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**Emerging Markets and Towards a New  
International Financial Order**

**Peter Nunnenkamp**

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## Emerging Markets and Towards a New International Financial Order

Peter Nunnenkamp

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INSTITUT KAJIAN MALAYSIA DAN ANTARABANGSA  
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## About the author

Dr. Peter Nunnenkamp is the Research Director of the Kiel Institute of World Economics, Germany, a post he held since 1994. His research areas include globalization of production and markets; international capital transfers and foreign direct investment; causes and consequences of financial crises; and the reform of the international financial architecture. He is author of many articles and books, which include *Globalization of Production and Markets* (1994; with J.P. Agarwal & E. Gundlach); *Latin America After the Currency Crash in Brazil: Why the Optimists May be Wrong* (1999), and 'Dealing with the Asian Crisis: IMF Conditionality and Implications in Asia and Beyond' (*Intereconomics* 33, 1998).

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## Emerging Markets: Latin America and Asia

### Abstract

International capital markets are far from functioning perfectly. However, recent financial crisis episodes do not support the view that pure contagion affected emerging markets (EMEs) with consistent macroeconomic policies and sound financial sectors. Economic fundamentals do matter still. Future access of EMEs to international capital markets depends on exogenous factors and on economic policies pursued in EMEs. As concerns the former, sustainable financing would be encouraged if longer-term engagements by pension funds were supported by deregulation in developed countries, and if reforms in the international financial architecture resulted in prudent bank lending. As concerns the latter, external financing requirements must be kept within reasonable limits, and capital inflows should be restructured towards relatively stable items. The timing and sequencing of capital account liberalization is crucially important to reduce the risk of a sudden reversal in capital flows.

## Ekonomi Pasaran yang Sedang Muncul: Latin Amerika dan Asia

### Abstrak

Pasaran modal antarabangsa memang tidak berfungsi secara sempurna. Walau bagaimanapun, peristiwa krisis kewangan dalam tahun-tahun kebelakangan ini tidak mendukung pendapat bahawa jangkitan tulen memberi kesan ke atas ekonomi pasaran yang sedang muncul (EPSM) yang mempunyai dasar makroekonomi yang konsisten dan sektor kewangan yang kukuh. *Fundamental* ekonomi tetap penting. Keupayaan EPSM untuk memanfaatkan pasaran modal antarabangsa pada masa depan bergantung kepada faktor luaran dan dasar ekonomi yang dilaksanakan oleh EPSM sendiri. Dari segi pasaran modal antarabangsa, pembiayaan yang mapan akan digalakkan sekiranya keterlibatan jangka panjang oleh dana pencen didukung oleh deregulasi di negara-negara maju, dan sekiranya reformasi dalam susunatur kewangan antarabangsa menghasilkan amalan peminjaman yang berhemat oleh bank. Dari segi dasar ekonomi EPSM, pembiayaan kewangan luaran haruslah dikawal dalam batas yang munasabah, dan aliran masuk modal haruslah distruktur semula ke arah item yang relatif stabil. Penentuan masa dan *sequencing* liberalisasi akaun modal amat penting untuk mengurangkan risiko pengaliran keluar secara tiba-tiba dalam aliran modal.

## Emerging Markets: Latin America and Asia

### Introduction

The role of private capital in financing economic development in emerging market economies (EMEs) is under scrutiny. Sustainable external financing depends on smoothly functioning international capital markets. Sudden shifts from euphoria to panic have shown, however, that the efficiency of international capital markets in allocating worldwide savings to where they may be utilized most productively cannot be taken for granted. Furthermore, various EMEs are concerned that they will be left on the sidelines in the global competition for foreign capital.

The vagaries of international capital markets are obvious indeed. Increased capital mobility has brought with it financial turbulence and currency crises in Asia, Latin America and Russia. Yet this paper objects the notion that EMEs are at the mercy of global capital markets in the sense, as a prominent economist Jagdish Bhagwati put it, that “you may be very healthy but suddenly you can catch pneumonia ... Markets may do something when you have done nothing wrong” (*Times of India*, 31 December 1997).

The major proposition of this paper is that a differentiated analysis of international capital markets and recent financial crises is required, in order to adequately assess the role of private foreign capital in financing economic development in EMEs on a sustainable basis. Differentiation is needed in several respects:

First, by reviewing recent trends in international capital flows in Section 2, it is shown that competition for foreign capital does not mean that some EMEs are crowded out of international capital markets if other EMEs attract rising capital inflows.

Second, Section 2 presents a balanced account on capital market failures and compares the behavior of different types of foreign investors.

Third, two distinct crisis episodes are portrayed in Section 3. The comparison of Brazil and Korea reveals that rash generalizations are counterproductive when it comes to explaining financial crises.

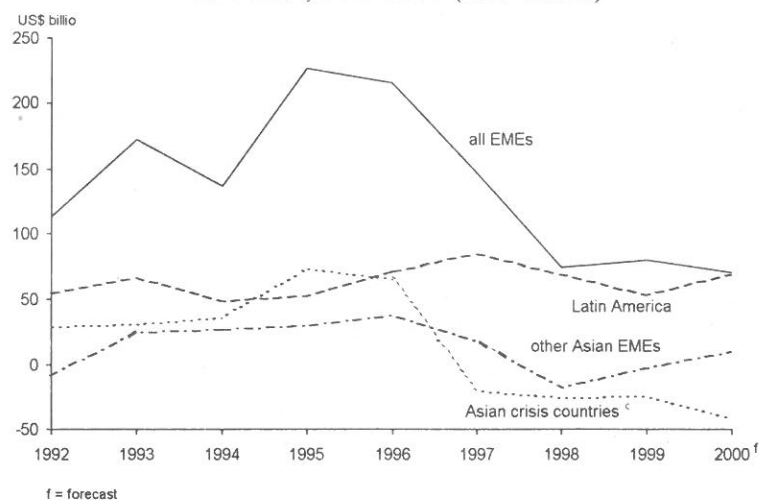


Against this backdrop, Sections 4 and 5 evaluate the future prospects of EMEs to sustain foreign capital inflows and draw some policy conclusions. The structure of capital inflows is considered critically important with regard to sustainability. Ultimately, the benefits and costs of capital mobility in the future depend on whether policy-makers will implement policies that allow EMEs to tap international capital markets and, at the same time, minimize the risk involved.

### Recent Trends in Capital Flows to EMEs

Since the early 1990s, EMEs have witnessed boom and bust in private capital inflows, comprising foreign direct investment (FDI), portfolio investment and other investment flows (including borrowing). All EMEs are expected to attract (net) private capital inflows of about US\$ 71 billion in 2000 (Figure 1). This figure is 37 percent below private capital inflows reported in 1992. Inflows in 2000 will be a trickle compared to the peak of private capital inflows of US\$ 227 billion in 1995. The subsequent discussion concentrates on the recent ebb of private capital flows to EMEs, after a short evaluation of the boom preceding the Asian financial crisis.

