Capital Flows, Global Banking and Financial Crises in the post-Bretton Woods Era as A Guide to the 21st Century's Financial Crises[1]

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1 . Introduction

One cannot help but notice that the rapid rise in the importance of global capital flows appears to be simultaneous with the most recent decline in the share of US commercial banks in the assets of all financial institutions operating in the US, and that both of these events occur after the breakdown of the Smithsonian agreement that signaled the final collapse of attempts to save the Bretton Woods System. From that date, international flows of capital have played an increasingly important role in determining the behaviour of the global economy. And from that date increased competition in banking has driven banks into different areas of activity, as well as into different geographical areas. The increase in capital flows has been accompanied by an increase in systemic financial crises in both developed and developing countries and the increase in international competition in banking has been accompanied by an increase in bank failures associated with systemic crises. The 1975-83 crisis in the Southern Cone was followed by the Latin American debt crisis of 1982, the thrift and banking crisis in the US, the global stock market breaks of 1987 and 1989, the EMS crisis of 1992, the global bond market collapse of 1994, the Tequila crisis of 1994-5 and most recently the crisis of the Asian Tigers in 1997-?. One can thus not help wondering if the combination of increasingly free competition in banking and increasingly free global capital flows is not structural, and whether the increase in the frequency of crisis might not be linked to this combination.

II. Financial Crises of the 20th or 21st Century?

The Asian financial crisis has been described by the Managing Director of the International Monetary Fund, Michel Camdessus, as the first crisis of the 21st century. However, there are a disturbing number of similarities in the characteristics of the crises that have punctuated the history of the post-Bretton Woods world. All of the crises have been initiated by a sharp increase in capital inflows. The change in the rate of capital inflow does not appear to be determined by any sudden change in the economic conditions or the so-called policy fundamentals of the country, but rather is a result of an internal policy of stabilisation that produces sharp divergence relative to the rest of the world in either interest rates or growth rates.

Since many of the internal stabilisation policies have been accompanied by liberalisation of the economy, removal of restrictions on the operation of the market, and deregulation of the financial sector, they have been interpreted as raising the expected returns to investment in the country because of the anticipate improvement in fundamentals. However, the direct causes of the increased flows appear to be more closely linked to the removal of controls on capital account and the introduction of restrictive monetary policy, privatisation, opposed movements in foreign interest rates and international investment diversification. In conditions in which banks are subject to increased competition, they have looked to international investments to increase return on

[1]Paper prepared by Prof. J. A. Kregel for the Seminario *Evaluación y Perspectivas de la Economía Mundial: La Crisi del Sureste Asiático* organised by the Instituto de Investigaciones Económicas y la Facultad de Economía, UNAM, Mexico City, 8-9 June, 1998.

equity and market share. It is the rise of competition in the banking sector that has provided the motor behind the capital flows that have been attracted by these policy changes.

Interest rate and growth rate differentials — policy differentials

In Chile, the decision to remove controls on capital inflows in the presence of tight monetary policy, accompanied by a decision to introduce a fixed exchange rate, brought massive inflows that were used to finance the privatisation of government assets. In the Latin American debt crisis it was the difference in growth rates in the aftermath of the oil crisis that attracted capital seeking higher rates that those that were available internationally due to the post-oil crisis recession in the developed countries. In the 1992 ERM crisis, it was again a combination of high interest rates in Italy and the UK, relative to rates in Germany and the US, that attracted arbitrage funds encouraged by the Italian decision to lift all remaining controls on capital flows and adopt the narrow exchange rate band of the ERM. In the build up to the Tequila crisis of 1994 the flows were due to a policy of low interest rates in the US and a strong anti-inflation policy in the presence of a pegged stable exchange rate that was further supported by the privatisation of the banks and other sectors of the economy that produced a boom in equity prices which had little to do with domestic profitability, but much to do with the search for higher returns and international diversification. The Asian crisis had its origins in the same period, as low rates in the US in the early 1990s drove investors in search of higher returns. The Asia countries had been employing stabilisation policies with success for decades, and their high growth rates and high interest rates, along with the problems in Latin America, produced large interest differentials that proved too attractive for international investors to resist. Thus, the existence of large arbitrage flows taking advantage of large international interest rate differentials appear to be an integral part of each experience of rapidly rising capital inflows.

It is a characteristic of arbitrage that it should not be permanent; that it is eliminated in its pursuit. Yet the interest rate differentials that are here under discussion are not market determined rates, they are usually the result of economic policy decisions that influence rate structures. It is now common to say that the flow of capital in free international markets punishes unsustainable policies. Yet, the interest rate divergences that produce these flows in the case of financial crises have usually been associated with policies to eliminate domestic inflation, or linked to what are called in IMF terms "structural adjustment" policies, that are designed to prepare a country for participation in the international trading system by reducing inflation rates and balancing government budgets. Even in the case of the US in the 1980s, the rise in rates was to eliminate inflation, and the sharp reduction in rates in the early 1990s was to restore the stability to the banking system in conditions of recession.

