Asian exceptionalism asserted that the crisis was an outcome of deeply rooted corruption and of the over-regulation of the economy throughout the region [e.g., Rubin's speech at Georgetown University, Treasury News, 1/21/98; Safire, 1998]. Proponents of the corruption thesis did not explain how the corrupt ties that bound firms and governments throughout SE Asia led to crisis in 1997-8 while having led to high growth up until that time. That is, why did corruption become catastrophic only in 1997? And moreover, if corruption was indeed widespread—as was asserted—why then were foreign investors and lenders willing to commit vast resources to these economies for so long?

[10] As of this writing (June 1998), Russia appeared to be entering a second round of crisis.

Some advocates of the corruption thesis argued that it was not the mere presence of corruption that caused the collapse, but rather it was the *intensification* of corruption that triggered the collapse. Granting this point, however, overlooks the structural circumstances that allowed corruption and risk taking to intensify prior to the crisis in some countries. In work on South Korea, Chang [1997, 1998a, 1998b] showed that corruption in fact did intensify because of the government's decision to curtail dramatically its *regulation* of the economy (by terminating longstanding programs of investment coordination and managed competition and by promoting financial liberalization). Thus, according to Chang, to the extent that corruption and risk taking intensified in South Korea it was an outcome of the government's decision to under-(and not over-)regulate the economy.

Chang's argument regarding South Korea is also more generally applicable to the region. In the case of the region's economies, there were recent moves toward external and internal financial liberalization. Internal financial liberalization allowed domestic banks to become heavily involved in foreign operations and allowed them to get involved in riskier domestic lending activities (themselves made possible by liberalization). The promotion of stock markets along with external financial liberalization contributed to the creation of an attractive investment climate for international portfolio investors. And in the broader context of the speculative booms that liberalization touched off in the region, higher rates of leveraging by the private sector became the norm. Thus, to the extent that risk taking and corruption may have intensified throughout the region, its intensification had its roots in changes in government policies and regulatory patterns that created space for these practices to flourish.

Turning to Russia, exceptionalism (regarding corruption, tax evasion, and crime) was similarly problematic as an explanation of the investor exit from that country. Given that these

problems were apparent since the collapse of Communism one cannot invoke their discovery in 1997-8 to account for a sudden investor exit from the stock and the government bond market. It was far more reasonable to attribute the exit from Russia and indeed Brazil to general investor skittishness on emerging markets following the collapse of conventional wisdom on SE Asia. Thus, Brazil and Russia fell victim to an emerging market contagion made possible by financial openness.

D. Increased Risk Potential and Constrained Autonomy in the Crisis of 1997-8 and Mexican Crisis

In what follows I consider the manner in which the general theoretical arguments regarding the problems associated with emerging economies' dependence on private capital flows are applicable to the crisis of 1997-8. I argue that the crisis was principally caused by the failure of the government to control portfolio investment flows and by the private sectors' excessive reliance on hard currency-denominated private loans. In pursuing this mistaken path, the countries involved in the current crisis were exposed to the problems of increased risk potential and constrained policy autonomy. Though these problems are generally applicable to a range of countries, they emerged with varying force due to different initial conditions.

Constrained autonomy

The ex-ante constraint on policy autonomy did not pertain to the countries of SE Asia in the years prior to the current crisis, given their recent histories of rapid economic growth. In the context of the sanguine conventional wisdom on SE Asia prior to the crisis, lenders and investors were willing to overlook and even *reinterpret* (per the World Bank's *Asian Miracle Report*) the distinctly non-neoliberal strategies associated with the Asian development model.

In sharp contrast to SE Asia, governments and central banks in Brazil and Russia (and

Mexico prior to its crisis) had to overcome portfolio and direct foreign investors' perceptions that these economies were risky.[11] In the case of Brazil and Mexico, investors had to be convinced that the economies had been rehabilitated. Rehabilitation was necessary in the Latin American cases because of the region's difficulties during the debt crisis of the 1980s, and because of the history of high inflation, exchange rate volatility, low growth, and the proclivity of "heterodox" governments to nationalize foreign investment. In the Russian case, the government, too, had to overcome investors' fears of high inflation and the country's poor record on tax collection, crime and political stability. In view of these perceived problems, it was necessary that economic and social policy in Brazil, Mexico and Russia be strongly neoliberal as a precondition for the maintenance of investor confidence, and hence in order to attract high levels of private investment. Governments had to pursue privatization and financial and economic liberalization in order to signal private investors and bondholders that it was safe to invest. In Brazil, in particular, the strong profile of President Cardoso's commitment to neoliberal policy at all costs has been critical to the maintenance of private (foreign and domestic) investor confidence.