FIGURE 1 Net Private Capital Flows<sup>a</sup> to Emerging Market Economies<sup>b</sup>, 1992–2000 (US\$ billion)



<sup>a</sup>Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — <sup>b</sup>Developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel. — <sup>c</sup>Indonesia, Korea, Malaysia, the Philippines and Thailand.

Source: IMF World Economic Outlook, April 2000

### The Boom of Capital Inflows before the Crisis

Booming private capital flows to EMEs in 1992–1996 can be considered the flip side of the sudden retreat of foreign investors when crisis was looming in Asia (Nunnenkamp 2000b). In other words, international capital markets overshot both ways, with booming inflows having been the prelude to the drama of seriously impaired access of EMEs to international capital markets in the late 1990s.

This interpretation requires two qualifications. First, the boom of private capital flows to all EMEs taken together masks significant shifts in the regional distribution of these flows. Second, the structural composition of overall private capital flows changed considerably during the boom phase. Both aspects are crucially important for assessing the sustainability of capital flows to EMEs.

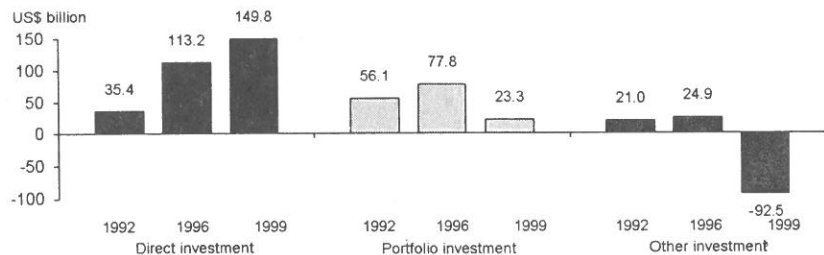
As concerns the structural composition of private capital flows to all EMEs, the most notable feature is that FDI gained relative importance from 1992 to 1996. The share of FDI in overall private capital inflows soared from 31 to 52 percent during the boom phase (see also Figure 2). In absolute terms, FDI flows to all EMEs increased steadily from US\$ 35 billion in 1992 to US\$ 113 billion in 1996. By contrast, portfolio already investment and, in particular, other investment (including borrowing) fluctuated heavily prior to the Asian crisis (IMF 2000: Table 2.2).

The regional distribution of private capital flows reveals a drastic shift towards Asia in 1992–1996, which attracted almost half of private capital flows to all EMEs in 1996 (Figure 3). At the same time, the Latin American share in private capital flows declined from 49 to 33 percent. Figure 3 also indicates that new competitors for foreign capital emerged in Africa and from the group of countries in transition.

Particularly in Latin America, concerns were widespread that fiercer worldwide competition for foreign capital would divert financial resources away from traditional recipients towards new competitors. Such concerns were largely unfounded, however. When interpreting the shares of particular regions in overall capital flows, it must be taken into account that absolute flows to all EMEs doubled from 1992 to 1996. Hence, a declining share does not necessarily mean that capital inflows decreased in absolute terms. Private capital flows to Latin America were indeed significantly higher in 1996 (US\$ 72 billion) than in 1992 (US\$ 56 billion). FDI flows to Latin America tripled, while other regions, too, attracted rising FDI inflows.

FIGURE 2 Major Items of Net Private Capital Flows<sup>a</sup> to Emerging Market Economies, 1992, 1996 and 1999 (US\$ billion)

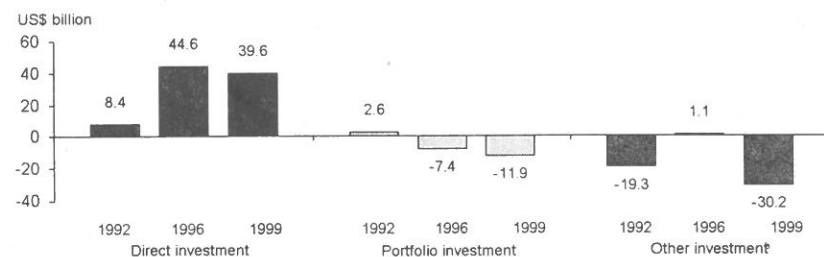
All EMES<sup>b</sup>



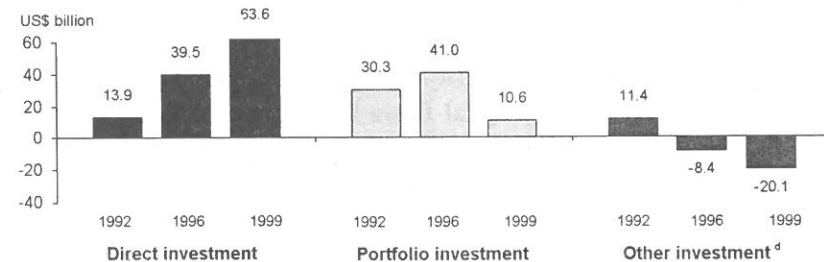
Asian Crisis Countries<sup>c</sup>



Other Asian EMES



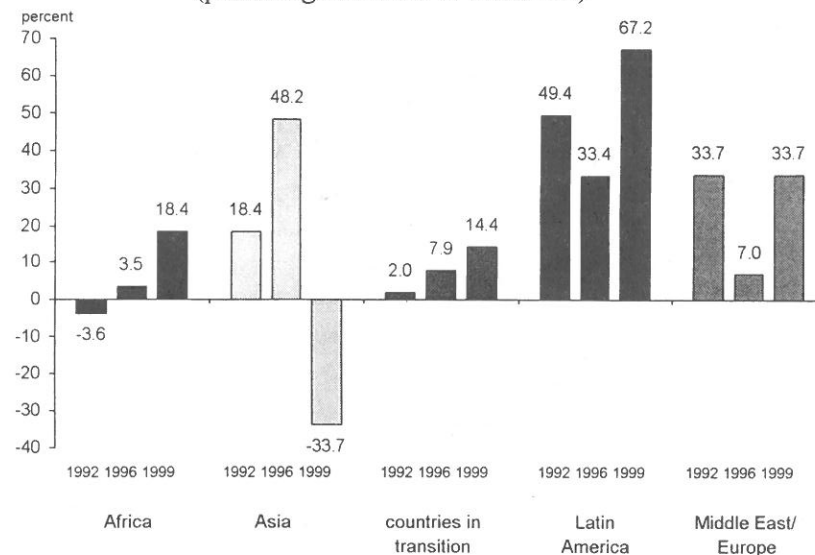
Latin America



<sup>a</sup>Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — <sup>b</sup>Developing countries, countries in transition, Korea, Singapore, Taiwan Province of China and Israel. — <sup>c</sup>Indonesia, Korea, Malaysia, the Philippines and Thailand. — <sup>d</sup>Including borrowing.

Source: IMF, World Economic Outlook, April 2000.