Thus, there is little reason to believe that capital flows based on an arbitrage of interest rate differentials will eliminate them. Unlike traditional arbitrage flows, there will not be self-eliminating, but rather self-reinforcing. As such, they serve to make the pursuit of domestic stabilisation more difficult. Since they are arbitraging non-market rates, they are of necessity playing on one-way bets as long as the policy exists. Only if the policy is successful will the flows be self-eliminating. But, again, unlike traditional arbitrage flows, instead of reinforcing the policies they will in general serve to undermine it.

For example, tight fiscal and monetary policies designed to combat domestic inflation will cause an increasing interest rate differential

that attracts foreign arbitrage flows that are invested domestically, increasing domestic credit and liquidity. This serves to offset the restrictive policy, unless the flows are sterilised, but this requires issuing more domestic debt at a higher interest rate. This will first increase domestic reserves and thereby create the impression of a strong exchange rate. Since the reserves are invested at international rates, there is negative carry which must be financed through an increase in the budget deficit, or the issue of even more domestic debt. This will put further upward pressure on interest rates and further reinforce the interest differential and attract more capital inflows. This puts upward pressure on the exchange rate and unless the policy brings inflation down very rapidly it will lead to a real appreciation that causes the foreign deficit to increase. A rising foreign deficit, a rising fiscal deficit and an appreciating real exchange rate clearly represent an unsustainable policy combination. A change in differentials, an external shock, some weakness in the exchange rate, or a butterfly flapping its wings in Borneo, may then set off the decision of investors to punish the unsustainable policies by withdrawing capital. As long as economies require different adjustment policies because of different internal conditions or because of asymmetry in the international business cycle, capital flows will arbitrage across these policies. The arbitrage will eventually render the policies unsustainable, but not by eliminating the interest differentials.

Reversal of Inflows

The second common characteristic of the recent financial crises has thus been that the large increase inflows is eventually followed by an equally large and rapid reversal when the external conditions that created them are eliminated or when they have render the domestic adjustment policies unsustainable. Capital flows were reversed in Chile and in Latin America by the introduction of a new monetary policy in the US that led to a sharp appreciation of the US dollar. In the ERM crisis it was the rising foreign and fiscal deficits in Italy and the UK, while in Asia is was a combination of rising foreign rates and conditions on the foreign balance. As the funds flowed out, the unsustainability of domestic policies was exposed. But, this unsustainability was induced in large part by the impact of the flows themselves on the conditions in the economy. One component that usually accompanies the reversal of flows is the discovery of structural weakness in the governance and regulation of the banking system.

Banking Crises

The large capital inflows usually create over extension in bank lending that only creates difficulties once the flows are reversed; the result is instability or a collapse of the banking system. This instability in the banking system is usually blamed on inappropriate domestic regulation of the financial sector or lax supervision of the implementation of regulations. While it is certainly true that in the crises in Chile, in Mexico in 1992 and in Asia, the banking systems had just undergone liberalisation and deregulation, and that regulators and supervisors are notoriously slow to adjust to changes in the structure and activity in financial markets, there is no known case in any country, developed or developing, of a large increase in flows into the banking sector not leading to an over extension of lending, a decline in the quality of assets and increased laxity in risk assessment. This was as true of the Florida banks in the 1927 property lending crisis as it was of all US banks and thrift institutions in the late 1980s.

Lending excesses are in general caused by sudden large increases in inflows of funds or from recent liberalisation of controls on acceptable areas of lending activity. Thus in a number of

crises the increase in bank lending was the result of banks moving for the first time into areas of activity that had been forbidden; the increased lending serving primarily to finance a rapid increase in asset prices and producing a so-called asset bubble. Property and equity prices rose very rapidly in the Chilean case, as well as in the runup to the Tequila crisis and in a number of Asian countries. In almost all of these cases, banks had recently gained the right to lend against residential and commercial property and to invest in finance and property companies. These bubbles are an additional source of instability, for bank loans are collateralised by the value of the property. Recent entry into such activity usually means that bank loan officers have little expertise in valuation of property so that there is a tendency to accept market prices which may be far above any reliable estimate of liquidation values.

In all but the ERM crisis, the reversal of capital flows was accompanied by a collapse of the banking systems. This was due to the over-lending, extension of lending to property and finance companies and the associated bubble in asset prices on the one hand, but also to another factor, the existence of substantial currency mismatches on balance sheets.

