THE ECONOMIC CRISIS IN EAST ASIA: CAUSES, EFFECTS, LESSONS

By Martin Khor
Director
Third World Network

1. INTRODUCTION

The East Asian economic crisis is probably the most important economic event in the region of the past few decades and for the next few decades.

Beyond this, there is yet no unanimity about its root causes nor about the solutions. The differences of views are being debated in academic circles and reflected in the media.

One thing though is certain: the earlier optimistic expectation that it would last only some months has proved wrong. Instead the financial crisis has been transformed into a full-blown recession or depression, with forecasts of GNP growth and unemployment becoming more gloomy for affected countries. Moreover the threat of depreciation has spread from a few countries to many in the region, and is spreading to other areas such as Russia, South Africa, and possibly Eastern Europe and South America.

2. THE CAUSES, PROCESSES AND SOME ECONOMIC EFFECTS OF THE CRISIS

The great debate on causes is whether the blame should be allocated to domestic policies and practices or to the intrinsic and volatile nature of the global financial system.

In the first phase of the crisis, as it spread from Thailand to Malaysia, Indonesia, the Philippines, then to South Korea, the international establishment (represented by the IMF) and the G7 countries placed the blame squarely on domestic ills in the East Asian countries. They cited the ill judgment of the banks and financial institutions, the over-speculation in real estate and the share market, the collusion between governments and businesses, the bad policy of having fixed exchange rates (to the dollar) and the rather high current account deficits. They studiously avoided blaming the financial markets, or currency speculation, and the behavior of huge institutional investors.

This view was difficult to sustain. For it implied that the "economic fundamentals" in East Asia were fatally flawed, yet only a few months or even weeks before the crisis erupted, the
countries had been praised as models of sound fundamentals to be followed by others. And in 1993 the World Bank had coined the term the East Asian Miracle to describe the now vilified economies.

However, there rapidly developed another view of how the crisis emerged and spread. This view put the blame on the developments of the global financial system: the combination of financial deregulation and liberalization across the world (as the legal basis); the increasing interconnection of markets and speed of transactions through computer technology (as the technological basis); and the development of large institutional financial players (such as the speculative hedge funds, the investment banks, and the huge mutual and pension funds).

This combination has led to the rapid shifting of large blocks of short-term capital flowing across borders in search of quick and high returns, to the tune of US$2 trillion a day. Only one to two percent is accounted for by foreign exchange transactions relating to trade and foreign direct investment. The remainder is for speculation or short-term investments that can move very quickly when the speculators' or investors' perceptions change.

When a developing country carries out financial liberalization before its institutions or knowledge base is prepared to deal with the consequences, the it opens itself to the possibility of tremendous shocks and instability associated with inflows and outflows of funds. What happened in East Asia is not peculiar, but has already happened to many Latin American countries in the 1980s, to Mexico in 1994, to Sweden and Norway in the early 1990s. They faced sudden currency depreciations due to speculative attacks or large outflows of funds.

A total of US$184 billion entered developing Asian countries as net private capital flows is 1994-96, according to the Bank of International Settlements. In 1996, US$94 billion entered and in the first half of 1997 $70 billion poured in. With the onset of the crisis, $102 billion went out in the second half of 1997. The massive outflow has continued since.

These figures help to show: (i) how huge the flows (in and out) can be; (ii) how volatile and sudden the shifts can be, when inflow turns to outflow; (iii) how the huge capital flows can be subjected to the tremendous effect of "herd instinct," in which a market opinion or operational leader starts to pull out, and triggers or catalyses a panic withdrawal by large institutional investors and players.

In the case of East Asia, although there were grounds to believe that some of the currencies were over-valued, there was an over-reaction of the market, and consequently an "over-shooting"

downwards of these currencies beyond what was justifiable by fundamentals. It was a case of self-fulfilling prophecy.

It is believed that financial speculators, led by some hedge funds, were responsible for the original "trigger action" in Thailand. The Thai government used up over US$20 billion of foreign reserves to ward off speculative attacks. Speculators are believed to have borrowed and sold Thai baht, receiving US dollars in exchange.

When the baht fell, they needed much less dollars to repay the baht loans, thus making large profits.

A report in Business Week in August 1997 revealed that hedge funds made big profits from speculative attacks on Southeast Asian currencies in July 1997. In an article titled "The Rich Get a Little Richer," the business weekly reported on the recent profit levels of US-based "hedge funds", or investment funds that make their money from leveraged bets on currencies, stocks, bonds, commodities. According to Business Week, in the first half of this year, the hedge funds performed poorly. But in July (the month when the Thai baht went into crisis and when other currencies began to come under attack) they "rebounded with a vengeance" and that most types of funds posted "sharp gains". The magazine says that a key contributing factor for the hedge funds' excellent July performance was "the funds' speculative plays on the Thai baht and other struggling Asian currencies, such as the Malaysian ringgit and the Philippine peso." As a whole, the hedge funds made only 10.3 percent net profits (after fees) on average for the period January to June 1997. But their average profit rate jumped to 19.1 percent for January-July 1997. Thus, the inclusion of a single month (July) was enough to cause the profit rate so far this year to almost double. This clearly indicates a tremendous profit windfall in July.

In some countries, the first outflow by foreigners was followed by an outflow of capital by local people who feared further depreciation, or who were concerned about the safety of financial institutions. This further depreciated the currencies.

The sequence of events leading to and worsening the crisis included the following.

(a) Financial liberalization

Firstly, the countries concerned carried out a process of financial liberalization, where foreign exchange was made convertible with local currency not only for trade and direct-investment purposes but also for autonomous capital inflows and outflows (i.e. for "capital account" transactions); and where inflows and outflows of funds were largely deregulated and permitted. This facilitated the large inflows of funds in the form of international bank loans to local banks and companies,
purchase of bonds, and portfolio investment in the local stock markets. For example, the Bangkok International Banking Facilities (BIBF) was set up on March 1993, to receive foreign funds for recycling to local banks and companies, and it received US$31 billion up to the end of 1996. South Korea recently liberalized its hitherto strict rules that prohibited or restricted foreign lending, in order to meet the requirements for entering the OECD. Its banks and firms received large inflows of foreign loans, and the country accumulated US$150 billion of foreign debts, most of it private-sector and short-term. In Indonesia, local banks and companies also borrowed heavily from abroad.

(b) Currency depreciation and debt crisis

The build-up of short-term debts was becoming alarming. What transformed this into crisis for Thailand, Indonesia and South Korea was the sharp and sudden depreciation of their currencies, coupled with the reduction of their foreign reserves in anti-speculation attempts. When the currencies depreciated, the burden of debt servicing rose correspondingly in terms of the local-currency amount required for loan repayment. That much of the loans were short-term was an additional problem. Foreign reserves also fell in attempts to ward off speculative attacks. The short-term foreign funds started pulling out sharply, causing reserves to fall further. When reserves fell to dangerously low levels, or to levels that could not allow the meeting of foreign debt obligations, Thailand, Indonesia and South Korea sought IMF help.

(c) Liberalization and debt: the Malaysian case

Malaysia also went through a process of financial liberalization, with much greater freedom for foreign funds to invest in the stock market, for conversion between foreign and local currencies, and for exit of funds to abroad.

The Central Bank however retained a key control: private companies wanting to borrow foreign-currency loans exceeding RM5 million must obtain the Bank's approval. This is generally given only for investments that would generate sufficient foreign exchange receipts to service the debts. Companies are also not allowed to raise external borrowing to finance the purchase of properties in the country. (Bank Negara Annual Report 1997, p53-54). Thus there was a policy of "limiting private sector external loans to corporations and individuals with foreign exchange earnings" which according to Bank Negara "has enabled Malaysia to meet its external obligations from export earnings." According to a private-sector leader, this ruling saved Malaysia from the kind of excessive short-term private-sector borrowing that led the other three countries into a debt crisis.

As a result of these controls, Malaysia's external debt has been
kept to manageable levels. Nevertheless the debt servicing burden in terms of local currency has been made heavier by the sharp ring it depreciation.