Figure 3 Regional Distribution of Net Private Capital Flows<sup>a</sup> to Emerging Market Economies<sup>b</sup>, 1992, 1996 and 1999 (percentage of flows to all EMES)



<sup>a</sup>Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — <sup>b</sup>Developing countries, countries in transition, Korea, Singapore, Taiwan Province of China and Israel.

Source: IMF, World Economic Outlook, April 2000.

This suggests that the emergence of new competitors for foreign capital typically induces foreign investors to grasp additional investment opportunities, without losing sight of investment opportunities offered by traditional recipients of foreign capital. Instead of redistribution of a fixed amount of investment funds, the overall pool of resources to be invested in EMES expands and international capital mobility tends to increase, when more EMES open up towards international capital markets.

Furthermore, the development of different items of private capital flows to Asia and Latin America during the boom period provides first clues as to the issue of sustainability. This issue was seriously underrated in Asia until the crisis hit, even though the Mexican experience of 1994/95 had shown already that the reaction to financial crises differs between major types of foreign investors (IADB and IRELA 1996: 41 ff.). Portfolio investors and bank lenders rushed for the exits so that overall private capital flows to Mexico turned negative in 1995. By contrast, FDI inflows proved to be relatively stable; FDI inflows in 1995 and 1996 were indeed significantly above FDI inflows reported in the pre-crisis year 1993 (Nunnenkamp 1998: 14 f.).

The volatility and sustainability of overall capital inflows thus depends on the structure of external financing. In 1995/96, the structure of external financing varied remarkably between Asia and Latin America; for the group of five Asian crisis countries (Indonesia, Korea, Malaysia, the Philippines and Thailand), the structure of external financing was exceptional prior to the crisis (Figure 4):

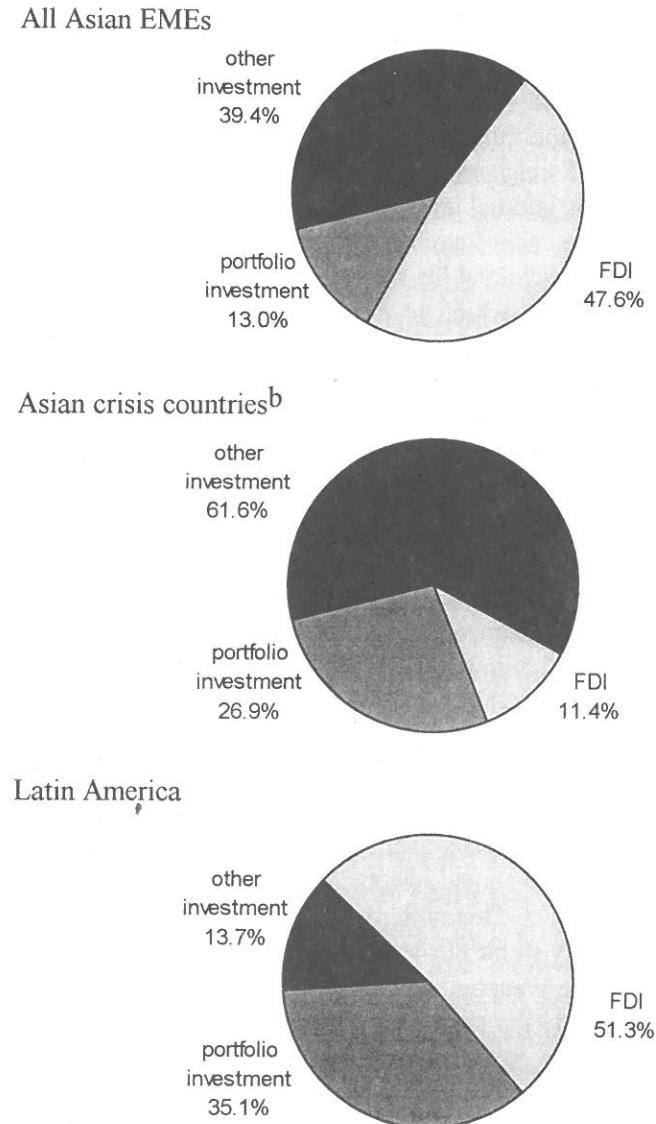
- FDI accounted for little more than 10 percent of overall net private capital inflows, compared to more than half of overall private capital flows to Latin America.
- The bulk of external financing of the five Asian crisis countries was in the form of other investment (notably borrowing from foreign banks), whereas other investment contributed just 14 percent to private capital flows to Latin America.

With hindsight, local policymakers and international investors should have been concerned about sustainability during the boom phase exactly in those Asian EMEs that plunged into crisis shortly afterwards.

### The (Irrational?) Behavior of Foreign Investors During the Crisis

The Asian crisis had serious repercussions on international capital mobility in general, and on the external financing of various EMEs in particular. The crisis has also highlighted the deficiencies of international capital markets (Reisen 1999). Two aspects of market failure figure prominently in the ongoing discussion. First, the herd behavior of foreign investors is said to have resulted in a collective rush for the exits in Asian crisis countries. The sudden reversal of capital flows is attributed to a coordination failure among foreign investors. Attempts to pull out of Asian

FIGURE 4 Structure of Net Private Capital Flows<sup>a</sup> to Emerging Market Economies in Asia and Latin America, 1995/6 (average share in overall private capital inflows)



<sup>a</sup>Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — <sup>b</sup>Indonesia, Korea, Malaysia, the Philippines and Thailand.

crisis countries as quickly as possible were completely rational from an individual investor's point of view. However, this behavior ran counter to the collective interest of foreign investors. The rush for the exits pushed Asian EMEs deeper into crisis, whereas a standstill of foreign investors could have dampened the crisis. Second, crises are widely believed to have spread from one country to another, even though economic fundamentals differed significantly among EMEs. Contagion within Asia and beyond is attributed to the failure of foreign investors to differentiate between various EMEs. Foreign investors are blamed for having put EMEs with and without serious internal imbalances into the same risk basket.

The first aspect, i.e., coordination failure in dealing with the Asian crisis, has important implications for reforming the international financial architecture, an issue which is discussed in a separate paper (Nunnenkamp 2000a). In the context of this paper, it is noteworthy that capital market developments after the outbreak of the Asian crisis confirm what was to be observed during the previous crisis in Mexico and during the period of booming capital flows to EMEs in 1992-1996. Once again, FDI proved to be stable. FDI flows to the five Asian crisis countries were indeed higher in 1998/99 than in the pre-crisis years 1995/96 (see also Figure 2 above).

Volatility was most pronounced with regard to bank lending. The sudden shift from other investment inflows to other investment outflows amounted to about US\$ 80 billion in 1996/97, i.e., more than 8 percent of the five countries' combined GNP in 1997. In 1997-1999, these countries suffered accumulated other investment outflows of US\$ 113 billion. Many portfolio investors, too, rushed for the exits, but the consequences were less severe for the five crisis countries: Compared to an annual average of US\$ 19 billion in the pre-crisis years 1995/96, net portfolio investment inflows declined to an annual average of US\$ 4.4 billion in 1997-1999 (IMF 2000: Table 2.2). This supports the view that portfolio investment comprises relatively stable elements such as investment by pension funds and life insurance companies, whereas volatility in portfolio investment is mainly due to the short-term profit orientation of managed investment funds (country funds and mutual funds) (Langhammer and Schweickert 1995: 22; Griffith-Jones and Cailloux 1999).