Thus, in countries such as Russia, Brazil and Mexico, where investor pessimism or disinterest had to be overcome, the credibility of the government's commitment to neoliberal policy was critical to the attraction of private capital flows. For this reason, we can say that the range of macroeconomic and social policies available to these governments was constrained by the overriding objective of attracting private capital flows. By contrast, given the status of the SE Asian economies, these governments did not risk repelling private capital by pursuing non-

[11] Note that bank-based lending to Latin America did not resume following the debt difficulties of the 1980s. However, bonds issued by the Brazilian and the Mexican government were sold in large numbers to private investors.

neoliberal strategies.

The evidence on constrained policy autonomy following the crisis (i.e., the ex-post constraint) is strong in the cases of all the countries involved in the crisis of 1997-8 (and Mexico following its crisis). Following the emergence of the crisis in each country, governments and central banks were compelled to take steps to stem the portfolio investment outflow and to prevent the currency from depreciating. These measures principally involved increasing interest rates in order to slow or reverse the investor flight and expending vast quantities of foreign exchange reserves in efforts to stabilize currency and stock prices. These interest rate increases introduced the possibility of defaults on domestic variable rate loans, bank distress, slowdowns in economic activity, rising unemployment, social dislocation and political instability. The depletion of foreign exchange reserves also impaired the government's ability to finance ameliorative policies aimed at easing the dislocation associated with the crisis and its aftermath. Given the problems caused by investor flight and currency deprecation, governments and central banks found it necessary to implement (or intensify in the case of Brazil) macroeconomic policies that would aggravate the consequences of the crisis for the majority of the population and could slow economic activity.

In those countries where a bailout followed the crisis (viz., Indonesia, Thailand, the Philippines, South Korea, and Mexico), all of the bailouts stipulated that governments introduce or intensify neoliberal reform and increase the openness of the economy. The influence of the IMF (and the US in the Mexican case) over macroeconomic and social policy in countries that accepted bailouts was substantially increased. Indeed, the entire direction and import of policy in the post-crisis period was principally aimed at restoring investor confidence and promoting an "Americanization" of these economies via radical neoliberal reform and greater openness to

foreign direct and portfolio investment. And in those countries where an IMF bailout was not requested (Malaysia, Brazil, Hong Kong, Singapore) domestic policymakers nevertheless pursued contractionary policies that were markedly similar to those mandated under bailouts elsewhere.

Increased risk potential

The arguments regarding increased risk potential, too, are highly germane to the crisis of 1997-8. To be sure, the expansion of portfolio investment inflows and relatively inexpensive hard currency-denominated loans provided governments and the private sector with resources to which they might not have otherwise had access. These portfolio investment inflows--and the initial rise in stock prices generated by the inflows--no doubt played an important role in stimulating the booms that each of the economies involved in the crisis of 1997-8 experienced. However, the liquidity of this portfolio investment ensured that markets could be destabilized quickly once currencies and stock prices started to come under pressure following investor exit. Such an initial destabilization could--and did--trigger a mutually reinforcing exit of portfolio and currency investors.

A dependence on foreign loans (especially short-term loans) on the part of the private sector in SE Asia and foreign bond sales on the part of the public sector in Brazil, Russia and Mexico also introduced increased risk potential to these economies. These economies were rendered vulnerable to the costs of currency depreciations and lender/bondholder herding. When lenders/bondholders began to turn bearish on these economies, currency depreciations of course meant that borrowers faced an increase in the cost of their repayment obligations.

Economic openness also introduced increased risk into the economies involved in the crisis of 1997-8. When US interest rates rose in Feb. 1995, investors began to exit Mexico

during that country's crisis. The same dynamic obtained in the current crisis when economic circumstances changed in the US and Japan in 1996-7. Insofar as the bailouts stipulate greater openness on the part of afflicted economies, these economies are rendered more vulnerable to the risk of experiencing the cycle of investor and lender flight followed by currency depreciation and financial crisis.

Financial openness also introduces the possibility of a cross-border contagion. Once one nation realizes the increased risk potential of liquid private capital flows and currency depreciation, it becomes likely that crisis will spread across borders. The likelihood that investors and lenders will see emerging economies in an undifferentiated fashion—the "guilt by association" of the tequila effect or the Asian flu—makes the possibility of cross-border contagion more likely in the case of emerging economies.

