

**An Assessment of the East Asian Debacle**

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# **An Assessment of the East Asian Debacle**

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## **Abstract**

This paper evaluates the policy choices and factors that have contributed to the Asian crisis. It is argued that the interaction between relatively closed and weak banking systems and liberalized financial flows played a major role in the crisis. The prospect of an IMF bailout is also likely to have induced risky capital inflows to Asia, as data on Taiwan suggests. The appropriate policy response is not to impose sweeping controls, as is often being recommended, but to partially restrict capital inflows while simultaneously freeing up limited outflows by domestic residents, and also exposing the banking and financial services sector to more external competition.

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## An Assessment of the East Asian Debacle

### I

#### Introduction

The East Asian crisis that has spread worldwide is already one of the most cataclysmic economic events of this century. It is not only the magnitude of the crisis that has been unprecedented. Equally noteworthy is the extent to which leading international organizations at the helm of policy, in particular the IMF, were caught largely unaware. In light of the inability of most analysts to foresee the crisis, or what should perhaps be described as the series of crises that have occurred since last year, a substantial degree of caution in drawing inferences about the underlying reasons is warranted, and even more so in coming to conclusions about the appropriate policies and remedies.

This article attempts to evaluate the factors underlying the crisis, with a view towards drawing broad inferences for policy. It is argued here that **bad banking systems** have been the predominant underlying cause and continue to constitute the fundamental problem in many East Asian economies. A second factor has been the expectation by private investors of an IMF bailout, often called the 'moral hazard' phenomenon. The expectation of IMF support, and the links between the international official agencies and private investors, are likely to have played a role in inducing large capital flows to East Asia. By contrast, the macroeconomic and/or financial market factors widely believed to have played a vital role (mainly full capital account convertibility, the pegging of exchange rates in the region to the US dollar, and excessive short-term debt) have either

been less important, or else are more in the nature of proximate factors that triggered the crisis, rather than underlying structural causes. By and large, despite substantial contagion effects in the financial markets, those countries with relatively safer and sound banking systems have been less adversely affected.

The paper is organized as follows. Section II points out that the unwarranted optimism about the East Asian economies during the pre-crisis period stemmed from excessive focus on macroeconomic variables, to the continuing neglect of banking and financial considerations. Section III assesses the overall financial market and economic performance of the Asian economies and concludes that neither capital-account convertibility nor fixed exchange rates *per se* are likely to have been a major factor underlying the crisis. Section IV argues that excessive short-term foreign debt, which others have correctly identified as a critical factor in the crisis, can in turn be partially traced back to weak banking systems. Section V provides evidence on the differential pattern of capital flows to Taiwan (which is excluded from IMF membership) and other Asian countries. This data suggests that links between the official agencies and private lenders, and the prospects of IMF guarantees for the latter, induced private capital flows to Asia. Section VI recommends appropriate policies on capital-account convertibility for India. It critiques the view that comprehensive capital controls are beneficial and argues for a selective approach, distinguishing between the economic impact of foreign inflows and resident outflows. Section VII concludes.

## II

The Flawed Doctrine of Fiscal Orthodoxy

The Asian countries, as is well known, had been undergoing one of the most remarkable booms in recorded history. From a narrowly domestic macroeconomic perspective, the two most important macro-economic fundamentals of inflation and fiscal balance were favourable. Some relevant macroeconomic data for eight East Asian countries, as well as China, India and Japan are provided in Table I. As can be seen in Table I, during 1990-96 inflation was low (in single digits for most of the Asian countries) and did not show signs of overt acceleration - the economies did not seem to be overheating in a major way.<sup>1</sup> Most of them were close to domestic budget balance, with Singapore and Taiwan running budget surpluses. In its widely cited report "The East Asian Miracle" the World Bank (1993) stated that "The sustained record of low inflation and sustained growth of the high-performing Asian economies reinforces the view that there is no substitute for fiscal discipline(p. 348)"<sup>2</sup>.

However, the situation was different on the external front, with many of the East Asian countries running large current-account deficits. Nevertheless, in line with the Lawson

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<sup>1</sup> There is evidence that for many of the Asian countries, inflation was rising sharply in the cities, which received the bulk of the capital inflows, even if not elsewhere. (Wall Street Journal, reprinted in Business Line, 2<sup>nd</sup> February 1995). Thus the nation-wide inflation data understated the extent of overheating. Secondly, it is known that official statistics are manipulated and of poor quality in many of the Asian countries. The Economist (1995) provides a rating of the quality of data. However, with the sole exception of China, where data are known to be tremendously manipulated, it is unlikely that actual inflation was so much higher than expected inflation as to constitute a serious economic hazard.