Dollar lending

The fourth common factor of the crises is that capital flows funded domestic lending in foreign currency terms. Dollar lending dominated the expansion of credit in Chile, the Latin American debt crisis was almost entirely syndicated bank lending of US dollars, and the Asian crisis also exhibited large exposures of both banks and firms in foreign currencies. Only in the ERM crisis was this factor absent, since investors were speculating on gains on foreign assets due to interest rate changes. But, even here, the necessity of hedging the currency risk was the factor that eventually brought the crisis to a head. The existence of foreign currency exposure represents two risks to stability. One is interest rate risk, for it is usually of short-term duration and will be responsive to changes in international interest rates. It may then require rapid repayment and substitution with domestic credit. The second is exchange rate risk. Large changes in exchange rates can produce rapid changes in liabilities, without any substantial change in asset values for banks or companies without foreign earnings. A depreciation of the exchange rate thus leads to an instant capital loss for banks and firms and a decrease in capital. A sufficiently large exchange rate change may not only produce illiquidity, but also insolvency. Since a rapid capital outflow will usually lead to a depreciation of the exchange rate, there will be an automatic increase in the fragility of banks and firms. The only way to stem these losses will be to repay the debt, or to hedge the remaining risk. This requires purchase of foreign currency and places further pressure on the exchange rate. Thus in those cases where there is substantial foreign currency lending by banks and borrowing by firms, capital outflows are usually accompanied by sharp movements in exchange rates that produce bank failures and corporate bankruptcies. The exchange rate regime, and the adjustment of that regime between stable and floating rates is thus also an important common factor.

Exchange Rate Stability

Thus, the fifth common factor is the existence of exchange rate stability during the period of capital inflow. This stability if often the result of nothing more that the flows themselves and the build up in reserves that is created through the sterilisation that is required to preserve domestic stabilisation policy. Exchange rates were fixed in Chile as part of the policy to reduce the impact of imported inflation due to expectations of future depreciations of the currency. In the ERM

rates were presumed to be fixed and to become irrevocable, while in the Asian crisis there was a ten-year experience of currency pegs producing a fluctuation of around 10% in rates relative to the dollar. In the Latin American crisis the dollar was chronically weak throughout the inflow period. The flows are thus reinforced by the exchange stability, as is the build up of foreign currency lending by banks and borrowing by firms. It is this second aspect, as seen above, that is important in the adjustment to the capital outflows. A collapse of the exchange rate regime, or a sharp change in the value of a foreign currency as in the US in the early 1980s, not only produces a withdrawal of capital, it has a direct effect on the financial stability of banks and firms and leads to additional pressure on the currency. Thus, exchange rate changes are driven by the impact on the balance sheets of economic agents, rather than on their expenditure decisions. This will produce exchange rate adjustments that are far in excess of what might have been considered sufficient to produce an adjustment in the foreign balance and speculation of further falls dominate the market.

Types of Capital Inflows

One factor that differs appreciably across the different experiences is the form of capital inflow. In Chile, the loans were primarily by foreign banks to domestic entities, while in the Latin American debt crisis, syndicated bank lending reached the level of an art form to provide the recycling of the petroleum surpluses. In the aftermath of the debt crisis, bank lending virtually disappears, to be replaced by fixed interest bond issuance. This was initiated by the issue of Brady bonds, and sovereign issues were subsequently used to pay down outstanding bank indebtedness. In the Tequila crisis the flows were primarily portfolio flows, into both equity and government debt, both denominated in pesos. The Asian crisis represents the return of bank lending to the global capital market, with a high proportion of the lending representing short-term bank lending. Thus, the form of lending has gone full circle from banks, to syndicated loans, to sovereign bonds, to portfolio flows and back to bank lending. The Asian countries originally had relatively high proportions of direct investment flows, and after the Tequila crisis, direct investment flows to Latin America have increased substantially.

Likewise, maturity has gone from short-term, to medium term (some syndications went up to ten years) to long term bonds to undefined term equity lending and back. Interest rates also went from fixed, to floating to fixed and back to floating. However, despite these differences in the form of the lending, there is one constant factor, the volatility of these flows in periods of crisis. The differences in the form of the capital inflows received by a country does not seem to have made a substantial difference in the impact of these flows on domestic conditions and the subsequent reversal of those flows.

Borrowers and Lenders

In addition to the various forms of flows, there is also a difference in the borrowers of the funds. In the case of Chile it was primarily private banks and firms. Although it is often suggested that the Latin American debt crisis differed from other crises because of the predominance of sovereign borrowers. This is not quite correct. US banks, who accounted for the majority of the initial lending by syndication to Latin America advanced about two-thirds of their loans to non-public sector borrowers. However, other banks lent almost exclusively to the public sector and when the crisis broke, public guarantees were quickly extended to private borrowers so that the eventual resolution of the crisis was between banks and sovereigns. The ERM crisis involved government borrowers virtually exclusively, while the Asian crisis was primarily lending to private

sector borrowers, although a number of these borrowers were either directly or indirectly under government control.