The interaction of increased risk potential and constrained autonomy are also relevant to understanding the crisis of 1997-8 and the earlier Mexican crisis. In order to try to contain the crisis of 1997-8 and the earlier Mexican crisis, the bailouts introduced a great deal of external influence in economic decision making. But by further opening the economy to capital inflows (as the neoliberal tenor of the bailouts required), the vulnerability of these economies to future crises may be exacerbated, necessitating future bailouts and increased foreign intervention in the economy. This argument also pertains to those countries that did not receive bailouts (namely, Brazil and Malaysia) since the national governments in these cases that initiated reforms that were analogous to those mandated under the bailouts.

IV. PREVENTING A REPEAT OF THE CRISIS OF 1997-8

The measures implemented to address the crisis of 1997-8 are unlikely to prevent their recurrence. Indeed, the increased external orientation and neoliberal reform induced by the crisis

render these economies vulnerable to recession and to a repeat of recent history. If there was a silver lining to the crisis of 1997-8 it was that it created some space for policymakers to consider measures that would prevent the recurrence of financial crisis in emerging economies.

This rethinking of the conventional wisdom came from a number of unlikely sources. Malaysian Prime Minister Muhathir's nationalist attacks on international currency speculators (though self-serving) helped indirectly to focus attention on the costs of uncontrolled financial openness in emerging economies. There also seemed to be some signs of a change in thinking on the part of prominent mainstream economists. For example, Stanley Fischer, the IMF's First Deputy Managing Director, made a number of well-publicized speeches in which he expressed doubts about the wisdom of premature capital account liberalization in light of developments in SE Asia [NYT, 2/3/98; Fischer, 1997]. In Fischer's September 19, 1997 speech at the IMF-WB Annual Meeting in Hong Kong and at a March 9-10, 1998 seminar at the IMF he acknowledged that there was a strong case to be made for phased capital account liberalization where the macroeconomic framework and the financial sector were weak [Fischer, 1997; IMF Survey, 3/24/98]. During the period where some control is desirable, Fischer argued that these controls should be market-based (as in Chile today) and should be gradually phased out as the macroeconomy improves. In view of these considerations, the IMF's Interim Committee was charged with examining the issue of amending the Institution's Articles of Agreement to allow phased capital account liberalization [Fischer, 1997; IMF Survey, 3/24/98]. Fischer further noted in his speech at the January 1998 World Economic Forum in Davos, Switzerland that the Chileans were to be commended for their efforts at curbing excessive reliance on short-term loans from abroad [NYT, 2/3/98]. At the same venue in Davos, Joseph Stiglitz, chief economist at the World Bank, called for similar curbs on short-term foreign borrowing by emerging

economies [NYT, 2/1/98].

The IMF's austerity solution to the crisis was attacked from many quarters as well.[12] For example, following the bailout of South Korea, economists Jeffrey Sachs and Paul Krugman and currency trader George Soros made well-publicized cases against the austerity measures prescribed by the IMF [NYT, 2/1/98].[13] Soros, in particular, argued that the crisis and the IMF's mishandling of it demonstrated that markets and the private sector alone could neither prevent nor resolve the crisis [Soros, 12/31/97].[14]

It remains unclear as to whether anything positive will ever result from these attacks on the IMF and the soul searching by some of the most prominent staff members of the IMF-WB. At the same time and in the same venues where phased capital account liberalization was discussed, the issue of amending the IMF's Articles of Agreement in order to include explicit jurisdiction over capital movements was also being debated [IMF Survey, 3/24/98]. Thus,

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[12] US Treasury Secretary Robert Rubin was the most prominent defender of the IMF's bailout policies. Beginning with his January 21, 1998 speech at Georgetown University, Rubin defended the soundness of IMF policy and argued that its bailouts protect US economic and foreign policy interests as well as those of the investors who would be hurt by an emerging market crisis [Treasury News, 1/21/98].

[13] The costs of Brazil's self-imposed austerity received a surprising degree of attention in the business press [NYT, 2/8/98].