The relatively low debt level, especially short-term debt, is what distinguishes Malaysia from the three countries that had to seek IMF help. The lesson is that it is prudent and necessary to limit the degree of financial liberalization and to continue to limit the extent of foreign debt, and moreover to in future keep the foreign debt to an even much lower level.

(d) Local Asset Boom and Bust, and Liquidity Squeeze

The large inflows of foreign funds, either as loans to the banking system and companies directly, or as equity investment in the stock markets, contributed to an asset price boom in property and stock markets in East Asian countries.

With the depreciation of currencies, and expectations of a debt crisis, economic slowdown or further depreciation, substantial foreign funds left suddenly as withdrawal of loans and selling off of shares. Share prices fell. Thus the falls in currency and share values fed each other. With weakened demand and increasing over-supply of buildings and housing, the prices of real estate also fell significantly.

For the countries afflicted with sharp currency deprecations and share market declines, the problems involved:

** The much heavier debt servicing burden of local banks, companies and governments that had taken loans in foreign currencies,

** The fall in the value of shares pledged as collateral for loans by companies and individuals, and the fall in the values of land, buildings and other real estate property. This has led to financial difficulties for the borrowers.

** The higher interest rates caused by liquidity squeeze and tight monetary policies have caused added financial burdens on all firms as well as on consumers that borrowed;

** As companies and individuals face difficulties in servicing their loans, this has increased the extent of non-performing loans and weakened the financial position of banks, and

** Higher inflation caused by rising import prices resulting from currency depreciation.

Moreover, in order to reduce the current account deficit, or in following the orthodox policies of the IMF, governments in the
affected countries reduced their budget expenditure. The main rationale was to induce a reduction in the current account deficit, which had been targeted by currency speculators as a weak spot in the economy. Added to the higher interest rate and the tightening of liquidity, this budget cut also added to recessionary pressures.

(e) The fall in output

In the region, the financial crisis has been transformed to a full-blown recession in the real economy of production. Worst affected is Indonesia with a 6.2% fall in GDP in the first quarter 1998, and a newly projected negative growth for 1998 of 15%, inflation of 80% and expected unemployment of 17% or 15 million. South Korea's GDP fell 3.8% in the first quarter 1998. Thailand's 1998 GDP is expected to drop 4 to 5.5 percent in 1998. Hong Kong's GDP fell 2% in the first quarter. Singapore enjoyed 5.6% growth in the first quarter but is expected to slip into negative growth sometime in the second half of 1998. In Malaysia, real GDP fell 1.8% in first-quarter 1998 (compared to 6.9% strong growth in 4th quarter-1997).

A bright spot for the region is a turnaround in the current account of the balance of payments. However this improvement came with a heavy price. The increased trade surplus was caused more by a fall in imports than by a rise in exports, especially in real (or volume) terms. Thus the trade surplus indicates the effects of recession on falling imports, rather than an expansion of exports. Another point to note is that an improvement in the current account need not necessarily mean a healthy overall balance of payments position unless there is also a positive development in the capital account. A possible weakness here could be an outflow of short-term funds, by either foreigners or local people. To offset this, a repatriation of funds owned by local companies or people back to the country should be encouraged.

(f) Easing of fiscal and monetary policy

Recently there has been an easing of fiscal and monetary policy in the affected countries in response to the depth of the recessionary conditions. These actions would hopefully have the effect of improving economic conditions and ease recessionary pressures.

3. THE RECENT DEBATE ON THE ROLE OF THE IMF

As the East Asian crisis continues to deepen, the debate on the role of the International Monetary Fund's policies has heated up. The IMF's top officials continue to defend their macroeconomic approach of squeezing the domestic economies of their client
countries through high interest rates, tight monetary policies and cuts in the government budget. Their argument is that this "pain" is needed to restore foreign investors' confidence, and so strengthen the countries' currencies.

However, some economists had already warned at the start of the IMF "treatment" for Thailand, Indonesia and South Korea that this set of policies is misplaced as it would transform a financial problem that could be resolved through debt restructuring, into a full-blown economic crisis.

The prediction has come true, with a vengeance. The three countries under the IMF's direct tutelage have slided into deep recession. Partly due to spillover effects, other countries such as Malaysia and Hongkong have also suffered negative growth in the year's first quarter. Even Singapore is tottering on the brink of minus growth.

The three affected countries had faced initial problems resulting from currency depreciation and stock market decline, such as debt repayment and a great financial weakening of the corporate and banking sectors. But then came a second set of problems resulting from the high interest rates and tight monetary and fiscal policies that the IMF imposed or advised.

For companies already hit by the declines in the currency and share values, the interest rate hike became a third burden that broke their backs.

But even worse, there are many thousands of firms (most of them small and medium sized) that have now been affected in each country. Their owners and managers did not make the mistake of borrowing from abroad (nor did they have the clout to do so). The great majority of them are also not listed on the stock market.

So they cannot be blamed for having contributed to the crisis by imprudent foreign loans or fiddling with inflated share values.

Yet these many thousands of companies are now hit by the sharp rise in interest rates, a liquidity squeeze as financial institutions are tight-fisted with (or even halt) new loans, and the slowdown in orders as the public sector cuts its spending.

In Thailand, "domestic interest rates as high as 18 percent have been blamed for starving local businesses of cash and strangling economic growth," according to a Reuters report of 3 June. In South Korea, thousands of small and medium companies have gone bankrupt as a result of high interest rates. Although the country has about US$150 billion in foreign debts, its companies in January also had double that (or more than US$300 billion) in domestic debt. According to the Wall Street Journal (9 Feb), the Korean economy was facing fresh agony over this huge domestic
debt as thousands of companies file for bankruptcy as they find it harder to get credit. "To blame for the tighter liquidity are higher interest rates, a legacy of the IMF bailout that saved Korea's economy from collapse, and a sharp economic slowdown."

In Indonesia, whilst top corporations with foreign currency loans have been hit hardest by the 80 percent drop of the rupiah vis-a-vis the US dollar, the majority of local companies have been devastated by interest rates of up to 50 percent. The rates were raised as part of an IMF agreement and were aimed at strengthening the rupiah. However the rupiah has not improved from its extremely low levels, whilst many indebted companies are unable to service their loans.

In Malaysia, which has fortunately not had to seek an IMF loan package, interest rates were lower than the three IMF client countries. Nevertheless they also went up during the first year of the Asian crisis. The interest rate hike and the reluctance of many banks to provide new loans caused serious difficulties for many firms and consumers. However, after the imposition of capital controls in September 1998, interest rates have gone down significantly, by about four percentage points. This has eased the financial position of debtors and banks. The capital controls were thus able to lay the condition for enabling interest rates to go down without this affecting the exchange rate.

Without making use of capital controls, countries subjected to currency speculation face a serious dilemma. They have been told by the IMF that lowering the interest rate might cause the "market" to lose confidence and savers to lose incentive, and thus the country risks capital flight and currency depreciation.

However, to maintain high interest rates or increase them further will cause companies to go bankrupt, increase the non-performing loans of banks, weaken the banking system, and dampen consumer demand. These, together with the reduction in government spending, will plunge the economy into deeper and deeper recession. And that in turn will anyway cause erosion of confidence in the currency and thus increase the risk of capital flight and depreciation.

A higher interest rate regime, in other words, may not boost the currency's level but could depress it further if it induces a deep and lengthy recession.

It is also pertinent to note that a country with a lower interest rate need not necessarily suffer a sharper drop in currency level. Take the case of China. Since May 1996, it has cut its interest rates four times and its one-year bank fixed deposit rate was 5.2 percent in May (according to a Reuters report). But its currency, which is not freely traded due to strict controls by the government, has not depreciated.
It has also been pointed out by UNCTAD's chief macroeconomist Yilmaz Akyuz that "although Indonesia and Thailand have kept their interest rates higher than Malaysia, they have experienced greater difficulties in their currency and stock markets." According to Akyuz, there is not a strong case for a drastic reduction in domestic growth (as advocated by the IMF) to bring about the adjustment needed in external payments.