The distinction between private and public borrowing is presumed to be important because private sector borrowing is thought to be a response to market incentives and thus any major imbalances may be justified as representing the result of market choices. This is the famous Lawson principle that says that if there is a private sector savings shortfall that produces borrowing abroad to finance a balance of payments deficit no action need be taken to remedy the imbalance. The presumption is that this simply represents consumption smoothing, so that private savings will rise in the future and repay the borrowing causing the foreign account to reverse and show a surplus at some future date. Alternatively, if the foreign borrowing is to finance the import of investment goods, this is again a case of smoothing rates of return. The higher expected rates of return from the current investment will produce the revenue to repay the foreign indebtedness. However, anticipations of future conditions may turn out to be disappointed and the anticipated future savings or higher anticipated returns may fail to appear, leaving the imbalance to produce a crisis.

On the other hand, public borrowing is presumed to be driven by political or social returns and thus to be incapable to generating the future monetary returns required to repay lending. Thus, it is not only an inefficient use of funds, but will of necessity require a depreciation of the debt. In general, the experience of the recent crises does not suggest that there is a great difference whether borrowers are public or private to the occurrence of a crisis.

For every borrower there is a lender. As already suggested, much of the history of the increased capital flows in the period may be linked to the crisis of commercial banking in the US and in other countries. In the early 1970s banks were suffering form both a loss of quality borrowers and low interest margins. Increasing foreign lending provided an opportunity to increase interest margins, at what were considered to be acceptable risks. In the Latin American episode this was translated into the idea of the absence of credit risk on sovereign lending. There was thus an increase in the supply of funds offered to borrowers as banks attempted to increase their return on assets by increasing their foreign lending. Of course, this did not exactly turn out to be the case. Nonetheless, the solution to the crisis via the issue of sovereign and Brady bonds provided banks with the possibility to profit from the trading of the bonds in the secondary market and to earn risk-free fee and commission income of underwriting the new sovereign issues, as well as the equity for government privatisation programs. Thus, the different role of the banks in the 1982 and 1994 Latin American crises reflects their shift in emphasis from increasing income through interest margins to the less risky increase in fee and commission income. This was the main reason for the shift in flows to portfolio investments, as the banks now encouraged investors to use their services to invest in emerging markets, rather than intermediating their funds to be lent in emerging markets.

But, by the time of the ERM crisis banks had become the providers of funding to arbitragers, who were using the bank funds, but accepting the market risks themselves. In the Asian crisis it was the banks themselves who had implemented the arbitrage strategy through proprietary trading. There seems to be little question that without the pressure to increase returns to capital, much of the increase in capital flows and its shifting across countries would never have taken place. Competition in the banking sector caused by deregulation must thus be recognised as a major cause of the financial crisis.

A Typical Post-Bretton Woods Crisis

Given the number of large number of common factors in the crises of the post-Bretton Woods period it is possible to outline the characteristics of a typical financial crisis. It would involve the introduction of a domestic stabilisation policy in which money growth is restricted, fiscal budgets are cut, and privatisation is introduced along with liberalisation of capital flows and the financial system along with the use some sort of foreign exchange rate anchor via a pegged exchange rate. The high interest rates that result create a differential sufficiently large to attract arbitrage capital inflows that turns the adjustable peg currency regime into a quasi-fixed exchange rate. The recently liberalized banks are free to lend internally, and domestic firms are free to borrow abroad, avoiding high domestic interest rates, but building up foreign currency risk exposure. The real appreciation of the exchange rate weakens the foreign balance, while the attempt to sterilised the inflows leads to even higher interest rates and weaker internal conditions , as well as higher deficits as high interest rate domestic bonds are issued to sterilise the inflows that are invested at low foreign rates. Eventually either the foreign balance or the fiscal balance goes out of control, or the domestic conditions deteriorate substantially as demand is compressed, creating conditions in which a rise in foreign rates or a fall in domestic rates leads to an outflow of capital, a collapse of the exchange rate and a massive capital loss on the balance sheets of banks and firms carrying unhedged foreign currency exposure. In an attempt to cover these losses the demand for foreign exchange creates massive imbalance and a free fall in the currency, producing widespread corporate bankruptcy and bank failures. This is the typical financial crisis of the 21st century. It starts, not with unsustainable policies, but with an attempt to introduce sustainable policies. It ends with the impossibility of the success of those policies due to the impact of capital flows. Such crises have occurred when stabilisation has been introduced as a response to domestic instability via and IMF structural adjustment programme, but they have also occurred when such policies have been practiced with success over substantial periods, as in Asia.