<sup>2</sup> The eight high-performing Asian economies in this study, led by Japan, included the Four Tigers (Hong Kong, Singapore, S. Korea and Taiwan) and the newly industrializing countries: Indonesia, Malaysia, and Thailand (NICs). For a variety of reasons China was not included in the study, despite its being part of East Asia and its similar rapid growth.

doctrine, it was often argued that the current-account deficit (which can be expressed as a sum of the public sector deficit and the gap between private investment and private saving) should not be a cause of concern since it arose out of private saving-investment decisions.<sup>3</sup>

The Lawson doctrine became the subject of renewed discussion in Mexico in the early 1990s. Following the advent of NAFTA (the North American Free Trade Agreement) Mexico was booming under free-market policies, with large scale privatization, the restoration of fiscal balance and declining inflation. The only source of potential trouble was a rising current-account deficit which was over 6% of GDP in 1993 and reached 8% of GDP in 1994. But since the fiscal situation was good, the international agencies and global financial markets looked favourably upon the Mexican economic boom.

The optimism was unwarranted. As it turns out, the peso almost halved in value against the US dollar between 20 December 1994 and early 1995, as panicky foreign investors withdrew and short-term debt could not be rolled over. A combined aid package of about \$40 bn. from the U.S. Treasury and the IMF helped to stabilize the economy.<sup>4</sup>

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<sup>3</sup> The Lawson doctrine is attributed to Nigel Lawson, the U.K. Chancellor of the Exchequer during the mid to late 1980s. Due to the free-market policies of the Conservative Party, the public-sector deficit shrunk from about - 5% of GDP in 1980 to balance by 1987, while simultaneously the current-account deficit rose from +2% of GDP to - 1% in 1987. In response to concerns that were expressed about the latter development, Lawson argued that since the current-account deficit reflected private decisions, it was not a matter to be taken into consideration in formulating macro-economic policy.

<sup>4</sup> Dornbusch and Werner (1994) had argued in early 1994 that the peso had become too overvalued (the real exchange rate appreciated by about 40% between 1990 to 1994) since the 'nominal anchor' policy did not let the peso fall as much as the (falling) inflation differential vis-a-vis the US, and that a currency crisis was imminent. Sachs, Tornell and Velasco (1996) stress that creditor panic, more than overvaluation, led to the peso's collapse.

Prior to the Mexican peso's collapse, optimism about the Asian economies - based on the macroeconomic fundamentals of declining inflation and budget balance - may have been somewhat justifiable. However, the events in Mexico should have alerted both private analysts and public policy makers about the prospects for a similar outcome in East Asia, particularly in Thailand which had a current-account deficit/GDP ratio of about 8% in 1996 and where the value of exports declined in nominal dollar terms during that year. There was indeed some recognition of this possibility<sup>5</sup>.

Nevertheless, the general view was that since the capital inflows were largely going into investment for most of East Asia, as opposed to consumption in Mexico, it would add to capital stock and growth and thus, presumably, generate exports.<sup>6</sup> The statement of the Deputy Managing Director of the IMF, after the Mexican tequila crisis, reveals an unwarranted degree of undue optimism,

“There has been so much research on the East Asian miracle during the past decade that it is hard to imagine that anything more remains to be discovered except for the ever elusive elixir of growth”<sup>7</sup> (Fischer, 1996)

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<sup>5</sup> The IMF did issue warnings to the Government of Thailand in 1996 but these were ignored. Some private analysts were also gloomy in their forecasts (Economist, 1998a). Krugman (1995), whose views will be discussed later in this section, stressed the role of investor mania in the emerging markets boom. See also the Economist (1996).

<sup>6</sup> Indeed, many of the East Asian economies had budget rules and legislation requiring that sovereign debt be used for development expenditures, to ensure that foreign borrowing funded investment and not than consumption. (World Bank, 1993) This view - that overseas borrowing to finance private investment and not consumption is alright - can be called the quasi-Lawson doctrine.

<sup>7</sup> In a similar sanguine vein, the President of the Federal Reserve Bank of New York stated in December 1996, “In my view, Asia's future looks brighter today than at anytime in the postwar period.” (McDonough, 1996). Following the collapse, official IMF statements may have been deliberately far more optimistic than their true perceptions, in order to shore up confidence of the financial markets. However, such optimism well before the crisis broke out can hardly be explained along these lines and clearly indicates poor judgement

The Lawson doctrine, which is simple-minded free-market orthodoxy, is clearly deficient in that it treats overseas borrowing like any other kind of borrowing.<sup>8</sup> Much of the outstanding debt in Mexico was that of government and quasi-government entities; merely looking at the current fiscal balance is not enough. The Lawson doctrine fails to delve deeper into the type and magnitude of capital flows, the incentive structures and possible market imperfections underlying different types of capital flows, the ratio of debt to equity, the maturity structure of the debt, the risk tolerance of borrowers and lenders, the difference between retail investors (individuals) and institutional investors, the impact of loan guarantees on the amount of lending and finally the potential instability of financial markets. In short, relying merely on broad macroeconomic data, as the IMF has traditionally done, to judge the economic situation proved inadequate in East Asia<sup>9</sup>

### III

#### The Role of Short-Term Debt

In attempting to identify causal factors in the Asian crisis, it is useful to distinguish between proximate and underlying factors, complementary (or potentially complementary) and independent and mutually exclusive factors. It is vital to try to

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<sup>8</sup> At a very basic level, overseas borrowing involves exchange rate and/or macroeconomic externality effects that impinge upon the entire economy and thus should be of concern for public policy.