Indeed it is very strange that the IMF as well as the leaders of Western countries are shrilly criticizing Japan for not doing more to reflate its ailing economy. They are calling for more effective tax cuts so that Japanese consumers can spend more and thus kick the economy into recovery.

The yen had been sharply dropping, causing grave concerns that this will trigger a deeper Asian crisis or world recession. Yet neither the IMF nor the Western leaders have asked Japan to increase its interest rate (which at 0.5 per cent must be the lowest in the world) to defend the yen. Instead they want Japan to take fiscal measures to expand the economy. This tolerance of low interest rates in Japan as well as the pressure on the Japanese government to pump up its economy is a very different approach than the high-interest austerity-budget medicine prescribed for the other ailing East Asian countries.

Could it be that this display of double standards is because it is in the rich countries' interests to prevent a Japanese slump that could spread to their shores, and so they insist that Japan reflates its economy whilst keeping its interest rate at rock bottom? Whereas in the case of the other East Asian countries, which owe a great deal to the Western banks, the recovery and repayment of their foreign loans is the paramount interest?

In the latter case, a squeeze in the domestic economy would reduce imports, improve the trade balance and result in a strong foreign exchange surplus, which can then be channeled to repay the international banks.

This is in fact what is happening. The main bright spot for Thailand, South Korea, Indonesia and Malaysia is that as recession hits their domestic economy, there has been a contraction in imports resulting in large trade surpluses.

Unfortunately, this is being paid for through huge losses in domestic output and national income, the decimation of many of the large, medium and small firms of these countries, a dramatic increase in unemployment and poverty, and social dislocation or upheaval. A price that is far too high to pay, and which in the opinion of many economists (including some top establishment economists) is also unnecessary for the people of these countries to pay.
They argue that instead of being forced to raise interest rates and cut government expenditure, the countries should have been advised by the IMF to reflate their economies through increased lower interest rates and increased government spending.

Recently the Financial Times (London) carried a strongly worded opinion article entitled "Asian water torture" with this sub-heading: "Unless the IMF allows the region's economies to reflate and lower interest rates, it will condemn them to a never-ending spiral of recession and bankruptcy."

Written by Robert Wade, professor of political economy in Brown University (US), the article notes that the IMF imposed very high interest rates on the basis that a sharp shock rise in rates would stabilize currency markets, dampening pressures for competitive devaluations and making it easier for client governments to repay foreign creditors. The argument has a theoretical basis, says Wade, but it assumes conditions not present in Asia. When financial inflows did not resume, the Fund's response was to give it more time and make the pain sharper.

"Investors on the contrary took the high rates as a signal of great dangers ahead, making them all the more anxious to get out and stay out," says Wade. "High rates and the associated austerity policies have caused so much damage in the real economy as to validate the perception of great dangers."

Wade blames the IMF for failing to grasp the implications of imposing high interest charges on Asian companies that are typically far more indebted than western and Latin American companies. "High rates push them much more quickly from illiquidity towards insolvency, forcing them to cut back purchases, sell inventories, delay debt repayment and fire workers. Banks then accumulate a rising proportion of bad loans and refuse to make new ones. The IMF's insistence that banks meet strict Basle capital adequacy standards only compounds the collapse of credit. The combination of high interest rates and Basle standards is the immediate cause of the wave of insolvency, unemployment and contraction that continues to ricochet around the region and beyond. The uncertainty, instability and risk of further devaluations keep capital from returning despite high real interest rates."

Wade finds the IMF's contractionary approach "puzzling" as the United States authorities after the 1987 stock market crash had acted to keep markets highly liquid whatever the cost, yet in Asia the Fund acted to contract liquidity.

"Is this because it knows only one recipe? Or because it is more interested in safeguarding the interests of foreign bank creditors than in avoiding collapse in Asia?"
Concluding that the IMF's approach is not working, Wade calls on governments in the region to change tack away from the current approach of very low inflation, restrained demand and high real interest rates as the top priorities. "They need to take a tougher stance in the rescheduling negotiations with the creditor banks, lower interest rates to near zero, and step on the monetary gas," he says.

This proposition might be found by many to be too bold. What if the markets react negatively and the local currency drops further? To take this into account, Wade complements his proposal with another: that the governments have to reintroduce some form of cross-border capital controls. They should then channel credit into export industries, generate an export boom, and let the ensuing profits reinforce inflationary expectations and reflate domestic demand.

The West, meanwhile, should stop pushing developing countries to allow free inflow and outflow of short-term finance as they are simply not robust enough to be exposed to the shocks that unimpeded flows can bring. There should also be reconsideration of the constitution of money funds (whose priorities are short-term results) and over-guaranteed international banks, which lie at the heart of the problem of destabilizing international financial flows.

"Until Asian governments lower interest rates, take control of short-term capital movements, and cooperate within the region, the crisis will go on and on like water torture. That will bring poverty and insecurity to hundreds of millions and turn parts of Asia into a dependency of the IMF and the US, its number one shareholder."

The Wade article is the latest in a series of increasing academic articles calling for a change in IMF policies.

The Harvard professor, Jeffrey Sachs, has been attacking the IMF ever since early November 1997, when he predicted that the bailout packages for Thailand and Indonesia, if tied to orthodox financial conditions like budget cuts and higher interest rates, could "do more harm than good, transforming a currency crisis into a rip-roaring economic downturn." The predicted downturn has now turned out to be much worse than anyone imagined.

Another prominent critic is Martin Feldstein, economics professor at Harvard University, president of the National Bureau of Economic Research and formerly chief economic advisor to the US government.

In the "Foreign Affairs" journal (March/April 1998), he says the IMF's recent emphasis on imposing major structural and institutional reforms, rather than focusing on balance-of-payments adjustments, will have short-term and longer-term
adverse consequences.

The main thrust of his article is that the IMF has strayed from its mandate of helping countries resolve their balance of payments problems (which could be best done by organizing debt rescheduling exercises between the countries and their foreign creditors) and instead has been imposing conditions relating to their economic, financial and social structures which are not relevant to resolving the debt and balance of payments problems at hand. This is a subject that needs separate treatment.

However, Feldstein also criticizes the IMF's short-term macroeconomic policies for Korea, which calls for budget deficit reduction (by raising taxes and cutting government spending) and a tighter monetary policy (higher interest rates and less credit availability), which together depress growth and raise unemployment.

Asks Feldstein: "But why should Korea be required to raise taxes and cut spending to lower its 1998 budget deficit when its national savings rate is already one of the highest in the world, when its 1998 budget deficit will rise temporarily because of the policy-induced recession, and when the combination of higher private savings and reduced business investment are already freeing up the resources needed to raise exports and shrink the current account deficit?"

Feldstein notes that under the IMF plan, the interest rate on won loans was 30 percent whilst inflation was only 5 percent (at the time the article was written, earlier this year).

"Because of the high debt typical of most Korean companies, this enormously high real interest rate of 25 percent puts all of them at risk of bankruptcy," he says:

"Why should Korea be forced to cause widespread bankruptcies by tightening credit when inflation is very low, when the rollover of bank loans and the demand for the won depend more on confidence than on Korean won interest rates, when the failures will reduce the prospect of loan repayment, and when a further fall in the won is an alternative to high interest rates as a way to attract won-denominated deposits?"

"Although a falling won would increase the risk of bankruptcies among Korean companies with large dollar debts, the overall damage would be less extensive than the bankruptcies caused by very high won interest rates that would hurt every Korean company. Finally, why should Korea create a credit crunch that will cause even more corporate failures by enforcing the international capital standards for Korean banks when the Japanese government has just announced that it will not enforce those rules for Japanese banks in order to avoid a credit crunch in Japan?"
The questions raised by the IMF's policies, and now about the severe effects they are having in the region, are very serious indeed, as they relate to the shape of the national economies of East Asia and the very future of the countries. Fortunately, Malaysia has not been forced by circumstances to seek an IMF rescue package, and thus we have more degrees of freedom to determine short and longer term policies to get out of the crisis.

For those countries already taking IMF loans, it is most difficult (if not almost impossible) to make or modify policies or to change course if things go wrong, as the IMF is always ready to threaten to stop its loans (which are given in small installments) if these countries try to veer even a little from the IMF path.