[14] In view of the IMF's mishandling of the crisis, Soros developed a rather odd proposal to prevent a recurrence. He proposed the creation of an International Credit Insurance Corporation (ICIC) as a sister institution to the IMF. The ICIC's principal task would be to guarantee international loans for a modest fee. Borrowing countries could only receive loan guarantees if they provided the ICIC with full information on all borrowings—insured or not, public and private. This proposal is predicated on the assumption that the crisis was caused by bad or insufficient information about the indebtedness of the private sector in SE Asia. However, the high degree of leveraging of the region's borrowers could hardly be considered a secret to the very lenders that were extending these loans.

"rethinking the capital account" may simply result in a further increase in the IMF's influence over decisionmaking in emerging economies. Moreover, following the Mexican crisis, a similar search for lessons ultimately resulted in a mere reconsolidation of the institutions' conventional focus on sound macroeconomic management and the failed effort to prevent crises via the dissemination of better information. It is ironic, too, that in a study of the Mexican crisis written prior to the events of 1997-8, the WB [1995] contrasted the misuse of capital inflows by Mexico with the sound use of such resources by SE Asian governments!

The arguments developed in this chapter indicate that governments in emerging economies must take steps to limit the growth of hard currency-denominated foreign debt and control highly liquid portfolio investment flows, even at the cost of slowing economic growth. The kinds of restrictive measures that might be used to control portfolio investment flows are quite familiar, and so they will be described only briefly here.

Capital controls are one such measure that deserves serious consideration especially in light of the events of 1997-8. Capital controls augment policy autonomy (by restricting investors' ability to flee whenever a government pursues a policy of which they don't approve) and enhance state capacity. More germane to the present discussion, they also reduce macroeconomic instability by dampening capital inflows and outflows. Crotty and Epstein [1996] have made a particularly forceful case for the necessity and feasibility of such policies in emerging economies.

Although they have fallen from favor in economic theory, capital controls remain an important component of economic management in some emerging economies today. Measures currently in place in Chile and Colombia (often referred to as the "Chilean model") represent an extremely promising direction for policy. The measures balance the need for capital with the

need to protect the economy from instability. In Colombia, foreign investors are free to engage in (less liquid) direct investment, but are precluded from purchasing debt instruments and corporate equity. As a consequence, foreign capital is much less able to flee Colombia en masse. In Chile, foreign investors may engage in portfolio investment, but they must keep their cash in the country for at least one year [Economist, 4/8/95]. Investors are therefore much more apt to base their investment decisions on a company's long-term economic prospects than on the opportunity for short-term speculative gain. To the surprise of many orthodox economists, this model has been performing well. Indeed, Chile has not only succeeded in securing large portfolio investment inflows, but has also remained largely unaffected by the Asian flu.

The Chilean model also offers valuable lessons on the matter of discouraging the kinds of private sector borrowing that contributed significantly to the current crisis. The Chilean government tries to discourage borrowers from taking on short-term foreign loans by imposing a kind of reserve requirement tax on loans with a maturity of less than one year. Borrowers who take on such loans are required to deposit 30% of their loan proceeds in a non-interest bearing account for a number of months. This measure has also proven beneficial to Chile in terms of reducing the risk potential of foreign borrowing, and deserves wide consideration elsewhere.

Many economists [Arestis and Sawyer, this volume; Felix, 1993; Grieve Smith, 1997; and essays in Haq, Kaul, and Grunberg, 1996] and important organizations like the UNCTAD have also proposed adapting James Tobin's proposal for a uniform global transactions tax on foreign currency trading (termed the "Tobin tax"). The Tobin tax is primarily intended to address the problem of foreign exchange market volatility caused by speculation in this market. But this approach would also offset some of the instability associated with international portfolio investment flows, as traders fleeing assets denominated in a country's currency would face the

tax in their foreign exchange transactions. In this way, the Tobin tax would offset the extreme liquidity associated with portfolio investment, reduce the profitability of international "churning" of investment portfolios, and thereby provide developing countries with greater financial stability. Relying on market incentives, such a Tobin tax represents a very simple policy tool for lengthening the time horizon of international portfolio investment. But it would also provide new pools of finance that could be targeted to developing countries to compensate those harmed by financial instability, and especially to finance long-term, real-sector development projects (as Felix [1993] has suggested).