The Response to post Bretton Woods Financial Crisis

A common feature of response to the difficulties in the domestic banking system has been first to extend government guarantees to deposits and then to nationalise the banking system. This occurred in Chile, in Mexico in 1982 and again, although in indirect form, in 1995. The US also came very near to full nationalisation of its savings and loan system at the end of the 1980s. Other countries escaped complete nationalisation, but there were major assumptions of ownership by government in most countries. In the current Asian crisis, where the banking systems were not completely private, governments have had to intervene and eventually assume ownership of a high proportion of the banking systems. It is interesting that in Asia, the process of liberalisation started at about the same time as it did in Chile, and although there were crises (in Thailand in 1983 for example), they did not have the same effect. Thus, while reform of the regulatory and prudential systems has been prescribed for the Latin American countries, the Asian banks were generally considered to have made adequate progress in this respect.

For those countries that sought support from the IMF there are also common features, since the IMF has in general applied similar policies across countries and across crises. The basic difference here is in the US thrift crisis and the ERM crisis.

Despite the recognition that the Asian

crisis was not quite like any previous crisis, it was treated as a "traditional" balance of payments crisis, aggravated in its nature by structural weakness in the banking system. Indeed, the IMF considers that "A financial crisis calls for a similar response from the Fund as any other balance of payments problems except that the response must be quicker and possibly larger than in a more traditional case" (Broughton, ibid, p.6). In a traditional balance of payments crisis the problem is an excess of imports over exports caused by loss of competitiveness and excessive domestic absorption due to an excessively stimulative government expenditure policy. The response is an exchange rate adjustment to restore competitiveness and switch expenditures from imports to domestic production, and a government budget surplus to reduce absorption and control of the money supply to keep inflation from eroding the beneficial impact of the devaluation on exports. The problem to be resolved is one of restoring monetary income and expenditure flows to macroeconomic balance. The funds that are lent by the Fund are supposed to allow the borrower to defend the existing (or a new) exchange rate and to provide a supplement to foreign exchange reserves to pay for the imports required, until an export surplus produces enough foreign earnings to repay the Fund. The conditions attached to Fund lending are therefore necessary to insure a surplus sufficiently large to repay the Fund. This is the type of crisis that was faced by many developed countries in the 1950s and 1960s, including the UK and Italy.

However, it does not correspond to the Chilean crisis, nor to the 1982 debt crisis, where difficulties were caused by changes in external conditions and the impact of capital inflows on the configuration of domestic policies. In these crises the problem was no longer one of generating sufficient foreign exchange flows through increased net exports, but to generate sufficient capital flows to allow external debt to be serviced and eventually repaid.

The Mexican crisis of 1994 is closer to a traditional crisis, since there was a large balance of payments deficit and an inappropriate composition of imports between consumption and investment. But the real crisis was the result of the reversal of foreign capital flows that put convertibility in jeopardy. Again the aim of the IMF was primarily to create conditions that would attract sufficient capital inflows to avoid this result. Thus the insistence on high interest rates in order to convince investors to "hold the currency".

The crisis in Thailand was not caused by an excessively large government deficit, nor was it due to a loss of competitiveness due to excessive inflation. The government budget was in surplus and the loss of competitiveness, which only occurred quite late, was primarily due to the strong appreciation of the dollar, rather then domestic inflation caused by excess demand. Nor was there an imbalance in consumption expenditures and imports relative to investment and exports, rather the opposite. However, within overall investment there was an increasing imbalance in favour of construction and real estate investments, rather than manufacturing investments producing exports. These real estate and speculative financial market investments were primarily financed by increasing domestic lending made possible by capital inflows from abroad; the impact was to cause an inflation in asset prices that was not dissimilar to that seen in the US and Europe a decade earlier.

In these conditions an exchange rate adjustment could eliminate the impact of the revaluation of the dollar, but it could not bring about any direct impact through expenditure switching. Nor could the control of domestic lending produce an impact on the inflation in asset prices that was financed by foreign borrowing. Indeed, attempts to cut down domestic

lending by increasing interest rates only made capital inflows larger. Neither could a tighter government budget improve conditions of domestic absorption since consumption was not excessive and investment was being driven by capital flows and asset expansion. Nonetheless, the IMF had been recommending a depreciation of the exchange rate for some time, and the conditional lending agreement included a reduction in domestic credit expansion, a sharp rise in interest rates and a tighter government budget.

The justification for the use of the same traditional policies that had been applied in a balance of payments crisis was slightly different. The budgetary restriction was justified as being required to fund the recapitalisation of the banking system without jeopardising the surplus, and the rise in interest rates was required to create a demand for the currency and to restore the capital inflows. The problem was still viewed as one of getting flows back in equilibrium, but of a slightly different nature.