<sup>9</sup> Paul Krugman is widely credited, and duly so, for his prescient pessimism regarding East Asia. However, it should be noted that in his first seminal article (Krugman, 1994) his gloomy prognosis was based entirely on the observation that the Asian economies had grown very fast due to rapidly increasing inputs of capital and labour, despite low total factor productivity growth (which reflects the impact of pure technical progress). Since capital and labour inputs were limited and were beginning to provide diminishing returns, GDP growth would inevitably slow down. As it turns out, growth has fallen sharply due to financial sector problems, instead of declining gradually due to macroeconomic resource constraints as Krugman predicted. In his later article after the Mexican peso's collapse (Krugman, 1995), he did stress the potential impact of financial market instability, but in very general terms. This second article, which deals with the investment boom generated by the mutually reinforcing beliefs of policy makers and private investors, was more insightful and will be discussed later

ascertain the relative importance of different factors and to try and identify the underlying policy choices or regimes that led to the observed outcomes.<sup>10</sup> For instance, if short-term debt has been the main factor underlying the currency crises, then restrictions on short-term bank lending are called for. If the problem has been one of unstable financial markets in general, then wider restrictions on capital-account convertibility and portfolio investment are called for. At one extreme, the crucial factor may have been only the fixed exchange rate, and none of the above, as some have argued. From this viewpoint, short-term debt rose because the fixed exchange rate induced too much lending by removing exchange rate risk; under a fully floating rate the build-up of short-term debt and hence the ensuing currency collapse would have been much less.

The analysis below tries to identify those factors that are linked to policy choices. In particular, to what extent are the following factors responsible: capital-account convertibility in general, the system of fixed rates in particular, and the amount of short-term debt? While cultural factors such as family networks do play a big role in the functioning of the Asian economies, they are outside the domain of this analysis

Relevant financial data for the Asian countries are outlined in Table II. Since the start of

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<sup>10</sup> For instance, the Government of India's Economic Survey lists a number of possible causes that have been advanced to explain the Asian crisis. (a) absence of lender of last resort to stem panics (b) imprudent lending by international lenders (c) high and unsustainable current-account deficit (d) high short-term foreign debt (e) large effective real exchange rate appreciation (f) Inefficient lending and fragility of the financial sector, arising from lack of adherence of financial intermediaries to prudential norms concerning capital adequacy, asset classification, provisioning, and absence of disclosure requirements and then goes on to cite several facts in support of the above factors. (Government of India, 1998) Such a laundry list does not attempt to sort out among these factors. For instance, the existence of a lender of last resort, or (a) may encourage imprudent lending, or (b) High levels of current-account deficits may be sustainable if a country does not have too much short-term debt

the crisis can be dated as July 2nd 1997, the day the Thai baht was floated, changes are measured from a month earlier, a pre-crisis date. As can be seen in Table II, between June 1997 to October 1998, Malaysia has suffered the biggest drop in stock prices (-62%) and Indonesia the biggest currency fall (-356%). The combined change in the exchange rate and stock prices, reported in the last column captures the full impact upon the financial markets. The worst affected overall has been Indonesia (-410%) and the least affected China (-10%).

The decline in a currency and the stock market are often taken as indicators of how badly the country has been affected. But financial market values should not be viewed as an end in themselves; they are mere influences on the macro variables that determine economic welfare. In assessing the welfare impact of the economic outcomes, what should be of concern is GDP growth and inflation: the bigger the drop in output and the bigger the rise in inflation, the worse off is the country. The data in Table I indicate that Indonesia has suffered the most, with a 16.5% drop in GDP so far in 1998 and 82% inflation.<sup>11</sup> China seems to be the best performer but its data are extremely suspect, while India's good performance reflects its relative isolation.<sup>12</sup>

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<sup>11</sup> To precisely quantify the economic outcomes, a loss or welfare function based on inflation and the deviation of real GDP growth from its long-run sustainable rate, with weights assigned to each term, would have to be set up and computed. The loss function is meant to capture short-run changes in welfare. No precise calculations are made here.

<sup>12</sup> The level of welfare of a country also depends on its per capita income. India, which has been relatively less affected than most Asian countries, nevertheless has a very low absolute level of welfare. Being relatively unaffected by the Asian crisis is not necessarily an indication of economic strength. The poorest countries in the world, mainly closed economies, have been the least affected.

Leaving aside China, **the best performer has been Taiwan**, which has grown by over 5% so far this year, a small drop from last year, with inflation close to zero.

The first point to note is that even if capital-account convertibility has been a contributing factor to the crisis, it is very unlikely to have been the predominant reason. Hong Kong and Singapore, financial centers, have the greatest degree of capital convertibility, but have been less adversely affected than Indonesia and Thailand, which have a lower degree of capital-account convertibility, as can be seen in Table III.<sup>13</sup> While, other things equal, unstable financial markets may well have aggravated the adverse outcome, it is reasonable to infer that the extent of capital-account convertibility per se has not been the major factor affecting economic performance.