The second aspect of market failure, i.e., contagion, is more controversial. Interest-rate spreads are a frequently used indicator of contagion. After the outbreak of the Asian crisis, "secondary market spreads increased dramatically ... Countries in all regions were affected ... By the

end of December, however, there were signs that investors were differentiating more carefully among developing country borrowers" (World Bank 1998: 14). Surprisingly, investors reacted still more strongly to the Russian crisis. Spreads skyrocketed with the Russian debt moratorium of August 1998 (see also Fernández-Arias and Hausmann 2000b: 26 ff.). While some EMEs (particularly in Latin America) were affected more than others, the variation of spreads across EMEs fell sharply: "Investors appeared to retreat across a broad front; ... countries were affected by pure contagion" (World Bank 1999a: 28).

Overall evidence on interest-rate spreads in recent years suggests that international capital markets sometimes failed to differentiate between higher-risk EMEs and lower-risk EMEs, whereas they did differentiate at other times. For instance, there was a sharp increase in the cross-country variation of spreads from May 1997 to August 1998 (ibid.). Likewise, the most recent narrowing of spreads on external debt of EMEs "masks considerable regional differences, ..., evidence of increasing investor differentiation among emerging markets" (IMF 2000: 59).

Another indicator of contagion relates to the accessibility of international capital markets at times of a crisis, rather than the terms at which these markets may be accessed. If pure contagion had been prevalent during the Asian crisis, essentially all EMEs should have been denied access to international capital markets. However, empirical evidence on the amount of capital raised in international financial markets by various EMEs is as ambiguous as the evidence on interest-rate spreads:

- The change in portfolio investment flows from 1996 to 1998 reveals considerable differences among Asian and Latin American EMEs. Portfolio investment turned negative not only in some Asian EMEs immediately affected by the crisis, but also in other Asian EMEs such as India and in Latin American EMEs such as El Salvador and Peru. In some EMEs, portfolio investment inflows remained positive in 1998, but dwindled to less than 10 percent of inflows reported in 1996 (e.g., in Mexico, P.R. China and Thailand). By contrast, inflows in 1998 were only slightly below inflows in 1996 in Argentina, Brazil and Singapore. Access to portfolio investment even improved in some cases, including Guatemala, Uruguay and Bangladesh.
- Similarly, the pattern of borrowing in international capital markets varied considerably among EMEs. Apart from the five Asian crisis countries, other investment flows turned negative from 1996 to 1998



in only four out of 23 Asian and Latin American EMEs (China, Singapore, Brazil and Peru). Other investment flows remained negative in three Latin American EMEs (Costa Rica, Nicaragua and Venezuela). The change in inflows was marginal for Bangladesh and India. Among the remaining 14 EMEs, six EMEs (including Colombia and Sri Lanka) suffered a decline in other investment inflows by 55-75 percent from 1996 to 1998, whereas flows turned positive (e.g., in Mexico) or increased significantly (notably in Argentina and Chile) in eight Latin American EMEs. These diverging developments, particularly in Latin America, contradict the view that international banks refused essentially all EMEs access to credit and ignored country-specific conditions during the Asian crisis.

All in all, the evidence on market failure is mixed. International capital markets are far from functioning perfectly. Major elements of private capital flows were extremely volatile because of the herd behavior of foreign investors. FDI is an important exception in this respect, however. At least temporarily, access to international capital markets became more expensive also for EMEs with relatively strong economic fundamentals and with weak economic links to the countries hit by financial crisis. Yet, pure contagion was not ubiquitous. Bank lending and portfolio investment did not dry up in all EMEs. Several EMEs regained access to international capital markets exactly when large parts of Asia were in crisis. True, "there was ample room for the mood of expectations in the financial sphere to shape fundamentals" (Fernández-Arias and Hausmann 2000b: 27); but it is an exaggeration to argue that EMEs with strong fundamentals suddenly collapsed as "the international financial system was too moody to be relied upon" (*ibid.*). Economic fundamentals do matter still. At the same time, domestic policy failures tend to have more serious consequences under conditions of increased capital mobility, as the following short account of recent crises in Brazil and Korea reveals.

### Two Distinct Crisis Episodes: Brazil and Korea

In the second half of the 1990s, we witnessed a series of currency and financial crises in Asia, Latin America and Russia. At the same time, international capital markets became increasingly integrated due to significant advances in information and communication technology. This coincidence has led many to conclude that globalized financial markets were the cause of crises. However, the notion of globalization crises

seriously underrates the country-specific determinants of financial turbulence.

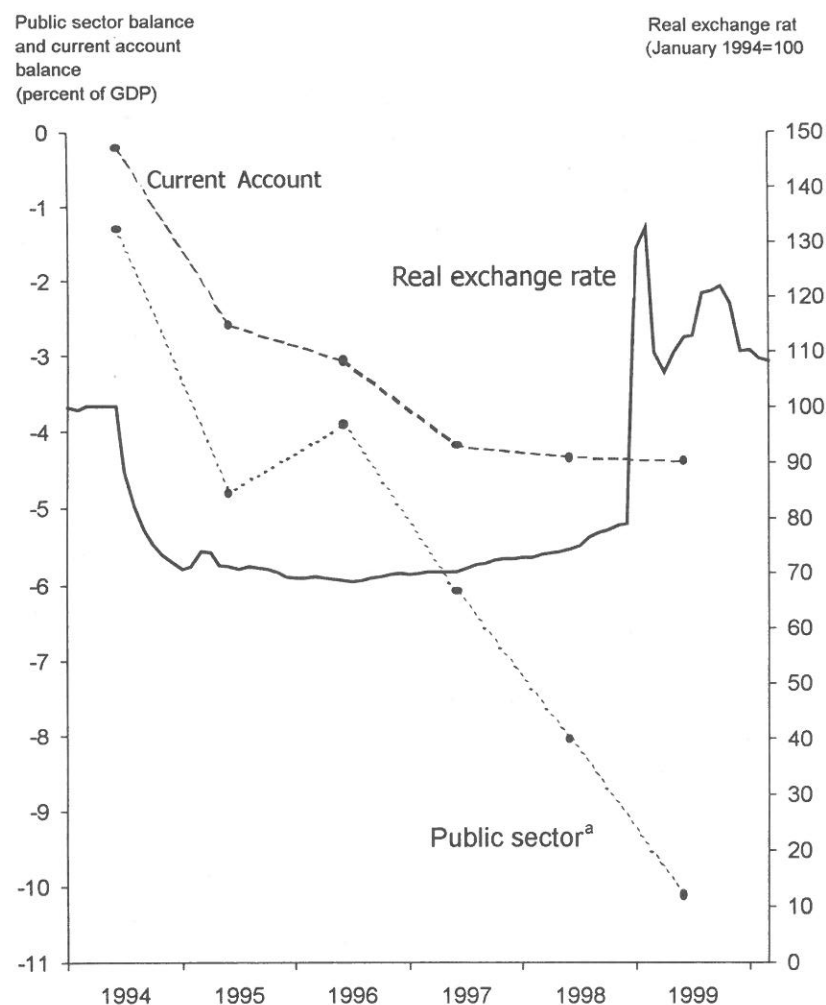
This is most evident in the case of Brazil, whose currency, the Real, collapsed in January 1999. Brazil had been the weak link in Latin America since the outbreak of the Asian crisis. The Real was attacked for the first time in October 1997. Brazil was affected for the second time, when Russia suspended debt-service payments in August 1998. The irony is that the Real fell only in early 1999, shortly after the IMF had agreed on financial support in the order of US\$ 42 billion. IMF support was explicitly designed to preempt speculative activity against the Real (EIU a, 1998, 4th quarter: 21).