Since most of the external borrowing had been undertaken in foreign currency without adequate hedging (and the reasons why this was the case are not really relevant in assessing the policies that were applied) the devaluation of the exchange rate meant an instant increase in the domestic liabilities of banks, property companies and firms who had borrowed abroad, while there was no impact, or a decline, in value of assets. There was thus a direct loss in capital value which had an impact on both liquidity and solvency at the same time. The depreciation also increased the interest burden, and thus immediately increased foreigner's claims without any offsetting increase in claims on non-residents. The result was an instant deterioration in the foreign balance. Thus, the private loss of wealth was reflected in the national accounts. The problem was not a flow problem, but a stock adjustment problem that created flows as a part of the adjustment process: at the new interest rates and reduced anticipated profitability, the stock of outstanding foreign debt was too large to be supported by foreign income flows and thus had to be reduced. Thus domestic banks and companies started to pay down debt or to hedge their exposure, producing a massive excess demand imbalance in the foreign currency market and a continuous devaluation in what was a one-way market. At the same time, the rise in interest rates caused other asset prices to decline. Since these assets had been the collateral behind much of the increased lending, the loans automatically became classified as non-performing, while foreign holders reassessed expected profitability and sold their investment positions. As central banks attempted to ease the refinancing burden for domestic firms by granting additional credit, the IMF responded to the continued pressure on the exchange rate by recommending higher interest rates, arguing that high rates were required to induce investors to hold the currency and restore confidence. However, in such conditions higher interest rates simply increased the balance sheet losses of firms and increased the urgency of their need to repay or hedge their foreign indebtedness, which means selling the domestic currency. In this case interest rates do not affect asset demand for the currency so much as the hedging demand. With a large stock of outstanding foreign currency debt, there is no plausible interest rate that will increase demand for the currency by more than the need of borrowers and lenders to sell to avoid bankruptcy. Indeed, higher interest rates may simply aggravate the problem. Further, in conditions in which firms are seeking to create liquidity as rapidly as possible, this will occur through distress sales of inventory and reducing costs by cutting production, thus domestic demand will be declining, as supplies on the market seeking rapid sale are increasing. In such conditions there is

unlikely to be great pressure on prices, and some of the pass through effect of the depreciation may even be absorbed in lower margins. In the short term inventories will be run down and alternative sources of supply are sought out. Thus, in the absence of any prior excess demand, there is unlikely to be any sharp deterioration in the inflation outlook that needs higher interest rates to offset. The "traditional" policies applied in the conditional lending in response to the crisis thus may have directly contributed to the failure of exchange rates to stabilise rapidly at new equilibrium levels and thus to the contagion within the Asean region.

In addition, the lending provided by the Fund was neither needed nor sufficient to allow support of a new exchange rate as in the traditional case. Instead, it was meant to instill confidence in foreign lenders to restore their previous flows of investments into the country. But, as stated before, foreign investors require the guarantee of liquidity, which in this case meant the possibility that short-term-lending will be repaid on a timely basis. Thus, the Fund did not expect to have its loans repaid from a current account surplus on the balance of payments so much as from a restoration of positive capital account balance. But, this means that Fund lending will have to be used to insure that short-term foreign lenders are repaid given the large differences between non-existent foreign exchange reserves and the short-term debt outstanding. Thus, rather than exchange rate stabilisation or the funding of the urgent imports of goods and services, the Fund is in fact lending to allow repayment of private sector free market foreign lenders. Rather than guaranteeing the new exchange rate, Fund lending guarantees the foreign lenders, who are the only creditors who emerge from the crisis without loss, but who have accepted expose to risk just as other lenders. Thus, not only is the "traditional" Fund conditionality no longer designed to insure repayment of Fund lending, it is no longer for exchange stabilisation, rather it is to insure the maintenance of convertibility of the domestic currency and the full repayment of foreign lenders, i.e. to guarantee free capital flows. The failure to distinguish between balance of payments - flow crises and capital account - stock crises not only contributed to the further development of the crisis.

But, what should the IMF have done? Clearly, the problem is one of intertemporal allocation. A bank that suffers a bank run lacks the liquidity to repay every depositor, but if it has the time to allow its investments to mature, then it can repay. The bank is in difficulty only if the recovery value of its portfolio falls below the value of its short-term liabilities, for then it is insolvent. There is no evidence to suggest that when the crisis broke out any of the Asean countries were in a position in which they could not have repaid their short-term borrowing if given a sufficient amount of time to realise investment. In short, this started as a liquidity crisis, not a solvency crisis (as was the case in Latin American in 1982). However, the use of high interest rates, currency devaluation and reductions in growth rates quickly acted on financial institutions and company balance sheets to create a solvency crisis. The appropriate action would have been to move quickly to solve the intertemporal problem by bringing the borrowers and lenders together to reschedule, even before the commitment of IMF funds. This is what was eventually required and achieved in Korea, with the agreement of the lenders to roll over a sufficient amount of short-term lending to make the possibility of repayment, given existing reserves and export surpluses, credible. But, it would have been much better to have started the process with this sort of negotiations, rather than providing funding to repay creditors and instigating a conditional lending package which

assured an increase in bankruptcies, income loss and debt deflation.