Neither should the blame be placed entirely on fixed exchange rates. Hong Kong, with its currency board, has been firmly pegged to the US dollar since 1983, a remarkably long period. But judged by overall macroeconomic performance, Hong Kong seems to have weathered the crisis, at least **so far**, better than Indonesia, South Korea and Malayasia whose currencies declined by 15%, 10% and 4% respectively between January 1994 and June 1997, even before the crisis erupted. While a flexible rate may facilitate the macro-economic adjustment process, it can be concluded that the pegging of

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<sup>13</sup> There are two columns on capital-account convertibility (CAPAC) in Table III. The first is the binary Classification (Yes/No) from the IMF's Summary of Exchange Rate Arrangements and Restrictions. 1996). This binary classification is too broad and is skewed toward describing the capital-account as closed, even when a wide range of transactions are permitted. The second numerical index is the statistical estimate of Yeches and Reisen (1993) for Indonesia, Korea, Malayasia, Taiwan and Thailand, extended to Phillipines and India by Rao and Singh (1998).

exchange rates to the US dollar has not been the prime mover behind the crisis, as is often alleged to be the case.

The countries whose currencies declined the most tended to have extremely high short-term debt in relation to reserves. India is said to have escaped the Asian crises because our ratio of short-term debt to reserves has been low, and continues to remain low. The emphasis on short-term debt, as opposed to total debt, is based on a distinction between **solvency** and **liquidity**. Insolvency can be defined as not having the capacity to generate earnings to pay back debt, or a lack of net worth. Illiquidity can be defined as lacking the funds to pay for current debt-service, although there is capacity to generate adequate future earnings to repay long-term debt.

Steven Radelet and Jeffrey Sachs (1998) have forcefully argued, in a deep and wide-ranging analysis along the above lines, that the Asian crisis resulted from a problem of liquidity, not solvency. They find that the ratio of short-term debt to reserves is the statistically most significant variable in explaining the Asian currency collapses. The ratio of short-term debt to reserves (from their computations) is shown in Table III. This ratio was 1.45 for Thailand, 1.704 for Indonesia and 2.073 for Korea in June 1997, just before the crisis broke out.

Their conclusion is that

“...the crisis was not due to fundamental changes in global market conditions or due to abrupt shifts in the debtor country’s situation but due to “intrinsic instability in international lending”<sup>14</sup> (Sachs and Radelet, 1998, p.6)

#### IV

##### Poor Banking Systems and Financial Openness

Although large short-term external debt has been the main proximate factor in the Asian crisis, its links to the financial system, the extent of capital-account convertibility and the broader policy choices still need to be investigated. Radelet and Sachs do emphasize the connection between the build-up of short-term debt and the quality of the banking system.<sup>15</sup> However, they stress that despite bad banking systems, those countries with capital-account restrictions, which effectively restricted the build up of short-term foreign debt, were relatively unaffected. This is certainly the case. Data on bank ratings in June 1997, before the crisis broke out, is also presented in Table III. While these ratings data have severe limitations, they are better than estimates of non-performing assets, which vary far too widely, and are often not available for all the banks. The countries with the worst bank ratings are China, India, South Korea and Indonesia (all rated D). India, and more so China, have emerged relatively unscathed so far, despite

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<sup>14</sup> One issue that needs to be examined is the extent to which the high ratio of short-term debt to reserves has been merely an endogenous response to exchange rate pegging, which provided an incentive for unhedged short-term borrowing. Both Indonesia and Korea had more flexible exchange rates than Thailand, with 15% and 10% nominal depreciation against the dollar between January 1994 and mid 1997 respectively (cf. Table II). Even though these are not large declines, flexibility in the exchange rate conveys to investors that there is exchange rate risk. Thus the build-up in short-term debt for both Indonesia and Korea suggests that Thailand’s peg *per se* cannot be said to be the driving factor behind build-up of short-term debt. The structure and quality of the banking system has also been a factor.

<sup>15</sup> As they point out, the now notorious Bangkok International Banking Facility (BIBF), introduced in 1992, allowed for rapid growth in the number of financial institutions that could borrow and lend ashore, but this rapid expansion in financial services was not matched by adequate regulation and supervision.

their bad banks, while South Korea and Indonesia with their more open financial systems have suffered a lot. But it is also the case that Singapore and Hong Kong, with relatively better bank ratings of B and C respectively, have not suffered too much, despite full convertibility. Thus the combination of **bad banks and full convertibility** has led to the worst outcomes.

The policy recommendation of Radelet and Sachs is to restrict overseas short-term bank borrowing. One can agree with the diagnosis of Radelet and Sachs, and yet disagree with their suggested remedy. The thrust of their position is that since financial markets are inherently unstable, lesser financial openness would be beneficial. Instead, it could be argued that the East Asian economies moved toward the wrong kind of openness, liberalizing capital flows **but** not competition in banking and financial services.