The IMF was confident that the peg of the Real to the US\$ was sustainable. By contrast, various economists and financial market analysts considered the Real to be overvalued by 20-40 percent (e.g., Sachs 1999; Dornbusch 1999). Therefore, it is highly controversial to argue, as reportedly done by the President of the Inter-American Development Bank, Enrique Iglesias (*Handelsblatt*, January 28, 1999), that the Brazilian crisis simply reflected contagion and was not caused by misguided economic policies. The opposite view maintains that "it is all homemade, just as Mexico at the time, with an overvalued exchange rate and a huge budget deficit, vast short-term foreign obligations and an explosive indexed domestic debt" (Dornbusch 1999: 1).

Figure 5 presents some relevant facts in support of the latter view. The Real appreciated significantly in real terms in 1994. In subsequent years, further real appreciation was prevented as the so-called Plano Real of 1994 succeeded in fighting inflation. Nevertheless, the current account deficit widened. Fiscal adjustment was delayed; the public sector deficit doubled from 4 percent of GDP in 1996 to 8 percent of GDP in 1998. Only after the currency crash, the Brazilian Congress became inclined to agree to fiscal austerity measures (*Financial Times*, January 22, 1999).

This suggests that Brazil experienced a fairly conventional currency crisis (see also Saqib 1999). The episode fits easily into first-generation crisis models, developed by Krugman (1979) and Flood and Garber (1984), well before the globalization of international capital markets became a buzzword. Accordingly, inconsistent domestic economic policies, in particular the combination of a pegged exchange rate with fiscal and monetary laxity, invite speculative currency attacks. The devaluation expected by speculators amounts to a self-fulfilling prophecy with dwindling international reserves of the country attacked. While domestic policy failure caused the Brazilian crisis, contagion from financial turbulence in Asia

FIGURE 5 Brazil: Public Sector Balance, Current Account Balance and Real Exchange Rate, 1994–1999



<sup>a</sup>1994–1996: operational deficit, which discounts the inflation rate; 1997–1999: nominal deficit; 1999: January–November.

Source: IMF, International Financial Statistics, CDROM; EIU, Country Report Brazil, (various issues).

and Russia may well have been the trigger. However, the case of Brazil does not support Bhagwati's notion, referred to in the Introduction, that "markets may do something when you have done nothing wrong".

At the first glance, Korea provides a more plausible case of pure contagion and having fallen victim to panicking international capital markets. In contrast to Brazil, Korea was widely praised for strong macroeconomic fundamentals until the outbreak of financial turbulence. Moreover, "Korea is both far away from Southeast Asia – with minor direct economic linkages – and structurally quite different" (Krugman 1998b). With hindsight, however, several structural weaknesses and policy-induced distortions have been identified as internal causes of the crisis.

- It largely escaped public attention that "Korea was characterized by a deteriorating financial situation in the financial and corporate sector well prior to the final attack on the won in October 1997" (Berg 1999: 50). Korean firms were highly leveraged, and profit rates "were already dangerously low by 1996" (ibid: 14; see also Kim 1999). Six of the largest 30 *chaebol* went bankrupt from mid-1996 to mid-1997. Non-performing loans tripled to 7.5 percent of GDP from late 1996 to September 1997.
- Likewise, the moral hazard underlying the deteriorating financial situation was ignored until recently (Krugman 1998a; 1998b). Korean enterprises undertook "excessive investment ... in the midst of fierce international competition" (Kim 1999: 464). Financial institutions did not carefully assess the business performance of their corporate clients. Both, enterprises and financial institutions followed government directions. According to Borensztein and Lee (1999), credits were systematically allocated to sectors with relatively poor economic performance. Lenders felt insured by the government, at least implicitly, and "never worried about their own collapse" (Kim 1999: 465). However, implicit guarantees proved worthless when it turned out that honoring them would be too costly for the government (Krugman 1998b).

- The structure of Korea's external financing rendered the country extremely vulnerable to changing expectations of foreign investors. In 1996/97, debt-related flows accounted for 73 percent of total long-term net resource inflows; the share of FDI was just 14 percent (World Bank 1999b: 308). More importantly still, short-term external debt outstanding at end-1996 exceeded Korea's international reserves by a factor of 3.4 (Berg 1999: 15). Hence, the Won could not be defended when the peg to the US\$ was increasingly questioned in the light of lower export growth, deteriorating terms of trade, and the rise of the

US\$ vis-à-vis the Yen (Ministry of Finance and Economy 1999; Diehl and Schweickert 1998). Excessive reliance on short-term debt was largely because the Korean government lifted restrictions on short-term capital inflows in the early 1990s, but kept limits on long-term investment.

All this suggests that the internal problems underlying the crises differed considerably between Brazil and Korea. Yet, domestic policy failures are obvious in both cases. It is thus somewhat hypocritical to blame foreign investors for having caused the crises. This is not to ignore that foreign investors rushing for the exits aggravated the consequences of crises. The sudden reversal of capital flows amplified the downturn of stockmarkets and the fall of the Won and the Real when these were floated (Figure 6). The overshooting of exchange rates was not prevented by huge financial rescue packages orchestrated by the IMF.