It is interesting that in the aftermath to the two crises that avoided widespread bankruptcies, the US banking crisis and Italy and the UK after the ERM crisis, extremely low interest rates couple with expansive fiscal policies provided support for the banking system and provided a recovery in growth and employment.

III. *Sequencing Liberalisation and Crisis Prevention*

Despite the clear indication that current policies not only have aggravated the crisis, but have also contributed to it, the official position is that it is solely the result of financial systems that are too weak and inappropriately regulated to take full advantage of the benefits of international capital flows. It has been suggested that financial crises could be avoided by means of an appropriate sequencing of liberalisation of the financial system.

It was the crisis of the economies in the Southern Cone that first suggested a relationship between the order, or sequence, of liberalisation and integration into the global economy and the occurrence of systemic financial crises. As a result, the proper sequencing of liberalisation measures came to be considered as crucial for prevention of financial crises. However, some thirty years after the experiences in Chile, financial crises in developing countries integrating their economies into the global economic system seem to have become more frequent and more costly in terms of lost output and employment. This suggests that there is something more fundamental than the proper sequencing of economic reforms at work, although some authoritative commentators still place the blame for the recent collapse of the Asian economies on the improper sequencing of liberalisation in the financial sector, even though appropriate sequencing has been official policy of the multilateral lending institutions and recommended by leading economic experts (eg, McKinnon) since the 1980s.

Nonetheless, it is true that all of the recent financial crises in developing countries have taken place while government regulations on foreign trade, the control and ownership of private enterprise, and the regulation of the financial system were being replaced by market discipline mechanisms through the privatisation of state-owned banks and companies, as well as the removal of government regulations on their operation. Indeed, one of the best indicators of an impending financial crisis appears to be the recent liberalisation of the financial services sector.

The generally accepted order for proper sequencing starts with the creation of prudential regulations and supervisory institutions in the financial system, prior to the privatisation of the domestic financial sector under the direction of an independent central bank. At the same time government intervention in the economy is reduced through a reduction in the share of government and a reduction in government expenditure deficits, transferring the responsibility for demand growth to private sector investment and consumption decisions. This requires the privatisation of the state-owned or controlled production sector and the introduction of competitive mechanisms in the domestic market. When internal competition has been established, competition in the domestic market and domestic demand decisions can be reinforced by foreign competition through current account liberalisation of trade in goods and services. The final step in the process is the opening of domestic financial markets to foreign competition and the liberalisation of capital account flows. In simple terms, the conventional view on sequencing is that the creation of a regulatory framework should precede liberalisation of the domestic financial

sector, and capital account liberalisation should follow liberalisation of the current account. (cf. Johnson, Darbar, Echeverria, 1997, p. 5).

Is Optimal Sequencing Possible?

Although inappropriate sequencing of liberalisation measures provides a coherent explanation of the causes of financial crises of those countries that have sought increasing global integration of their economies as development strategy, it is far from clear that the ideal sequencing of reforms set out above is itself viable. First, the change in development strategy that has occurred in most countries was the result of systemic financial crises caused by capital flows, in particular the Latin American debt crisis of 1982. Faced with a choice of repudiating debt or attempting to repay in foreign currency, a decision to follow the latter course required opening of the economy in order to earn foreign exchange and attract further capital flows from abroad to roll over existing indebtedness. The liberalisation measures have thus not been part of a planned sequence of measures to transform the operation of the economy, but instead imposed as part of an urgent financial rescue packages that have included structural adjustment programmes primarily designed to create domestic conditions capable of generating foreign exchange through export surpluses and increased foreign investment flows.

Second, these programmes have generally recommended a reduction of government debt and deficits. The only way to meet these objectives in a short period of time is by means of the accelerated privatisation of the financial and state-owned enterprise sector. There is simply no time or sufficient thought given to the creation of the appropriate institutional safeguards in the form of prudential regulations and supervisory agencies with appropriately trained personnel for banks, and anti-trust regulations for the production sector. It is the creation of foreign financial flows, rather than the appropriate institutions for a strong financial sector, that are the objective of the exercise. There is also pressure to transfer decision-making from government agencies to market mechanisms. This means pressure to remove restrictions and regulations before market institutions and actors are fully developed so as to allow for the full expression of private incentives. Opening the domestic economy to competition from foreign competitors is often viewed as a priority measure to provide competitive stimulus to domestic producers to increase productivity. As in the case of privatisation, there is insufficient time to allow domestic producers, or the new owners of formerly government controlled enterprises, to adjust to the new conditions of market competition. Since it is difficult to allow privatisation of producing firms if there are no private domestic financial institutions to provide the financing that was formerly supplied by government direction, there is also pressure to liberalise both at the same time.