The experience of Indonesia, which moved towards capital convertibility in the 1970s but did not reform its banking system in tandem, points to this conclusion. In Indonesia the crisis worsened immensely in late 1997 because of panic as insolvent banks were closed by the IMF in late 1997. There is a wealth of anecdotal evidence regarding the poor quality of banks in the Asian countries. These banks were often run by family networks, and linked to the ruling political families. Had there been more competition in banking in the pre-crisis period, arguably, the quality and efficiency of the banking system would have improved and the Asian economies would have been in better shape to weather the

crisis, especially Indonesia, where many banks were owned by then President Suharto's family. As the Economist recently put it,

“Before the crisis, the (East Asian) economies restricted the entry of foreign banks. They may have been open or semi-open to capital flows, but from an institutional point of view their financial systems were comparatively closed. In the mid-1990s foreign-owned banks accounted for roughly 5% of bank lending in South Korea, Thailand and Indonesia - about the same share as in India, though more than in Japan, whose financial system is in an appalling state” (1998b)

In this connection, the experience of Japan, the worst performing Asian economy this decade with GDP growth averaging close to 2%, is instructive. The economic travails of Japan clearly indicate the crippling influence of a bad banking system. Japan's current problems did arise from the asset price bubble in the late 1980s, due to its exchange rate agreement with the US to try and lower the yen, which in turn led to an excessively easy monetary policy in Japan.<sup>16</sup> However, the resulting extent of the financial bubble, its subsequent collapse and the inability of the economy to recover a decade later can be largely traced to its poor banking system, rated D+ in Table III, and not due to any exchange rate target. The exchange rate system in Japan has been flexible and has fluctuated a lot this decade.

While the distinction between liquidity and solvency is useful, it may not be correct to conclude, as Sachs and Radelet have done, that the East Asian crisis has been **only one** of liquidity stemming from too much short-term debt. Liquidity and solvency problems are likely to be, and often are, mutually reinforcing factors. Had the problem been merely

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<sup>16</sup> Following the February 1987 Louvre agreement, Japan and the US had agreed to try and keep the yen-dollar rate (not formally declared) within a 5% band of the then prevailing exchange rate. Japan was pressured by the USA into abiding by this agreement, despite opposition by the Bank of Japan.

one of liquidity, the Thai central bank's initial defence of the baht's peg to the US dollar in May 1997, when it sold \$ 4 billion, **should have sufficed** to stave off investor panic, and stability would have returned to the currency market. Indeed, the May intervention was followed by a period of relative currency calm in June. However, prevailing one-month interest rates in excess of 100% through June indicated that the market continued to expect that the peg was unsustainable and that a devaluation was likely soon.<sup>17</sup> The continuing pressure on the baht, culminating in the July 2nd decision to float, were indicative of underlying solvency problems as well, and not just a liquidity crunch.

Insofar as there is a solvency problem, capital controls only postpone the collapse of the economy and the currency and thus make the recovery process more protracted and difficult. Despite being very open to foreign trade, China has staved off the effects of the Asian crisis so far, due to the combination of its fixed exchange rate and fairly stiff capital controls. However, the economy is in dire straits. Despite repeated pronouncements by officials that they will not devalue, such an outcome seems increasingly likely, with an ensuing catastrophic impact upon Hongkong and much of East Asia as well. As of October 1998, the Chinese yuan is reported to be trading at between a 5-10% discount on the black market. Further the 'errors and omissions' item in the balance of payments indicates that capital is fleeing China.

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<sup>17</sup> From the uncovered interest parity condition, it can be deduced that when market expect a devaluation soon, there is a sharp rise in short-term rates and associated inversion of the yield curve

## V

The IMF and Destabilizing Capital Flows

There is another entirely different but vital aspect of the East Asian crisis - the potential role of moral hazard in inducing the boom in private investment. The term moral hazard refers to the phenomenon whereby the actions of the insured are affected by the amount of insurance available. The distinguished economist Milton Friedman (1998), in a recent article in the Asian Wall Street Journal, has argued that the exchange rate guarantees and the \$40 billion Mexican package, much of which went to aid the banks and foreign investors, induced private capital to continue flowing to risky Asian and other emerging markets, notably Russia, under the expectation that the IMF would bail them out if needed.

Assessing the role that moral hazard may have played in the Asian boom is a difficult task. To begin with, it should be recognized that capital flows were volatile even during the nineteenth century and first half of this century, well before the IMF was even formed. Financial panics, boom, bust and subsequent recovery are endemic to the market system and have repeatedly occurred during the gold standard era, when private individuals had to shoulder most of the risk of their investments. The Asian collapse is just the latest manifestation of this intrinsic instability, which is a cost of the market system that at the same time provides a secular increase in living standards.

Nevertheless, there is compelling evidence that lends substantial credence to the view that perverse incentives, categorized as the moral hazard phenomenon, is a factor that **has**

**contributed** to the East Asian crisis. Table IV presents data on **net** capital flows to Asia, both aggregate and the relevant sub-category of other net investment, which is mostly bank lending.<sup>18</sup> As can be seen, Taiwan - the **best** performer (judged by GDP growth and inflation, cf. Table I) of all the East Asian countries, excluding China which has dubious data - has had a total **net capital outflow** in recent years, and an outflow under the sub-category of other net investment as well. Unlike all the other Asian countries during this decade, Taiwan has experienced net private capital outflows. Taiwan, officially designated as a province of China, is not a member of the IMF and cannot rely on any explicit or implicit, full or partial assistance, in case of external financing difficulties.