4. THE NEED TO REGULATE THE GLOBAL FINANCIAL SYSTEM

The East Asian crisis has shown up the threats of volatile and large short-term capital flows to the economic stability of developing countries. What is urgently needed is greater transparency of how the global financial players and markets operate, and reforms at both international and national levels to regulate these speculative flows.

(a) Lack of Transparency

The workings and movements in the international financial markets and system have played the most important part in the East Asian financial crisis. The crisis is also manifesting now in Russia, South Africa and will likely spread to other countries.

It becomes obvious that this global system needs to be monitored and also reformed. Yet there is a great lack of transparency on what constitutes the financial markets, who the major players are, what are their decisions and how money is moved from market to market, and with what effect. Financial crises cannot be prevented or resolved unless this lack of transparency is removed. That is a first step.

After greater transparency, there is the need to improve the system, to remove its worst aspects and excesses, and to put in place a system in which currency and other financial instruments (shares, bonds, etc) are used for legitimate trade or real-investment purposes and not for non-beneficial speculative gain.

Transparency and reforms are needed in the following areas:

** We need to know who the major institutions and players are in the ownership of financial assets, and their behavior and operational methods, and the markets they operate in.
How do they gain their leverage? From where do they get their funds and credit and on what terms? How do they operate and through which channels? In particular, how do they view emerging markets and what are their methods to derive maximum profits there?

These institutions include hedge funds, mutual funds, pension funds, investment banks, insurance companies, commercial banks and the finance departments of multinational and big companies.

** What is the system by which central banks of the major Northern countries regulate, deregulate (or decide not to regulate) the behavior of funds, speculators and investors?

How do central banks coordinate among themselves? Do they (or some of them) coordinate among themselves to influence parameters such as exchange rates and interest rates? What is the role (or lack of role) of the Bank for International Settlements?

** The IMF is the major international financial institution, whose policies can determine the finances and fate of nations. There is lack of transparency on how the staff (who are powerful in the institution) set their policies and conditions, globally and for each nation.

How do the staff determine the policy framework and the specific conditions for loans for each client country? Do they come under the political influence of particular countries (especially the US) and of the major shareholders, and thus lead to a situation where decisions are not made only or mainly on professional grounds?

How do they major shareholders collaborate among themselves? What is the linkage of interests between the IMF secretariat, the US Treasury and other major countries' finance ministries, and the international banks (whose interests they usually serve in getting loans repaid from developing countries)?

There are some studies relating to some of the questions above. However these studies are few. Much more investigation has to be done, so that some basic knowledge of the institutions and system can be gained. On that basis, proposals for changes and reforms can be made.

(b) The Need for Reform

The present system suits the interests of financial owners and speculators. These players have powerful backers in governments or in the U.S. Congress and other Parliaments in the North. Thus getting global reform going is an uphill task.

Nevertheless it is becoming daily more evident that the present
system is very unstable and will continue to produce large-scale crises which is becoming too costly for the IMF or the Group of 7 rich countries (G7) to bear. Therefore the question of "a new financial architecture" is being raised by the G-7 themselves.

However the G-7 approach is to try as far as possible to have business as usual. This means not reforming the present system of free and liberal flows of short-term or long-term capital. They do not want regulation at global or national level.

Their approach is to get national governments in developing countries to strengthen their banking systems so that the banks can withstand more shocks that volatile flows will bring in future.

The G7 countries' focus is to have "greater transparency" at national level (so that investors will not foolishly put money in weak spots) and tighter banking regulation so that there will be less chance of a systemic bank collapse. Such an approach may of course be useful in itself, as no one doubts the importance of strengthening national policies and financial systems.

But surely this "national approach" in developing countries is grossly insufficient and needs to be complemented by a global approach to monitor and regulate cross-border financial flows. At national level, governments should also be allowed and encouraged to institute regulations to reduce the power of speculative funds (this needs to be done especially in the rich countries) and to reduce the volatile inflows and outflows of short-term capital.

There is a strong case (getting stronger by the day) for greater international and national regulation of financial flows, players and markets, as well as reform of the IMF.

At global level, there should be a system of monitoring short-term capital flows, tracing the activities of the major players and institutions, so that the sources and movements of speculative capital can be publicly made known.

There can be also be serious pursuit of a global tax on short-term financial flows, such as the well-known Tobin Tax, where a 0.25% tax is imposed on all cross-country currency transactions. This will penalize short-term speculators whilst it will have only a very small effect on genuine traders and long-term investors. The advantage is that not only will speculation be discouraged, but there can be far greater transparency in the markets as movements of capital can be more easily traced.

At national level, in the North countries, which are the major sources of international capital flows and speculation, national regulations can be imposed to reduce the power and leverage of funds.

For example, banking regulations can be introduced to limit the
amount and scope of credit to hedge funds. Proposals can be made for this and other similar objectives.

At national level, in the South, countries should explore options of regulating and discouraging inflows of short-term speculative capital. The well-known case of Chile where 30% of all incoming foreign capital has to be deposited with the Central Bank interest-free for up to one year, can be emulated by other countries.

This device was introduced after an episode of excessive inflows of funds. It has helped to reduce short-term speculative inflows and outflows whilst at the same time it was not a disincentive for the inflow of long-term foreign investment.

Another measure worth emulating is the requirement that local companies seek Central Bank permission before securing foreign-currency loans, and permission should be given only if or to the extent that the project being financed is shown to be able to yield foreign exchange earnings sufficient to service the loan. This is a requirement established by the Central Bank in Malaysia, and it helped to prevent the country from having the large and excessive short-term foreign-exchange private corporate loans that flooded other countries like Thailand, Indonesia and South Korea.

Further, countries that face a possible danger of sudden and large outflows of funds can consider some limited restrictions (at least for a limited time when the danger is imminent) on the freedom of residents and resident companies to transfer funds abroad.

Such limitations had in the past been in place in countries that now practice financial liberalization. Indeed restrictions on capital outflows still exist in many developing countries (such as China and India) and have helped to stabilize their financial situation.

Whilst the desirability of regulations on inflows and outflows of short-term capital make eminent sense, countries that have already liberalized and are dependent on the "goodwill" of the financial markets are afraid that reintroducing them could generate a backlash from the market and from the G7 countries.

Thus, it is crucial that the G7 countries themselves review their own anti-regulation position, and give the stamp of approval and legitimacy for developing countries to have these measures. Otherwise countries may not be able to institute measures that are good or necessary for their financial stability and their economic recovery on the fear of being labeled as "financial outcasts."

Once again, the ball is at the feet of the G7 countries to take the lead in both international level and national level reforms.
Meanwhile Malaysia has broken the policy taboo by introducing capital controls and fixing the local exchange rate to the dollar. Many other developing countries are watching closely to see if this enables Malaysia to implement policies that lead to faster recovery. If the Malaysian "experiment" works, this could lead to more countries taking the same path.

5. SOME POLICY LESSONS FROM THE ASIAN CRISIS

Whilst the debate on the causes and processes of the Asian crisis goes on, it is time to draw at least some preliminary policy lessons. Developing countries should rethink the benefits and risks of financial liberalization. In particular, they have to take great care to limit their external debt (especially short-term debt), improve the balance of payments and build up their foreign reserves.

(a) Need for Great Caution About Financial Liberalization and Globalization

One of the great lessons of the Asian crisis is the critical importance for developing countries to properly manage the interface between global developments and national policies, especially in planning a nation's financial system and policy.

In a rapidly globalising world, developing countries face tremendous pressures (coming from developed countries, international agencies and transnational companies) to totally open up their economies.

In some cases and under certain conditions, liberalization can play and has played a positive role in development. However, the Asian crisis has shown up that in other circumstances, liberalization can wreak havoc, especially on small and dependent economies.

This is especially so in the field of financial liberalization, where the lifting of controls over capital flows can lead to such alarming results as a country accumulating a mountain of foreign debts within a few years, the sudden sharp depreciation of its currency, and a stampede of foreign-owned and local-owned funds out of the country in a few months.