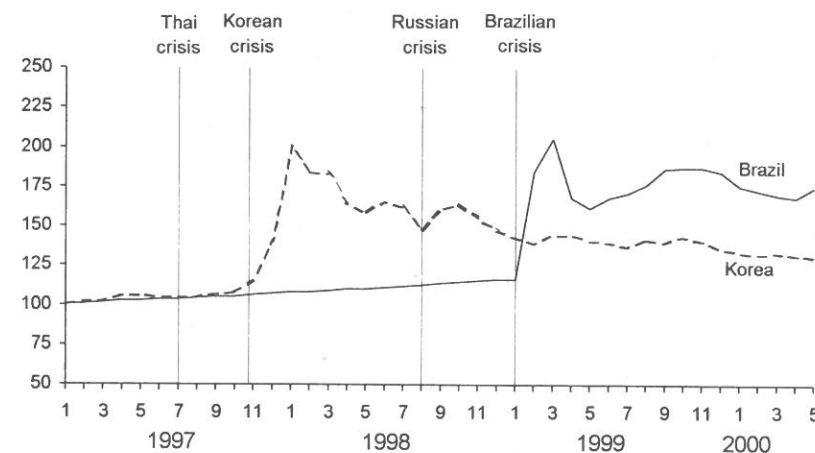
In other words, Brazil and Korea do not provide evidence to the effect that the globalization of financial markets renders crises likely even in EMEs characterized by prudent macroeconomic policies and sound financial sectors. Rather, increased international capital mobility allows foreign (and domestic!) investors to react more quickly and violently to any news, be it bad or good news. Interpreted this way, increased capital mobility may also help explain economic developments in Korea since late 1997 and in Brazil since early 1999.

The Won recovered since early 1998 from its sharp devaluation, while the Korean stockmarket declined until October 1998 (Figure 6). Korea's GDP shrank by about 6 percent in real terms in 1998. Korea suffered the vicious circle which sets in as soon as a major bubble bursts (Krugman 1998a; 1998b): Asset prices declined when nervous investors began to pull their money out of banks. Foreign investors fleeing the country weakened the Won. The decline in asset prices and the weak currency added to the fragility of financial intermediaries. Faltering banks sent another blow to asset prices so that investors fled all the faster.

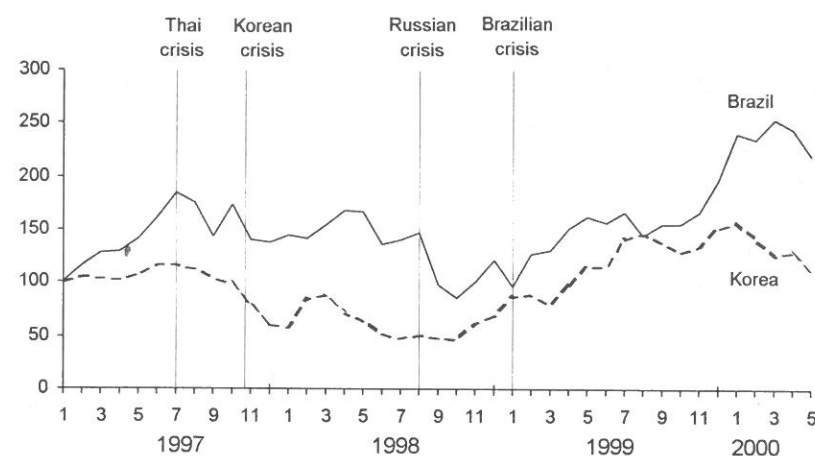
However, Korea has also become the poster country for recovery from crisis. Real GDP increased by almost 11 percent in 1999. Korea's output is now above pre-crisis levels (*The Economist*, April 15, 2000: 82). Stockmarkets rallied in 1999. Korea returned to private capital markets as early as April 1998 with a – heavily oversubscribed – US\$ 4 billion bond issue (denominated in US\$) (Berg 1999: 23). International rating agencies had upgraded Korea's sovereign credit rating to investment grade by April 1999 (Ministry of Finance and Economy 1999: 13).

FIGURE 6 Brazil and Korea: Nominal Exchange Rates and Stockmarkets, 1997–2000 (January 1997=100)

a) Nominal exchange rate<sup>a</sup>



b) Stockmarket<sup>b</sup>



<sup>a</sup>National currency vis-à-vis US\$. — <sup>b</sup>In national currency.

Source: Datastream.

Portfolio investment and FDI picked up. Foreign equity participation in the financial sector was an additional source of capital inflows (IMF 2000: 78). Unlike the early 1990s, recent capital flows to Korea were mostly non-debt creating. The maturity profile of its external debt

improved significantly, with short-term liabilities being redeemed. International reserves of Korea increased almost tenfold from end-1997 to March 2000.

All this indicates that the reaction of foreign investors to good news was as pronounced as their earlier reaction to bad news. Korea is widely considered “the star performer” among Asian EMEs with regard to reforming the financial sector: “The country has made a huge effort to strengthen and diversify its financial system. Banks have been recapitalised and non-performing loans sold and restructured. There has been a widespread reduction in leverage. ... South Korea’s nascent bond market is growing fast” (*The Economist*, April 15, 2000: 83).

While Korea recovered more quickly than expected from deep recession, the Brazilian economy proved to be fairly robust after the outbreak of the crisis in January 1999. Growth forecasts of early 1999, according to which Brazil’s GDP was expected to decline by some 5 percent in real terms (Nunnenkamp 1999: Table 1), turned out to be wide of the mark; GDP actually expanded modestly by 0.8 percent in 1999. The forecast for 2000 is about 4 percent (EIU a, 2000, 1st quarter: 7).

An important reason that Brazil weathered its crisis well is that banks were in relatively good shape. In contrast to Asia, Latin America avoided generalized financial distress in the banking and corporate sectors (IMF 2000: 70 ff.). Banks and enterprises in Brazil had largely hedged the risk of devaluation, and the country had strengthened prudential regulations and supervision. Hence, the financial sector was little affected by the currency crisis in early 1999.

### External Financing of EMEs in the Future

Recent capital market developments suggest that one should not put too much confidence in forecasts on the EMEs’ future access to private foreign capital. Most analysts underestimated the violent reaction of capital markets to crisis, and they were also caught by surprise when crisis-ridden EMEs returned fairly quickly to international capital markets. In December 1998, Rana (1998: 11 f.) considered the medium-term prospects for private capital flows to Asian EMEs “not very encouraging”; he continued: “Stability and recovery of international private capital flows ... is still in the distant future”. In early 2000, the concern rather was whether the impressive recovery of various EMEs involves “the risk of a new excessive rush into emerging markets” (*The Economist*, April 15, 2000: 84).

Short-term forecasts presented by the IMF (2000: 62) and the Institute of International Finance (IIF) (reported in *The Economist*, April 15, 2000: 82 ff.) differ in some respects, while going together in other respects.

- According to the IMF, net private capital flows to all EMEs in 2000 will remain somewhat below inflows reported in 1998 and 1999. The IMF expects net private capital inflows to pick up considerably in 2001. By contrast, IIF projects net private capital flows to EMEs to increase by some 30 percent in 2000. The forecasts have in common, however, that increased inflows in the near future will remain substantially below record inflows in pre-crisis years.
- Even though absolute numbers on specific elements of private capital flows differ considerably, equity investment, notably FDI, is expected by both institutions to be by far the most important source of external finance for EMEs in coming years. The two forecasts are also consistent in that reduced bank lending to EMEs in general, and to Asian EMEs in particular, will result in further net outflows of debt-related capital in the short run.