In the years before the crisis, Taiwan's booming economy should have been attracting foreign capital like the other countries in the region, based on both strong fundamentals and the euphoric mood about East Asia's prospects. That it has not done so is an extremely remarkable and noteworthy fact. While more detailed data and background knowledge would be informative, and further investigation is required, as a first approximation, one can conclude that it has not attracted large net capital flows, unlike the rest of Asia, due to its political status.

Apart from direct moral hazard, attention must be paid to the indirect consequences of the synergy of views and activities of private investors and official agencies. Paul Krugman (1995) has insightfully and persuasively attributed much of the capital flow to emerging markets in the early 1990s to these alliances. The Washington consensus, as he

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<sup>18</sup> For reasons of brevity, Table IV does not provide data on portfolio investment and direct investment, the

described it,

“meant not only the US Government but also those institutions and networks of leaders centred in the world’s de facto capital - the IMF, World Bank, think tanks, politically sophisticated investment bankers, and worldly finance ministers, all those who meet in Washington and *collectively define the conventional wisdom of the moment*... ..  
 .....Indeed, the five-year reign of the Washington consensus may be usefully thought of as a speculative bubble - one that involved not just the usual economic process by which excessive market optimism can be a temporarily self-fulfilling prophecy, *but a more subtle political process through which the common beliefs of policy-makers and investors proved mutually reinforcing.*” (Krugman, 1995, italics added)

Taiwan’s experience suggests that some governments and those international agencies which have provided exchange rate and default risk guarantees for overseas private investors may have done more harm than good to the Asian economies. Although the failure of comprehensive planning in developing economies has led to a drastic reduction of direct State intervention, it has been replaced by indirect State intervention with governments actively promoting private capital flows that have had adverse effects.

## VI

### Lesson for Indian policy: Inflows versus Outflows

From the analysis in Section IV it can be concluded that an eclectic policy of financial openness is called for, distinguishing between openness for the banking and financial system versus that for capital flows. Within the context of capital flows, a similar distinction between the consequences of liberalizing, or restricting, inflows and outflows is useful. Most writing on this subject, including that by distinguished economists such

as Jagdish Bhagwati (1998) and Krugman, is far too simplistic insofar as it does not deal with this distinction.<sup>19</sup>

The relative costs and benefits of liberalizing outflows versus outflows depend to a large extent on what are the perceived benefits and costs of capital-account convertibility and the associated constraints in achieving these benefits. Leaving aside the benefits of portfolio diversification stressed in academic finance theory, most advocates of increasing inflows uncritically presume that savings is a major constraint on growth: emerging economies are believed to have huge, viable investment projects and primarily need foreign savings to augment the domestic savings to finance them. From this standpoint, the chief benefit of capital convertibility is to attract inflows in order to promote growth.

The above viewpoint can be questioned. Without a properly functioning legal system and well developed private property rights, investment opportunities in the emerging markets, adjusted for risk, are not necessarily that high and the need for more savings not necessarily that acute. Large capital inflows are not necessary for sustained growth, as data on Taiwan's net capital outflows in the Asian context suggests. More generally,

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<sup>19</sup> A clarification is in order. An inflow here refers to money originating overseas and vice versa for an outflow. Clearly, at the time of redemption or portfolio liquidation, an inflow leads to an outflow and vice versa. It is presumed in the discussion above that once an investment is made, repatriation is allowed. Policies to suddenly impose exchange controls on existing investments (a kind of default), as Malaysia has done recently, are not discussed here. While these may have a beneficial short-run impact, over time such measures that change the rules of the game are likely to damage investor confidence and discourage further investment.

most of sustained growth is due to improved total factor productivity or technical progress, as is well known from the broad evidence on growth accounting. Further emerging economies, including India, have high domestic saving rates; much of the saving gets channelized into unproductive assets such as gold. If domestic residents are reluctant to invest in local infrastructure and similar projects, it may well reflect an accurate perception on their part that the risk-adjusted returns are not adequate.

By contrast, liberalizing outflows for domestic residents and allowing them to invest in limited amounts in overseas mutual funds has tangible benefits that are not adequately recognized. The quality of domestic financial services and banking will improve due to competition from overseas entities and financial intermediaries, a benefit that cannot be easily captured by GDP data.<sup>20</sup> A second and substantive benefit of freeing outflows is that the possibility of a currency decline can act as a check on fiscal laxity and also as an offset to unduly rapid private sector growth. On the other hand, larger inflows often allow an unsustainable expansion to continue, which would not have been possible in a closed economy that cannot live beyond its means. Although financial markets will eventually react so as to weaken the currency, they tend to do so in a delayed and destabilizing manner. Finally, a limited freeing up of outflows while limiting inflows is likely to induce the currency to decline, thus facilitating the desirable macroeconomic

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<sup>20</sup> For this 'quality' benefit to accrue to domestic residents, it is not enough to allow investment in foreign assets via a domestic entity, such as the Unit Trust of India. Domestic residents should also be given the opportunity to invest in financial intermediaries abroad.

goal of preventing a real exchange rate appreciation with its potentially adverse impact upon the external sector.<sup>21</sup>

## VII

### Conclusion

The main conclusions of this paper can be summarized as follows. The Asian crises have resulted largely from bad banking systems, rather than pegged exchange rates or capital-account convertibility per se. Excessive short-term foreign debt has certainly played a major role in inducing creditor panic and ensuing currency collapse in many East Asian countries as Radelet and Sachs have stressed. However, it is quite likely that with greater competition in financial services and with better banks the build-up of short-term debt and/or its economic impact would have been less. The case of Taiwan suggests that the prospect of an IMF bailout is likely to have played a role in inducing large capital flows to Asia and the subsequent crisis.