Surely then a clear conclusion from the Asian crisis is that it is prudent and necessary for a developing country to have measures that reduce its exposure to the risks of globalisation and thus place limits on its degree of financial liberalization.

Countries should not open up and deregulate their external finances and foreign exchange operations so rapidly when they are unprepared for the risks and negative consequences. Measures should be adopted to prevent speculative inflows and outflows of funds, and to prevent opportunities for speculation on their currencies.
At the least, the process of opening up to capital flows should be done at a very gradual pace, in line with the growth of knowledge and capacity locally on how to adequately handle the new processes and challenges that come with the different aspects of liberalization.

This will require policy makers (including in the Central Bank, Finance Ministry, Securities Commission and Planning Unit) to have the proper understanding of the processes at work, the policy instruments to deal with them, adequate regulatory, policy and legal frameworks and the enforcement capability.

Moreover, the private sector players (including banks and other financial institutions, and private corporations) will also have to understand, master and control the processes such as inflows of funds through loans and portfolio investment, the recycling of these to the right sectors and institutions for efficient use, and the handling of risks of changes in foreign currency rates.

The whole process of learning and training and putting the required infrastructure in place will need a long period. Some European countries, which started with already sophisticated financial systems, took more than a decade to prepare for liberalization, and yet failed to prevent financial failures.

(b) Manage External Debt Well and Avoid Large Debts

At the macro policy level, a very critical lesson from the Asia crisis is that governments have to pay great attention to external debt management.

They have to take great care to limit the extent of their countries' foreign debt. It was the rapid build-up of external debt that more than anything else led to the crisis in Thailand, Indonesia and South Korea, and to a smaller extent, Malaysia.

Developing countries should not build up a large foreign debt (whether public or private debt), even if they have relatively large export earnings.

The East Asian countries are big exporters, including of manufactured goods, and perhaps this led them to the complacent belief that the export earnings would comfortably provide the cover for a rapid build up of external debt. However, a bitter lesson of the crisis is that high current export earnings alone are
insufficient to guarantee that debts can be serviced.

For a start, future export growth can slow down (as happened). Then, there can also be a high growth in imports and a large outflow of funds due to repatriation of foreign-owned profits or due to the withdrawal of short-term speculative funds.

In good years these factors can be offset by large inflows of foreign long-term investment. However if the negative factors outweigh the inflows, the balance of payments will register a deficit. Such deficits mean that the country's foreign reserves are being run down.

When a point comes that the reserves are not large enough to adequately pay for the interest and principal of the external debt that is due, the country has reached the brink of default and thus has to declare a state of crisis requiring international assistance.

That flashpoint was reached in 1997 by Thailand, Indonesia and South Korea, necessitating their seeking rescue packages from the International Monetary Fund. Their problems had been compounded greatly by the sharp depreciation of their currencies, thus raising equally sharply the burden of debt servicing in terms of each country's local currency, and making the situation impossible to sustain.

Thus, having a large foreign debt puts a country in a situation of considerable risk, especially when that country has liberalized and its currency is fully convertible and thus subject to speculation.

In particular, having too much short-term debt can be dangerous as it has to be repaid within a short period of months or a year, thus requiring the country to have large enough reserves at that period to be able to service the debts. The structure of debt maturity should also be spread out, keeping in mind the dangers of "bunching", or too much debt coming due at the same time.

It is thus important to watch the relation of levels of debt and debt servicing not only to export earnings but also to the level of foreign reserves. Reserves should be built up to a comfortable level, sufficient to service debt, especially short-term debt.

(c) Manage and Build Up Foreign Reserves
The careful management of foreign reserves has thus emerged as a high-priority policy objective in the wake of the Asian crisis.

Maintaining and increasing foreign reserves is, unfortunately, a most difficult and complex task. There are so many factors involved, such as the movements in merchandise trade (exports and imports), the payment for trade services, the servicing of debt and repatriation of profits, the inflows and outflows of short-term funds, the level of foreign direct investment and the inflows of new foreign loans.

All these items are components of the balance of payments, whose "bottom line" (or overall balance, either as surplus or deficit) determines whether there is an increase or run-down of a country's foreign reserves.

As can be noted, these items are determined by factors such as the trends in merchandise trade, the external debt situation (in terms of loan servicing and new loans), the "confidence factor" (which affects the volatile movements of short-term capital as well as foreign direct investment).

To these must now be added the state of the local currency which in the past could be assumed to be stable but which recently has become a major independent factor that both influences the other factors and is itself influenced by them.

To guard and build up the foreign reserves, the country has thus to take measures in the short and longer term to strengthen the its balance of payments, in particular the two main aspects, the current account and the capital account.

The first aspect is to ensure the current account (which measures movements of funds related to trade and services) is not running a high deficit.

It was the fear that East Asian countries' wide deficits in recent years were unsustainable that gave cause for speculators to trigger a run on their currencies.

One of the only positive results of the recession is that the current account is now swinging strongly into surplus.

The second aspect is to build up conditions so that the capital
account (which measures flows of long and short-term capital not directly related to trade) is also manageable and well behaved. This can be very tricky, especially in the present volatile circumstances.

On one hand, the country may now need inflows of long-term investment and long-term loans in order to provide liquidity and build reserves. But these must be carefully managed so as not to cause large future outflows on account of problems of profit repatriation and of debt repayment.

And on the other hand, there is the difficult problem of how to manage short-term capital flows. In some past years there were excessive inflows, especially of foreign portfolio investment.

In the past year there has been the reverse problem of large outflows of short-term funds caused by the withdrawal of foreign and local funds to abroad.

It is important that these outflows be reduced so that the overall balance of payments can be in surplus, and the foreign reserves be built up.

Since the flow of these short-term funds are influenced by intangible factors such as "confidence", reducing the net outflows is one of the great challenges of the recovery process.

(d) The Need for Capital Controls and a Global Debt Workout System

The international orthodoxy in recent years of the benefits to developing countries of having a financially open system is now crumbling in light of the extremely high costs being paid by countries that opened up and saw sudden entry and exit of foreign funds.

A new paradigm is emerging that grants that developing countries should have the right to impose capital controls to protect their interests and to enable a degree of stability.

A major lesson of the Asian crisis is that capital controls should not be taboo but be seen as a normal, acceptable and indeed valuable component of the array of policy options available to promote development.

The crisis has also exposed the great lack of an international mechanism that comes to the aid of a country facing severe problems
in external debt repayment. A mechanism that includes the declaration of a debt standstill by countries in trouble, with a Chapter 11 type system in which creditors give the affected countries time to restructure their loans and economic activities in an orderly debt workout, is badly needed.

(e) The Market Can Make Big Mistakes and Needs Regulation

Another lesson of the Asian crisis is that the market can make mistakes too, and large or mega mistakes at that.

In recent years, it had become fashionable to think that mistakes are only made by governments, whilst the market knows best.

The debt crises of the 1980s were said to be caused by over-borrowing by the public sector which, being inefficient, had used the loans for unproductive projects, thus plunging their countries into a financial mess.

This led to the conclusion that economic resources and leadership should be passed on to the private sector, which was assumed to be much more efficient since corporations operated on the profit motive.

It was assumed that financial liberalization and private sector borrowing would not pose problems as banks, investors and companies would have calculated accurately their credit, loan and investment decisions.

There was thus the complacent acceptance of the build up of private sector external debt since it was believed the businesses would make the profits to repay their loans.

The Asian crisis has shattered the myth of the perfectly working market and its efficient use of resources. It shows that markets and the private sector are imperfect, as seen by the huge inflows then sudden outflow of foreign funds, and by the imprudent large external loans taken by the local companies and banks which they are now unable to repay.

When the private sector makes mistakes it can be as costly as (or even more so than) when governments make mistakes. Most top-level companies and many banks in the affected East Asian countries are in trouble or insolvent as a result of having loans and projects gone sour.

Most serious are the loans contracted in foreign currency, for a default in these can bring down the country's financial standing.
In the case of the unrepayable foreign loans in Thailand, Indonesia and South Korea, the "market failure" was caused not only by their local banks and companies. The blame has to be shared by foreign banks and investors that also make the mistake in assessing the credit-worthiness of the loans.