Finally, it would also be advisable for governments in emerging economies to consider designing simple measures that might indicate (both to them and to investors) whether they are vulnerable to a crisis triggered by investor exit or a currency collapse.[15] Three such indicators might serve as "ex-ante circuit breakers"; these circuit breakers would make apparent when a country faced high levels of risk of currency depreciation and investor/lender flight. As a country approached the danger range, governments would implement measures to curb imports, slow the pace of foreign borrowing, slow the entry and exit of portfolio investment or limit the fluctuation of the domestic currency. There would have to be, say, three sets of thresholds for

[15] Note that a group of economists associated with the IMF (as both consultants and employees) proposed the development of a new early warning system to improve upon the IMF's failed Special Data Dissemination Standard. It involved monitoring a very broad array of crisis indicators. These indicators included internal and external imbalances, problems in the domestic financial sector (including declining international reserves, currency appreciation, credit growth, money supply growth, increasing domestic inflation), the rate of real GDP growth, and political instability [IMF Survey, 8/18/97]. Given the array of indicators proposed, it is doubtful that anything but mixed signals could be derived from such a cumbersome signaling procedure.

these indicators—for emerging economies at the lowest, medium and highest levels of development.

Two indicators of currency risk might be given by the ratio of official reserves to total short-term external obligations (the sum of accumulated foreign portfolio investment and short-term hard-currency foreign borrowing); and the ratio of official reserves to the current account deficit. A simple indicator of vulnerability to a lender withdrawal would be the ratio of official reserves to private and public foreign currency-denominated debt (with short-term obligations receiving greater weighting in the calculation). The vulnerability to portfolio investor exit could be measured by the ratio of total accumulated foreign portfolio investment to gross domestic capital formation. If a large proportion of domestic capital formation were financed by inward portfolio investment, this would provide an indication of the country's vulnerability to a reversal of those flows and its excessive reliance on a particularly liquid type of international capital flow. As a country approached the danger range, new capital inflows would have to "wait at the gate" until domestic capital formation increased by a certain level. Thus, this indicator would slow unsustainable growth in an emerging economy until a larger proportion of any increase in investment could be financed domestically. Given the experiences of 1997-8 and 1994-5 (in Mexico), slower growth may be a worthwhile price to pay in lieu of the instability created by a sudden exit of external finance. These indices are merely suggestive and preliminary in nature; further research will be undertaken to develop the appropriate trigger ranges and test these for particular countries.

Table 1. Countries involved in the crisis of 1997-8: Net private capital flows (US $ billions) and annual percentage change in the stock market index, 1980-1996.

COUNTRY		1980	1989	1991	1993	1995	1996
Indonesia	*PI*	0	.2	0	2.5	4.8	3.0
	DFI	.2	.7	1.5	2.0	4.3	8.0
	Loans	1.6	3.0	5.2	-1.0	3.4	6.1
	STK	--	31.0	-40.8	114.6	9.4	24.0
Malaysia	*PI*	0	.2	0	3.7	2.3	4.4
	DFI	.9	1.7	4.0	5.0	4.1	4.5
	Loans	1.1	-1.3	.4	2.2	4.0	2.5
	STK	--	58.2	9.9	98.0	2.5	24.4
The Philippines	*PI*	0	.3	0	1.4	2.0	1.9
	DFI	-.1	.6	.5	1.2	1.5	1.4
	Loans	1.3	.6	.7	1.5	.5	1.5
	STK	--	31.2	76.7	154.4	-6.9	22.2
Singapore	*PI*	-.1	-.4	-.6	-7.9	-7.5	--
	DFI	1.2	2.9	4.9	4.7	7.0	--
	Loans	--	--	--	--	--	--
	STK	--	--	--	--	--	--
S. Korea	*PI*	--	-.06	.4	.2	.3	--
	DFI	6.0	1.1	1.2	.6	1.8	--
	Loans	--	--	--	--	--	--
	STK	--	.3	-12.2	27.7	-14.0	-26.2
Thailand	*PI*	0	1.4	.04	3.1	2.2	1.6
	DFI	.2	1.8	2.0	1.8	2.0	2.3
	Loans	1.8	1.7	3.0	3.2	6.3	10.2
	STK	--	127.3	16.0	88.4	-5.8	-35.0
Brazil	*PI*	0	0	.8	5.5	4.4	4.0
	DFI	1.9	1.3	1.1	1.3	4.9	9.9
	Loans	4.6	-3.5	.6	8.4	8.9	14.0
	STK	--	1,762.5	2,316.0	5,437.2	-1.3	63.8
Russia	*PI*	--	0	0	0	.1	5.0
	DFI	--	0	0	0	2.0	2.5
	Loans	--	4.6	4.3	2.9	-.8	3.2
	STK	--	--	--	--	--	190.6

Notes: PI=Net portfolio equity flows

DFI=Net foreign direct investment

Loans=Net flow of long-term debt (excluding IMF loans)

STK = annual % change in local stock market price indexes (1996 data are preliminary).