Further, since most countries face privatisation in conditions in which their domestic financial systems are in disarray or collapse, the sale of domestic assets must be primarily to foreign buyers or financed by foreign financial institutions. But, foreign buyers will require guarantees on the repatriation of profits and capital which requires extensive liberalisation of the capital account prior to the privatisation of the domestic sector. Foreign investors will also require exchange rate stability, so that exchange stabilisation is often part of the policy. It is also justified because it is thought to provide additional pressure on domestic produces and thus to reduce both domestic and imported inflation. But, by creating conditions for free capital flows, exchange markets often overshoot and rates appreciate in real terms, creating a cumulative movement in which exporters are penalised and

the current account deteriorates while the capital account expands.

In short, it is not clear that the proposed ideal sequencing of liberalisation measures is in fact viable as a policy or a development strategy for an economy attempting structural adjustment that prepares it for entry into the global market system. The sequencing that is required to satisfy the short-term adjustment measures after a crisis is nearly the opposite of that recommended by the recent experience of financial crises. Thus, structural adjustment programmes designed to resolve crisis conditions by creating an environment that attracts large foreign capital inflows may in fact require a sequencing of liberalisation measures that provides the very basis for further financial instability. This suggests that while improper sequencing may have contributed to financial crises, it is not a viable recipe for their prevention except in conditions that are unlikely to prevail in practice.[2] It also suggests that rapid structural adjustment and the associated need to attract foreign capital inflows may have contributed more to the resurgence of financial instability than any improper sequencing decisions as such. Indeed, although the conventional view of proper sequencing of liberalisation was originally formulated in the aftermath of the Chilean experience of liberalisation of its economy in 1974-82, it appears not to have been followed, or even strongly recommended, as a course of prevention in any of the countries that have experienced financial crises subsequently because the emphasis was on short-term structural adjustment, rather than building economic institutions capable of allowing a market economy to produce the efficient allocation of resources.

IV. If Sequencing Takes Too Long

An alternative approach to the idea that weak financial markets have been the cause of the crisis has been put forward, with an alternative solution, by US Undersecretary of Treasury Lawrence Summers: "The case for capital account liberalization is a case for capital seeking the highest productivity investments. We have seen in recent months in Asia -- as at many points in the past in other countries -- the danger of opening up the capital account when incentives are distorted and domestic regulation and supervision is inadequate. Inflows in search of fairly valued economic opportunities is one thing. Inflows in search of government guarantees or undertaken in the belief that they are immune from the standard risks are quite another. The right response to these experiences is much less to slow the pace of capital account liberalization than to accelerate the pace of creating an environment in which capital will flow to its highest return use. And one of the best ways to accelerate the process of developing such a system is to open up to foreign financial service providers, and all the competition, capital and expertise which they bring with them. The recently concluded global financial services agreement demonstrates that countries recognize these beneficial effects of external liberalization"(Summers, 1998).

We have thus come full circle in seeking an alternative relation between the difficulties of US banks and international capital flows. In

[2] Arguments against proper sequencing were presumably present in the minds of those who favoured the simultaneous introduction of liberalisation and the rapid introduction of markets via a Big Bang or Shock Treatment approach in the transition economies. It is based on the idea that if government controls are preserved in any sector inertia will be created that will prevent further liberalisation. To make the process irreversible, it was necessary to change everything at the same time. However, this approach does not seem to have been any more successful and financial crises have also been endemic in the transition economies.

difference from the position stated in part II, that internationalisation of banking and global capital flows have been the major factor behind the financial crises that has prevented developing countries from achieving their goals of industrialisation and stable growth, according to this alternative view, the only solution to the problem of US banking is free global capital flows, and the combination of the two is the only solution to the avoidance of systemic financial crises that will shield developing countries from financial crises. Given the recent experience of Mexico, as well as Asia, this is the view that is likely to prevail. The future thus holds in store increasingly large global banks organising the flows of capital across national markets. Given the size that will be required, it is unlikely that there will be more than a dozen of these global banks. About two-thirds will be US banks. The Group of 30 (cf. G-30, 1997 and Kregel, 1998) is already preparing the way of the deregulation and liberalisation of these global banks, just as the thrift industry was deregulated in the US in the 1980s. This will be the aspect that dominates the financial landscape in the new millennium.

We can thus conclude that Asia was not the first crisis of the 21st century. The first crisis of the 21st century will involve the operation of the new global mega banks and thus will not be a regional crisis, limited to Asia or Latin America, but a truly global crisis.

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