Thus, the financial deregulation measures taken in recent years by governments on the assumption that markets, companies and banks would behave rationally and efficiently, should be reviewed.

There should be a re-balancing of the roles of the state and the markets. At least, the governments have to consider having stronger regulation to prevent private banks, financial institutions and companies from making mistakes, especially in relation to foreign-currency loans.

Malaysian Bank Negara's regulation, that private companies have to seek its permission before taking foreign loans, which will be given only if it can be shown that the projects can earn foreign exchange to finance debt servicing, should be maintained in Malaysia and emulated by other countries.

Indeed, the enforcement of this ruling can be tightened, since many of the companies that obtained permission and borrowed heavily now face difficulties.

(e) Other Issues

The key challenge at present is to adopt the appropriate policy options to steer towards a recovery as soon as possible, whilst recognizing the negative and even hostile external environment.

To a significant extent, regional and global developments will continue to provide the backdrop and a critical influence over future developments in the country. For example, if Japan does not recover quickly enough, or China devalues, or the currency crisis spreads to Latin America and Eastern Europe, or if the New York stock market declines suddenly, there will be a significant externally generated negative effect on recovery prospects.

Affected countries can however attempt to take measures that reduce the risks generated from external factors and at the same time improve the domestic conditions for recovery.

In minimizing external risks, it would be wise to retain and strengthen the kind of policies and financial regulations that
prevented the country from getting more heavily into external
debt, such as not allowing companies to borrow foreign-exchange loans
unless they can show evidence these will generate the foreign
exchange earnings to service the loans.

In a period of increased possibility of reduced external demand,
measures should be strengthened to increase domestic linkages
in the economy, for example between domestic demand and supply.

There should be increased local production (especially through
small and medium sized enterprises) to meet local consumer needs,
in all sectors (food, other agriculture, manufacturing and
services and inputs in all these sectors). This should be backed up by a
sustained "buy local" campaign.

There should be reduced dependence on foreign savings (loans or
capital) in order to strengthen the balance of payments and reduce
exposure to foreign debt or volatile foreign capital flows.

East Asian countries normally has a very high domestic savings
rate. For example, in Malaysia, Gross national savings was 40% of
GNP in 1997. The current account was in deficit by 5% of GNP, thus
necessitating inflows of foreign funds by that amount in order to
maintain balance in the balance of payments.

Since 40% is already one of the highest national savings rates in
the world, Malaysia should put its efforts in using the national
savings in as efficient and productive a way as possible, and reduce or eliminate the need to augment this with net foreign
savings inflow. This would reduce future exposure of the country
to foreign loans or short-term and speculative inflows. The same
principle can be adopted in other East Asian countries.

On the domestic front, the urgent needs include the resolution of
the bad financial situation of private sector companies, and an
improvement of the position of the banking system and of banks in
relation to non-performing loans. In the process of doing this,
fair and proper criteria and procedures should be adopted.

Appropriate fiscal and monetary policies will also be required,
balancing the need to revive the economy with the need to have an
appropriate exchange rate.

The trade offs involved in choosing a set of policies will
require a delicate and difficult balancing act, made even more
problematic by the unpredictability of reactions of "market
forces" and by external factors such as regional and global
developments that are largely beyond the nation's control.

For countries that are under IMF conditions, the difficulty of
choosing correct policies becomes much more complicated as the policies are mainly chosen by the IMF, and the governments have to bargain intensely with the IMF for any changes to be made.

Martin Khor
Third World Network
228 Macalister Road
10400 Penang, Malaysia
Tel 60-4-2266159
Fax 60-4-2264505
E-Mail: twn@igc.apc.org.
THE NEED FOR A POLICY FRAMEWORK TO DEAL WITH DIFFERENT FOREIGN CAPITAL FLOWS

By Martin Khor, Director, Third World Network

1. Introduction

The big debate on what to do to prevent future financial crises continues. At the level of the Group of 7 rich countries, there is a division between the United States that insists markets should be left alone (and countries should improve their economic policies and financial systems) and several others (including France, Germany, Japan) which advocate greater government intervention to curb market excesses.

From several press reports, it looks as though Europe and Japan are ready to initiate some modest action, such as having the dollar, yen and euro float within a band to be defended by government intervention.

But the US believes the financial markets are sound and should not be regulated or interfered with. Instead governments have to strengthen their national systems to attract positive responses from the market players. This position seems to be the biggest stumbling block to international regulation or reform of the markets.

As long as there is no consensus between the three giants (the US, Europe and Japan), there will be the steam of debate but no international action.

Then there many developing countries, led by Malaysia, that feel vulnerable to the sudden and sometimes unpredictable inflow and outflow of foreign funds. Although some of these countries have been castigated by many pro-market analysts as the culprits which deserved punishment for wrong policies and weak or corrupt financial institutions, they feel they are the victims of a fundamentally flawed market manipulated by a few giant players.

The view that East Asian countries and Brazil are victims rather than culprits is now gaining more and more credence with senior academics and some policy makers, even in the West and Japan.

However, the debate on what (if anything) should be done to reform the global financial system can be properly conducted if more focus is put on how and why funds flow across borders.

It is well known that foreign exchange valued at between one to two trillion US dollars is transacted across borders daily, and only very little of that (one to two per cent) is due to payment for trade and services.
The bulk is "foreign investment" and short-term capital flows as well as speculative capital taking positions on the markets.

It is very important, especially for vulnerable developing countries, to establish a policy framework to deal with international capital flows.

In doing so, the first task is to distinguish between the various types of foreign funds, and their impact on recipient countries. The next step is to consider measures to manage these different types of capital flows.

This is of course a tall order, but it is a good starting point for seriously tackling the global financial crisis, and for developing countries like Malaysia to better prevent or manage future shocks.

One of the critical aspects to look at is the potential effect of different types of funds on foreign exchange and the balance of payments.

This is because in the present financially open system that most countries subscribe to, a country with inadequate foreign reserves or with a deteriorating balance of payments can be subjected to panic withdrawal of funds, speculative attacks and currency depreciation, the kind of "market behavior" that sank the East Asian countries.

The following sections deal with specific forms of capital flows, the potential problems that are associated with them, and the policy issues that arise.

2. Foreign Direct Investment

Firstly, there is foreign direct investment (FDI), usually considered the best kind of foreign funds. Even here, however, distinctions have to be made between different types and their different effects.

A large part of FDI comprises foreigners or foreign firms purchasing equity in local companies, or financing mergers and acquisition, that may not result in new productive activity.

Then there is the more commonly thought of FDI, where foreign firms do start new production, such as opening or expanding factories, and engage in plantation, mining and service activities.

FDI is usually very much sought after, because it can have many benefits, including inflow of long-term capital, technology and marketing networks. However some types of FDI may not bring in capital (as credit is raised in the host country itself) nor result in technology transfer. Some types of FDI can also have
negative effects, such as displacement of local firms, net foreign exchange outflow and adverse social impacts.

The overall effects of FDI should thus be analyzed, especially on the balance of payments. Foreign firms are known to have high imports of capital goods and inputs. They also earn and can repatriate high levels of profit. These can be a drain on foreign exchange. Indeed because of these factors, there is often a tendency for FDI to cause a deterioration in the balance of payments.

If the foreign firm produces mainly for export, the export earnings may help offset this tendency. Still, estimates should be made on whether there is a net foreign exchange gain from this more "ideal" form of FDI.

However, if the foreign firm produces mainly for the local market, and especially if it displaces the products and services of local firms (rather than replacing imports), then it is likely to have a significant negative effect on foreign exchange and the balance of payments.

Developing countries have tried to get firms to use more local inputs, and thus reduce the drain on foreign exchange caused by imported capital and inputs.

But this policy will be harder to implement in future because of the WTO agreement on trade-related investment measures, which prohibits "local content" requirements on investors.

The potential problem with even the good forms of FDI is that the outflow of profits can be rather or even very high, and as stocks of FDI increase, so too does overall profit outflow. This can be a big drain on the balance of payments.