For assessing the future prospects of EMEs to attract foreign capital on a sustainable basis, various factors have to be taken into account. Long-run trends indicate that international capital mobility is on the rise (Gundlach and Nunnenkamp 1997: 5 f.). Following Feldstein and Horioka (1980), perfect international capital mobility implies that domestic saving rates are uncorrelated with domestic investment rates. As it stands, international capital mobility is still far from being perfect. However, the correlation between domestic saving and investment rates, calculated for a sample of OECD countries, has weakened considerably since the 1980s. This trend is likely to persist in the future with more countries liberalizing their trade and financial regimes, further advances in information and communication technology reducing transaction costs, and more enterprises globalizing their production strategies.

The critical question is to which extent EMEs will benefit from increased international capital mobility. The favorable response of foreign investors to improving economic conditions, e.g., in Korea and Brazil, suggests that EMEs will not be denied access to international capital markets for long even after major economic crises. It is open to debate, however, whether external financing will be provided on a more sustainable basis in the future than in the past. The risk of further boom-and-



bust cycles largely depends on the EMEs themselves, but some factors are clearly beyond their control. Exogenous factors include the following:

- In the short run, “an external shock, such as a sharp fall on Wall Street, could upset confidence” (*The Economist*, April 15, 2000: 84). The IMF (2000: 63) argues: “Unfavorable developments in the advanced economies, in particular higher-than-projected interest rate hikes or a sharper slowdown in the United States, could harm the prospects for emerging market economies for attracting inflows or boosting exports”. The associated reduction in private capital flows would affect Latin American EMEs in the first place. Latin America remains vulnerable in view of sizable net external financing requirements stemming from large current account deficits and persistently low national saving rates.
- In the longer run, the investment behavior of multinational corporations is relevant for putting external financing on a more sustainable basis. UNCTAD (1996: 97) argues that traditional FDI determinants such as the local market size of host countries are losing in importance, relative to globalization-related FDI determinants such as cost differences between locations, the availability of complementary local factors of production and openness towards world markets. As a consequence, more EMEs may become integrated into the globalization strategies of multinational enterprises. This would improve the chances of smaller and less advanced EMEs to attract FDI, which would help them restructure capital inflows towards less volatile items. In addition, FDI prospects in Asia depend on whether European companies will grasp existing investment opportunities, in order to reduce their still existing underrepresentation in the region.
- As concerns portfolio investment, the structure of inflows is critically important. In particular pension funds could potentially provide the longer-term capital needed for sustainable economic development in EMEs (Griffith-Jones and Cailloux 1999: 11 ff.). Demographic developments and the reform of pension systems in major developed countries are expected to result in rapidly expanding pension fund assets (see also Rana 1998: 11). According to the World Bank (1997), pension fund assets in Europe will rise nine-fold over the next 25 years. At present, the foreign exposure of pension funds is restricted in major developed countries. The risk control systems and prudential regula-

tions of some developed countries require that institutional investors hold only investment grade securities. This has fueled volatility, as “a downgrading of a country’s credit rating leads to an immediate sell-off of the affected assets and to the closing of new funding” (Reisen 1999: 9). Liberalizing the foreign engagement of pension funds could benefit both recipient and source countries. Deregulation may help reduce the home bias of pension funds and create new opportunities in international diversification for developed country savers. In EMEs, the long-term nature of pension fund engagements would allow for sustainable financing of productive investments and help reduce the volatility of overall capital inflows.

- Future developments in borrowing from international credit markets are fairly difficult to predict. At present, bank lenders are still reluctant to resume lending to EMEs. In the longer run, the behavior of international banks depends on whether the current debate on the reform of the international financial architecture will result in a more reasonable burden sharing should new financial crises arise. Reform proposals aiming at ‘bailing in’ private lenders may soften the boom-and-bust cycles in bank lending observed in recent years (Nunnenkamp 2000a). However, it seems rather unlikely that significant progress will be made in this area of reform, as the banking community, most policymakers in Washington and even some EMEs are strictly opposed to binding rules on private sector involvement in sharing the costs of financial crises. It is thus open to question for how long bank lenders will remain cautious.
- Finally, EMEs should not pin their hopes on substantial inflows of official capital from developed countries. This applies especially to EMEs with higher per-capita income. Official development assistance is stagnant, and may even continue to decline in real terms (Nunnenkamp 2000b). Moreover, indications are that official development assistance will be directed more strongly towards poverty alleviation in low-income countries in the future. Even at times of crisis, substantial inflows of official capital can no longer be taken for granted by relatively advanced EMEs, in the light of recent criticism raised against huge official rescue packages.

These exogenous factors notwithstanding, future access to international capital markets and the sustainability of capital inflows largely depend on EMEs themselves. The risk is that the surprisingly quick

recovery from crisis and renewed capital inflows might slow the momentum for reform, even though “the work of strengthening emerging economies’ defenses against new crises is far from over” (*The Economist* 2000: 84; see also IMF 2000). Even in Korea, widely considered the “star performer” among Asian crisis countries, corporate reform has barely begun. In other Asian EMEs, e.g., in Indonesia, the banking system is still extremely weak, as the non-performing loan problem is far from being resolved. As argued before, EMEs in Latin America remain vulnerable to reversals in market sentiment.

Consequently, the pace of reform needs to be maintained both, in Asia and Latin America, in order to transform economic recovery into robust growth and put external financing on a more sustainable basis. As concerns external financing in the future, the challenge facing EMEs is twofold: (1) External financing requirements must be kept within reasonable limits, and (2) the structure of capital inflows should be improved where inherently volatile flows dominated overall capital inflows in the past. Major policy choices related to these challenges are discussed in the concluding section.

### Critical Policy Choices in EMEs

After recent financial crises, the fundamental question facing EMEs obviously is whether the course of opening up towards world markets should be reversed. Some policymakers and economists (for example, Wade and Veneroso 1998) have commented upon financial crises as if international capital markets are doing EMEs nothing good. This suggests that overshooting is a phenomenon prevailing not only in international capital markets, but also in critical assessments of the functioning of these markets.

It is highly unlikely that, for example, the Asian crisis countries would have caught up economically with developed countries as quickly as they did over the past decades, if they had remained closed to world goods and capital markets. Various studies have shown that openness is instrumental to catching up in the longer run (for example, Sachs and Warner 1995; Gundlach 1997). Closing the capital account, in order to avoid being at the mercy of volatile international capital markets, would amount to shooting in one’s own feet. This may explain why “there has been remarkably little interest among emerging economies in capital controls” (*The Economist* April 15, 2000: 83).

The opportunity costs of closing the capital account would be particularly high in EMEs with low national saving rates. Latin America and South Asia, for example, are in greater need than high-saving East Asia to supplement national savings by foreign capital inflows. But even East Asian EMEs will fare better with renewed capital inflows than without. Especially capital inflows in the form of FDI offer benefits in terms of managerial know-how, easier access to foreign markets and transfers of internationally available technologies, i.e., factors that help overcome the crisis and resume the process of catching up. According to Krugman, “the mere potential for FDI may act as a stabilizer against the risk of domestic financial panics” (1998d: 9).