STK Indonesia= JSE Composite (Aug. 10, 1982=100)

STK Malaysia=KLSE Composite (Jan. 1977=100)

STK Philippines=PSE Composite (Jan. 2, 1985=100)

STK South Korea=KSE Composite (Jan. 1980=100)

STK Thailand=SET (April 30, 1975=100)

STK Brazil=IBOVESPA (1968=0.000000001)

STK Russia=ASP General 100 (June 20, 1994=100)

Data on Hong Kong are note available.

Sources: PI, DFI and LOAN data are from *Global Development Finance*, 1998, vol. 1, World Bank[Washington, DC, 1998].

Stock index data are from the *Emerging Stock Markets Factbook*, 1997, International Finance Corporation [Washington, DC, 1997].

Table 2. Mexico: Data on net private capital flows ($US billions) and annual percentage change in the stock market index, 1980-1996.

	1980	1989	1991	1993	1994	1995	1996
PI	0	0	4.4	14.3	4.5	.5	3.9
DFI	2.2	3.0	4.8	4.4	11.0	9.5	7.6
Loans	6.8	-1.5	4.2	2.5	4.6	16.3	4.3
STK	--	98.0	127.7	47.9	-8.7	16.7	21.0

Notes: PI=Net portfolio equity flows

DFI=Net foreign direct investment

Loans=Net flow of long-term debt (excluding IMF loans)

STK = annual % change in Mexican stock market price index (1996 data are preliminary).

STK Mexico=BMV General (Oct. 1978=0.7816)

Sources: PI, DFI and LOAN data are from *Global Development Finance*, 1998, vol. 1, World Bank [Washington, DC, 1998].

Stock index data are from the *Emerging Stock Markets Factbook*, 1997, International Finance Corporation [Washington, DC, 1997].

Table 3. Currency composition of long-term debt (%), 1980-96

COUNTRY		1980	1989	1991	1993	1995	1996
Indonesia	DM (%)	7.8	5.2	4.9	4.1	4.9	4.8
	Yen (%)	20.0	34.4	35.7	37.6	35.3	34.5
	US $ (%)	43.5	24.6	19.4	19.9	21.5	24.3
Malaysia	DM (%)	3.3	11.2	4.6	3.0	--	.8
	Yen (%)	19.0	33.9	36.1	37.5	--	28.0
	US $ (%)	36.7	32.6	29.8	29.4	--	55.7
The Philippines	DM (%)	2.0	1.6	1.6	1.4	1.5	1.6
	Yen (%)	21.9	30.6	34.3	38.3	36.9	35.3
	US $ (%)	51.6	40.6	32.9	30.4	31.5	33.8
S. Korea	DM (%)	3.7	3.9	5.2	4.2	--	--
	Yen (%)	16.6	27.1	31.4	32.0	--	--
	US $ (%)	53.5	35.3	39.3	45.7	--	--
Thailand	DM (%)	4.7	3.1	3.7	2.3	--	2.1
	Yen (%)	25.3	41.4	45.6	50.1	--	45.4
	US $ (%)	41.0	22.9	19.1	22.6	--	32.1
Brazil	DM (%)	8.1	7.9	9.3	5.8	4.8	4.3
	Yen (%)	8.5	5.6	7.5	6.4	6.3	5.8
	US $ (%)	67.8	64.1	59.4	63.0	67.4	69.2
Russia	DM (%)	--	28.9	38.6	24.4	24.8	22.4
	Yen (%)	--	3.8	2.7	1.7	1.9	1.6
	US $ (%)	--	33.6	34.3	62.5	62.1	65.5
Mexico	DM (%)	4.3	4.2	3.9	3.7	3.0	3.5
	Yen (%)	1.4	10.6	7.2	8.8	7.5	7.7
	US $ (%)	78.7	58.9	61.8	60.6	66.1	67.8

Notes: DM (%)=% of long-term debt owed in Deutschmarks

Yen (%)=% of long-term debt owed in Yen

US $ (%)=of long-term debt owed in US Dollars

Data on Hong Kong and Singapore are not available.

Sources: Data on currency composition of debt are from *Global Development Finance*, 1998, vol. 1, World Bank [Washington, DC, 1998].

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