From the above, it can be seen that even for FDI, a country needs to have a good assessment of the effects (especially on the balance of payments) and thus a good policy that manages the balance-of-payments effects by increasing the export earnings, retaining as much of the revenue within the country, and minimizing the outflows of foreign exchange. An appropriate approach would be to have a selective policy towards FDI, welcoming the forms that result in positive effects on growth, jobs, technology transfer and export earnings, and also having certain conditions on their operations that tries to maximize the benefits to the host country.

3. Foreign Portfolio Investment

Then there is foreign portfolio investment, including foreign purchases in the local stock market. A distinction could theoretically be made between the "serious" investors who plan to stay for some time (and might therefore be encouraged) and the
short-term speculators looking for quick profits and are likely to exit when enough is made, or at the first sign of trouble.

In reality, a distinction may sometimes be hard to make between the first and second kinds of investors, and even between them and the unethical manipulators. In a panic situation, as was seen in Asia, any portfolio investor may acquire the herd instinct and quit fast, leading to an overall large exodus of funds.

Developing countries should decide how much they need to open up their stock markets, and what measures can be taken to reduce the volatility that can result from having too high a level of foreign ownership.

There are also the worse kinds of foreign portfolio investors that are actually speculators who enter the stock markets to manipulate the prices (or the stock futures index) in order to make a killing. Developing countries should therefore be on the lookout for (and prevent) the unethical and manipulative moves, such as deliberate short selling to push a market down, or the kind of double play on the currency market and the stock exchange futures market that Hong Kong experienced (and countered through massive government purchase of shares) in 1998.

In any case, the proper management of foreign portfolio investment is vital to prevent manipulation, excessive speculation, excessive surges of inflows, and the potentially devastating herd-type massive panic outflows.

To prevent excessive inflows of portfolio investment, Chile introduced a policy requiring that a percentage of the foreign funds (excepting FDI) entering the country be deposited interest free for a year with the Central Bank. This reserve requirement acts as a tax on the funds, with the rate of tax being higher the shorter the period of stay. This acts as a deterrent to short term speculative flows. The percentage can be varied, depending on circumstances. It has gone as high as 30 per cent (when there was too much inflow, in recent years) and as low as zero (as of now, when the country wants to attract more inflow due to a shortage of funds).

Malaysia's initial move of September 1998 requiring portfolio investment funds to remain in the country for a year, and the subsequent revision of this to an exit tax (with variable rates depending on length of stay) are also interesting examples of measures to discourage the speculative forms of portfolio investments. The effect of these measures will be closely watched by other countries.

4. Foreign Loans and Credit

Another form of foreign capital flows relate to loans and credit
denominated in foreign currencies that are provided to persons and institutions in the country. The proper management of foreign credit is vital if developing countries are not to fall into a debt trap.

In the 1970s and 1980s, a large volume of foreign loans was given to governments and the public sector in developing countries. A substantial part of the loans did not go into productive or income-generating projects. Moreover, the fall in commodity prices caused these countries' export earnings to shrink. This combination of factors meant that many countries were unable to service their foreign loans, and had to request for debt rescheduling.

The requests were met only if the countries agreed to follow "structural adjustment policies" devised by the International Monetary Fund and the World Bank. As a result, about 80 developing countries, the majority of them being African or Latin American, fell into a "debt trap" and their national economic policies came under the influence of the IMF and World Bank.

From this experience came the new orthodoxy that governments should not obtain foreign loans as they are not good at managing and using these loans. But a new assumption was made, that if local private banks and companies were to take such foreign loans there would not be much risk as banks and corporations are supposed to be good in financial management since they are commercially oriented.

In the 1990s, many developing countries (including those in Asia) were persuaded to "liberalize" their financial operations. Thus, countries like South Korea, Thailand and Indonesia that in the past controlled the private sector's ability to take on foreign loans now relaxed their conditions and in fact encouraged the inflow of foreign-currency credit to local commercial banks and companies.

This was a very costly mistake. Firstly, a significant part of the private sector's foreign loans was also badly managed, as they were channeled to sectors (such as property development and share purchases) that were already bloated. Secondly, the unexpected and very sharp depreciations of the East Asian countries' currencies meant the borrowers had to pay much more in terms of their local currency to service their foreign debts.

Many of the loans had been on a short-term basis, and when they matured, the local banks or companies would ask for renewals of the loans, which were thus "rolled over." However, as the Asian crisis broke out, the foreign creditors refused to roll over the loans and asked for repayment. Even some loans that were not yet due were "called in."

The failure of private banks and companies to meet their foreign
debt obligations was a major cause of the financial crisis in South Korea, Thailand and Indonesia. The private foreign loans had gone out of control, due to the policy of financial liberalization.

There was an exit by foreign creditors which also by and large stopped providing new loans. This exit by foreign creditors together with the exit by foreign portfolio investors constituted the "panic withdrawals" that led to the economic disasters in the affected countries.

In devising a policy for foreign loans, a country has to remember the brutal fact that the loans (whether obtained by the public or private sectors) have to be repaid, with interest, in the specified time frame, and in the foreign currencies denominated.

This can be done only if the borrower has invested the foreign loan in a project or activity that yields a net revenue sufficient to service the debt.

But whilst making sufficient profit may be enough for an individual company or agency to repay its foreign loan, this is not enough from a national perspective.

This is because the loan has to be repaid in foreign currency. An individual company can ask its bank to convert the amount to be repaid (or to be serviced) from local currency (in which the firm's revenue may be earned) to the specified foreign currency in which the loan was taken and has to be repaid.

That may be alright for the borrowing company and its bank. But for the Central Bank to be able to meet the private sector's overall demand for foreign currencies to meet its debt obligations, the Central Bank must have sufficient foreign reserves.

In order for the private sector's foreign loans not to cause a negative effect on the level of the foreign reserve, the loans as a whole have to be invested in activities that together yield sufficient foreign exchange earnings to enable the debts to be serviced.

This is often a tall order. For a government agency or a private company to use the loan wisely enough to ensure its repayment is often hard enough; but for the loans as a whole to earn in foreign exchange sufficiently to service the foreign loans can be a special rather than a general achievement.

This is why many countries fall into a debt trap: it may be easy to get a foreign loan (at least the first few times!) but it is much harder to be able to service it satisfactorily.

Thus, developing countries have to device prudent policies on foreign loans. Governments should limit the amount of foreign credit they themselves should get and make sure that a large part
of it earns (or helps the country to earn) foreign exchange.

Just as importantly, the governments of developing countries should place strict controls over the private sector's foreign loans, and not leave it to each company or bank to decide if and how much it wants to borrow from abroad or in foreign currencies.

In Malaysia, the Bank Negara (or Central Bank) has a ruling that local private companies are not allowed to take foreign loans above a certain level except with its permission. Such permission is to be given only if the borrowing company can show that the loan will give rise to foreign exchange earnings. The amount of loan permitted is also related to the projected foreign exchange earnings. This rule helped to prevent Malaysia's external debt from being higher than what it might otherwise have been and thus helped to enable the country to have the option not to seek a rescue package from the IMF. In South Korea, Thailand and Indonesia, where such limits had been lifted, there was an explosive growth in the foreign borrowings of private banks and firms which helps explain why these countries fell into a debt trap and had to seek IMF rescue loans.

5. Highly Leveraged and Speculative Funds and Capital

Finally, there is another category of foreign capital that needs especially strict controls: the funds that are used to speculate in and manipulate local financial and capital markets.

These funds are used by institutions (which may include hedge funds, investment banks, commercial banks and big corporations) to take positions on the currency, money, bond, stock and commodity markets in the expectation that changes in the values of currencies, or in the prices of shares and commodities, or in interest rates, can bring them quick and large profits. Often these institutions do not even bring in their own capital, but make use of their great leverage to borrow large sums from banks. With their extensive credit lines, they make use of derivatives and other financial instruments to further expand the value of funds at their disposal, and then make bets on the markets.

Due to financial globalization and liberalization, many developing countries have experienced financial turbulence caused by the operations of these big market players. They have been able not only to take advantage of, but to actually instigate and cause swings in the values and prices of currencies, stocks and interest rates.