It would be inappropriate to conclude that the lesson from the Asian crisis is to put capital-account convertibility policies on hold indefinitely. Rather than going uniformly slow on external financial liberalization, more openness in financial services and banking, coupled with less openness in capital flows is called for. A policy of 'speed up and go slow' with regard to outflows and inflows respectively would also be appropriate.

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<sup>21</sup> Even before the Asian crisis, this author has been consistently arguing along the above lines, i.e. that India's capital-account policy should be to encourage outflows (in particular, for resident Indian individuals) and discourage inflows. (Moorthy, 1997a, 1997b and 1997c).

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Table 1. Macro-economic Indicators

COUNTRY	REAL GDP (% CHANGE)				INDUSTRIAL PRODUCTION (% change over 12 months)		INFLATION (%) (Consumer Price Index)		
	1970-90	1990-96	1997*	LATEST@	1997#	LATEST##	1990-96^	1997#	LATEST###
CHINA	8.8	8.6	9.9	7.6	9.2	10.2	11.0	0.4	-1.5
HONGKONG	7.1	7.5	5.5	-5.2	-3.0	-4.5	8.4	4.8	2.7
INDIA	4.3	5.2	7.5	5.1	2.4	2.4	10.1	6.3	15.0
INDONESIA	6.3	7.2	8.0	-16.5	7.1	-3.0	8.6	11.6	82.4
MALAYSIA	6.6	8.8	8.1	-6.8	9.4	-10.9	3.9	2.9	5.5
PHILLIPINES	3.7	2.8	5.2	-1.2	19.4	-12.1	10.7	6.1	10.0
SINGAPORE	7.7	8.4	5.8	1.6	8.0	-6.6	2.5	2.0	-0.8
S.KOREA	8.2	7.7	7.2	-6.6	2.4	-11.8	10.3	6.6	6.9
TAIWAN	7.9	8.3	6.6	5.2	8.1	6.7	3.7	0.2	0.4
THAILAND	6.7	8.9	6.7	-0.4	-10.7	-13.9	5.1	7.7	7.0
JAPAN	5.9	2.2	2.9	-1.8	-1.0	-9.1	1.4	1.8	-0.3

\* April 1996-March 1997 for India, calendar year for Indonesia and Thailand. Rest all 1996Q4/1997Q4.

@ Change over four quarters - Q3 for China and Hong Kong. Rest all Q2. Calendar year for Thailand (1997-98). April 1997 to March 1998 for India.

^ For Hong Kong and Taiwan only 1994-96 average

# December to December Figures

## Economist, October 24th-30th, 1998 issue.

**Table 2. Financial Market Indicators**

Country	Exchange Rate (per \$)				Stock Indices			Exchange rate plus Stock Price Change(%)	
	Jan 1994	Jun 1997	% Change Jun 1997- Dec 1997	% Change Jun 1997- Oct 1998	Jun 1997	% Change Jun 1997- Dec 1997	% Change Jun 1997- Oct 1998	Jun 1997- Dec 1997	Jun 1997- Oct 1998
CHINA	5.9	8.3	0	0	1422.1	-15.3	-9.8	-15.3	-9.8
HONGKONG	7.7	7.7	0	0	14831.6	-28.6	-34.8	-28.6	-34.9
INDIA	31.1	35.7	-8.1	-19.3	3861.4	-8.4	-28.4	-16.6	-47.4
INDONESIA	2113.0	2428.0	-50.7	-356.1	693.5	-42.5	-53.5	-93.3	-409.7
MALAYSIA	2.6	2.5	-39.3	-50.8	1119.3	-53.0	-62.1	-92.3	-112.9
PHILLIPINES	27.0	26.4	-31.8	-69.7	2796.1	-35.6	-46.5	-67.5	-116.2
SINGAPORE	1.6	1.4	-11.9	-21.0	2047.9	-19.3	-44.3	-31.1	-65.3
S.KOREA	808.1	891.0	-24.6	-57.3	763.3	-42.5	-50.1	-67.1	-107.5
TAIWAN	26.4	27.9	-16.1	-24.4	8282.9	-7.1	-15.2	-23.2	-39.6
THAILAND	25.5	24.7	-60.7	-63.6	552.9	-27.3	-41.6	-88.1	-105.1
JAPAN	113.0	131.1	8.3	2.1	20611.6	-22.2	-31.0	13.8	-29.0

Sources: Economist Various Issues.