The Asian crisis, with all its consequences in currency and output collapses and job losses, was triggered by these kinds of funds and their manipulative activities.
They do constitute a major part (and probably the most dangerous and poisonous part) of the "short-term capital flows" that are often talked about these days.

Yet because the activities, modus operandi and even the identities of these players are shrouded in secret, this highly speculative capital flow ("capital play" might be a more appropriate term) is often not considered when the dangers of short-term capital flows are discussed.

The debacle of the US hedge fund, Long term Capital Management, revealed the incredible power that some hedge funds (and other highly leveraged institutions) have over the markets. With a capital of about US$4 billion, LTCM was able to borrow $200 billion and take positions worth $1.3 trillion in financial markets.

If one institution could have this kind of financial muscle, then the combined strength of a few macro hedge funds, investment banks, global commercial banks and large multinational corporations and their influence on the financial markets is unimaginably enormous.

International regulations to rein in the power of these funds and institutions are urgently required. But until such global-level regulations are established (and that may take a long time, if ever at all), developing countries should put in place policy and regulatory measures to control, prevent or strictly manage this category of foreign capital.

Some of Malaysia's foreign-exchange control measures introduced last September were aimed specifically at this kind of capital. The moves to deinternationalise the ringgit (by not recognizing ringgit sales or trade outside Malaysia) and to fix the ringgit to the dollar were meant to create conditions that make it difficult or impossible for financial speculators to gamble on the ringgit's value.

6. Conclusions

Foreign direct investment, portfolio investment, foreign loans and credit, and highly speculative funds are the major categories of foreign capital that flow in and out of a country.

Since developing countries are too small to be a big player on the global market, they can be very vulnerable not only to the decisions of the big institutions that determine the volume and timing of the flows, but also to the manipulative activities of some of the global speculative players.
However, developing countries can take some defensive measures, and must urgently formulate a comprehensive policy to deal with the different kinds of capital flows.

Such a framework may include a selective policy towards attracting foreign direct investments of the right type; a careful policy on portfolio investment that welcomes serious long-term investors but keeps out the damaging short-term profit-seekers; a very prudent policy towards public and private foreign loans; and measures that prevent the manipulative and speculative activities and funds in the financial and capital markets.

Even with the best intentions and plans, there is no certainty that a country can be shielded from the adverse turbulent effects of global capital flows and financial operations.

The national policies have to be augmented by international regulatory action, which is still absent. Until that comes about, if ever, each nation should look out for itself in this predatory world.

NEW BATTLES BEGIN SOON IN THE WTO

By Martin Khor (Director, Third World Network)

(Note: The Third World Network is an international organization based in Penang, Malaysia, that deals with economic, environmental and development issues from a Third World perspective).

BLURB: Even as the financial crisis places a heavy burden on the affected developing countries, a new challenge is emerging at the World Trade Organization. The developed nations are piling on the pressure to launch a new Round of trade negotiations during the WTO's Ministerial Meeting this December. They are now planning their strategy to get developing countries to agree to putting more issues, such as investment, competition, government procurement, environment and labor standards, onto the WTO system. This will put developing countries into deeper trouble. It is thus time for these countries to pay attention to the developments in WTO and resist the attempt to start a new Round.

(FIRST of two articles)

----------------------------------
The Asian financial crisis, which has now spread to Russia and Brazil, should have at least taught the world the lesson that there are great risks for developing countries when they are asked to liberalize their economies too fast, or to take part in "globalization" in an indiscriminate way.

Opening the economy when a country is not yet prepared to withstand the shocks generated by the world economy, or when its local firms and farms are not ready to compete with international giant corporations, can cause disruption.

Yet before we can even digest the full lessons of how to manage the interface between the domestic and external economies, pressures are once again mounting to get developing countries to open up even more to the big companies of the industrial countries.

The extra pressures are coming in the World Trade Organization, which will be holding its third Ministerial Meeting at the end of November in the United States.

The European Union, backed by Japan, Canada and other developed nations, have announced they want to launch a new "Round" of trade negotiations at this meeting.

In such a Round, several issues will be made the subject of negotiations for new multilateral Agreements that will be legally binding on WTO members.

For example, the Uruguay Round (1984-90) concluded with many new Agreements covering services, agriculture, intellectual property rights, investment measures and other issues. It also created the WTO to replace the old GATT (General Agreement on Tariffs and Trade).

The developing countries were generally against these new issues entering the trade system, as the Agreements legally oblige them to change their national policies and laws so as to open up their economies further to foreign goods, services and companies.

Since the farmers and local firms are generally small and lack the technology or marketing skills, they are unable to fairly compete with the big companies of the West or Japan.

There is a deep fear that when these Agreements are implemented (after a grace period of five years or so), the developing countries will face a lot of problems.

Cheaper goods or services may swamp the market, replacing what is locally made. Bigger foreign firms with the latest technology or with marketing outreach will increasingly take more market share away from the local sector.
This may well cause retrenchment and dislocation, especially in the less developed of the Third World countries. The least developed countries are understandably most worried.

Even before these problems arising from the Uruguay Round have been understood (let alone dealt with), the big companies are once again pushing their governments to open up yet more areas in the developing countries for them to enter.

The European Union therefore proposed launching a new round of negotiations, which it even conferred the glamorous term "the Millennium Round."

Although the US originally seemed cool to the idea (preferring to push issues it liked on a sector by sector basis), President Bill Clinton endorsed having a new Round in the WTO when he made his State of the Union address last month.

The developed countries thus seem united in pushing the WTO into this "new Round."

Developing countries should be very wary of what this means because a range of issues that will be to their disadvantage will be thrown into the preparations of this new Round.

The EU has already made it clear that it wants to pursue "new issues" such as international investment rules, competition policy and government procurement through this Round.

These three issues were put on the agenda of the first WTO Ministerial Conference in Singapore in 1996. Most developing countries were against having any negotiations for Agreements on these issues, but the pressure from the developed countries was so strong that they compromised and agreed to taking part in "working groups" to discuss the issues.

The developing countries made it clear that the working groups had the mandate only to discuss the topics in a sort of academic way, in what was called an "educative process". They had no mandate to start negotiations for Agreements.

The three working groups have now gone through two years of discussion, during which the developed countries made it clear they intend to "upgrade" the talks into negotiations.

Their plan now is to use the device of the Millennium Round to make the three issues (investment, competition, government procurement) the subject of talks for new Agreements.

But this is not the end of the story. Some of the rich nations also want other issues like "trade and environment" and "labor standards" to be part of the new proposed Round.
The governments of these countries want to placate the environmental groups and labor unions who have been protesting about the negative effects of free trade.

If the environment and labor standards are also thrown into the pot of the New Round, the influential civic groups may then be won over, or at least they may not campaign so hard against the proposed Round. Or so the establishment thinking goes.

The US meanwhile is very keen that the Uruguay Round issues of services, agriculture and intellectual property rights be revisited and revised so that its corporations will have yet more market openings or advantages.

New negotiations on these existing topics, which are already on the agenda in any case, will also likely be put on the agenda of the New Round.

However, it is far from certain that there will be a new Round. Many developing countries are against it. Their position is that the WTO should allow developing countries (who after all are the majority) the time and space to tackle the problems of implementation of the existing Agreements.

That is cause for enough headaches and economic dislocation. The present financial crisis and its bad impact on trade and growth has now magnified the problem.

How then can they cope with negotiations on yet more new issues, which are certain to cause another round of new and potentially disastrous problems or crises?

Whist this position obviously has merit, the developing countries are unfortunately not united. India, Malaysia, Egypt and many African and least developed countries have spoken out against a new Round.

But most Latin American and a few Asian countries have indicated they are for the European proposal.

Those countries that have thought through the problem and oppose negotiations on new issues should now get together and strengthen their position as the talks in the WTO hot up in the next few weeks.

The financial crisis should not deflect the attention of policy makers or the public from what is happening in the WTO. Otherwise, through pressure or by default we will be landed with a new Round that is not of our choosing and that will place more obstacles not only to the recovery process but to our development in the long term.