**Table 3. Banking and Financial Data**

Country	Bank Rating June-97	Quality of Data^^ Mar-95	CAPAC?	CAPAC Index **	Ratio of Short-term Debt to Reserves June - 1997 ^	Debt service ratios (%) 1996@	Short-term debt / total external debt (%) 1996@
CHINA	D	C	N	n.a.	n.a.	8.7	19.7
HONGKONG	C	A	Y	n.a.	n.a.	11.5	n.a.
INDIA	D	B-	N	0.444	0.301	24.1	7.5
INDONESIA	D	C+	Y	0.865	1.704	n.a.	25.0
MALAYSIA	C-C+	B-	Y	0.638	0.612	8.2	27.8
PHILLIPINES	D+	B-	N	0.377	0.848	13.7	19.3
SINGAPORE	B	A	Y	1.000	n.a.	n.a.	n.a.
S.KOREA	D	A	N	0.594	2.073	n.a.	n.a.
TAIWAN	n.a.	A	n.a.	0.353	0.244	n.a.	n.a.
THAILAND	D-D+	B-	N	0.593	1.453	n.a.	41.4
JAPAN	D+	n.a.	N	n.a.	n.a.	n.a.	n.a.

\* The Bank Financial Strength Rating is Moody's assessment whether a Bank is likely to require financial support from shareholders, the government or other institutions. The ratings range from A (highest) to E (lowest). The coverage of the banking systems is not generally complete, so that the ratings are not necessarily representative of the credit quality of the entire system. The reported rating is the average computed from ratings of individual banks. Source (International Capital Markets, November 1997, IMF, Annex III, Pg: 133-134)

\*\* - Source - Helmut Reisen and Helene Yeches, (1993), *Time-varying estimates on the openness of the capital account in Korea and Taiwan*, *Journal of development Economics*, 41, pp - 285-305.

^ - Source - Steven Radelet and Jeffrey D.Sachs (1998), *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, *BPEA*, 1:1998.

@ - Source - Economic Survey 1997-98, Govt. of India, (From Global Development Finance 1998, World Bank).

^^ - Source - Economist, March 4<sup>th</sup> 1995., p. 28

**Table 4. Selected Asian Economies: Capital Flows (In percent of GDP)**  
(Source: *World Economic Outlook, Interim Assessment, Dec'97, IMF., p.6*)

	83-88**	89-95**	91-94	1996	1996	1997@
<b>China</b>						
Net private capital flows#	1.20	2.50	2.73	5.20	4.70	3.70
Other net investment	0.50	-0.60	-1.08	0.20	-0.30	-0.80
Change in reserves##	-0.40	-2.20	-2.30	-3.20	-4.00	-4.50
<b>India</b>						
Net private capital flows#	1.50	1.20	1.10	1.50	2.00	2.90
Other net investment	1.50	0.60	0.33	0.10	0.60	1.40
Change in reserves##	-0.10	-0.70	-1.50	0.30	-1.10	-1.50
<b>Indonesia</b>						
Net private capital flows#	1.50	4.20	3.53	6.20	6.30	1.60
Other net investment	1.00	2.60	1.88	3.10	2.70	0.10
Change in reserves##		-1.40	-1.58	-0.70	-2.30	1.80
<b>Korea</b>						
Net private capital flows#	-1.10	2.10	2.33	3.90	4.90	2.80
Other net investment	-1.60	0.80	0.55	2.50	3.00	3.40
Change in reserves##	-0.90	-0.80	-0.75	-1.50	0.30	-1.10
<b>Malaysia</b>						
Net private capital flows#	3.10	8.00	11.30	8.80	9.60	4.70
Other net investment	0.80	2.30	3.65	4.10	4.50	-0.60
Change in reserves##	-1.80	-4.70	-6.83	2.00	-2.50	3.60
<b>Philippines</b>						
Net private capital flows#	-2.00	2.70	2.80	4.60	9.80	0.50
Other net investment	-2.70	0.90	1.10	2.40	8.50	4.50
Change in reserves##	0.50	-1.10	-1.70	-0.90	-4.80	2.10
<b>Singapore</b>						
Net private capital flows#	5.00	3.80	2.73	1.30	-10.10	-5.50
Other net investment	-3.20	-2.40	-3.28	-4.60	1.80	3.60
Change in reserves##	-6.10	-10.30	-10.38	-7.20	-11.10	-14.60
<b>Taiwan Province of China</b>						
Net private capital flows#	0.20	-4.00	-1.78	-3.60	-3.20	-3.80
Other net investment	0.70	-2.80	-1.58	-3.30	-2.10	-2.60
Change in reserves##	-13.50	-0.60	-2.15	1.50	-0.40	0.70
<b>Thailand</b>						
Net private capital flows#	3.10	10.20	9.10	12.70	9.30	-10.90
Other net investment	1.50	7.40	6.78	10.00	7.70	-12.00
Change in reserves##	-1.40	-4.10	-3.33	-4.40	-1.20	9.70

\* Net capital flows comprise net direct investment, net portfolio investment and other long and short term net investment flows, including official and private borrowing.

\*\* Annual Averages

# Because of data limitations, other net investment may include some official flows.

## A minus sign indicates an increase. @ Estimates