The relevant question is not whether to open up, but how to open up in order to keep the risk involved in capital account liberalization within reasonable limits. In this respect, recent financial crises in Asia and Latin America offer various lessons. First of all, EMEs must pursue consistent and credible economic policies. As Krugman (1998c) has shown, capital account liberalization implies hard policy choices, as free capital flows, exchange-rate stability and monetary policy autonomy constitute an “impossible trinity” (see also Frenkel and Menkhoff 2000: 11 ff.).

The choice is essentially between adopting a flexible exchange-rate regime that allows for autonomous monetary policy, or fixing the exchange rate *definitely* by forgoing autonomous monetary policy and establishing a currency board. It is widely agreed by now that intermediate solutions between these two extremes such as pegged but adjustable exchange rates, which were common in Asia and Latin America until recently, invited speculative attacks (Institute for International Economics 1999): “In a world of high capital mobility, democracies cannot credibly attach priority to the maintenance of pegged exchange rates above all other goals of policy (Eichengreen 1999). Against this backdrop, various EMEs shifted towards floating in the past two years, while some EMEs are moving to the other extreme.

Second, international capital inflows must not be considered a substitute for raising national investment funds. This has traditionally been the case in many Latin American EMEs (*The Economist* 1995). As indicated above, the challenge for Latin America is to increase national saving rates, in order to keep external financing requirements within reasonable limits. Latin American governments may contribute directly to achieving this aim by maintaining the pace of fiscal consolidation. This applies especially to Brazil and Colombia, which reported budget deficits of 10 and 6.4 percent of GDP, respectively, in 1999 (IMF 2000, Table 2.2).



Third, as concerns sustainability, the structure of capital inflows matters as much as overall external financing requirements. The recent shift in East Asia from debt-related inflows to equity-related inflows is instrumental to soften renewed boom-and-bust cycles. In this context, a widely held misconception needs to be rectified, namely that FDI is a promising source of external finance for only a few large and fairly advanced EMEs (Nunnenkamp 2000d). True, FDI flows to all non-OECD countries are concentrated on a small group of EMEs. Relative to the host countries' GDP, however, the evidence reveals that various small and less advanced EMEs proved more attractive to FDI than EMEs that were major recipients in absolute terms. Hence, small and less advanced EMEs are not necessarily on the sidelines in the global competition for FDI. They should grasp the opportunity to improve the structure of external financing by offering favorable investment conditions to foreign direct investors.

Fourth, the risk involved in international capital mobility may be reduced by keeping limits on short-term capital inflows until well functioning domestic financial markets ensure an efficient intermediation of capital inflows. Chile is the poster country for discouraging speculation by taxing short-term capital inflows (Rogoff 1999). Even Stanley Fischer (1998: 5), First Deputy Managing Director of the IMF, conceded: "A case can be made that countries with weak financial systems should restrict short-term inflows." Yet, few EMEs have applied Chilean style controls on capital inflows so far. EMEs fear that they would have to pay a much higher premium on long-term capital inflows, or that controls would result in a sharp reduction in overall lending by international capital markets (Rogoff 1999).

In contrast to capital inflow controls, the imposition of capital outflow controls by Malaysia in September 1998, was highly controversial. Krugman (1998e) argued that outflow controls may be a better choice than steep rises in interest rates or a sharp depreciation of the exchange rate for a country whose currency is subject to a serious attack. Most economists insisted, however, that the costs of outflow controls outweigh the benefits. Controls invite evasion and corruption and, if strictly applied, may scare off investors for long. Malaysia lifted controls in 1999, and claimed victory (*The Economist* May 1, 1999: 75). By mid-2000, it is fair to conclude that adverse effects of Malaysia's approach proved to be smaller than many had feared. At the same time, Malaysia's recovery "has not exactly proved the proponents right. For there is a recovery in

progress throughout Asia" (Krugman 1999; see also Rogoff 1999). The controls turned out to be largely irrelevant, as the panic was subsiding just when the controls came on (*The Business Times*, Singapore, August 27, 1999, quoting Paul Krugman). When the controls were imposed, the Ringgit had already fallen by some 40 percent, so that their effectiveness in preventing a currency collapse has not been tested. Furthermore, the controls formed "only one part of an overall economic regime that is in many ways a model for other emerging markets" (*The Economist* May 1, 1999: 75).

In summary, the timing and sequencing of capital account liberalization is crucially important for attracting foreign capital inflows on a sustainable basis. EMEs must prepare well for complete capital account liberalization: "They will need to adapt their policies and institutions, particularly their financial systems" (Fischer 1998: 2). Financial institutions must be supervised effectively, prudential standards should be in line with international best practice and must be enforced, and governments must not create expectations that private sector liabilities are guaranteed. The composition of capital inflows requires careful monitoring (IMF 2000: 81). In order to avoid excessive reliance on short-term financing, the sequence of capital account liberalization should be the very opposite of Korea's approach in the early 1990s. Restrictions should be lifted for FDI in the first step, while limits may be kept on short-term capital inflows. This is also because precautionary controls on short-term capital inflows appear to be superior to restricting capital outflows in the midst of a crisis.

## Notes

- <sup>1</sup> Interview of Jagdish Bhagwati with the *Times of India* on December 31, 1997.
- <sup>2</sup> The need for a new international financial architecture is discussed in Nunnenkamp (2000a).
- <sup>3</sup> On Asian EMEs, see also Rana (1998).
- <sup>4</sup> This issue is analyzed in more detail in Nunnenkamp (2000c).
- <sup>5</sup> Private capital flows to Latin America were lower in 1994/95 than in previous years. This temporary decline is to be attributed to the Mexican Peso crisis, rather than a redirection of capital flows resulting from the emergence of new competitors in other regions.
- <sup>6</sup> Note also that FDI flows to Asian EMEs other than the five crisis countries exceeded overall private capital flows to these countries in 1995/96; both portfolio investment and other investment was negative for other Asian EMEs in 1995/96 (IMF 2000: Table 2.2).

- <sup>7</sup> The subsequent statistical information is from IMF, International Financial Statistics, CD-ROM.
- <sup>8</sup> The subsequent paragraphs draw on Nunnenkamp (1999).
- <sup>9</sup> International reserves of Brazil declined by some 20 percent within a few days, and Brazilian debt was downgraded by Moody's (The Economist, September 12, 1998: 59).
- <sup>10</sup> On recent fiscal policy trends in Brazil, see, e.g., IMF (2000: 67 ff.). The primary balance of the consolidated public sector swung into a surplus of about 3 percent of GDP in 1999, as a result of tight expenditure controls and revenue enhancing measures. Yet, with interest payments soaring, the nominal deficit rose to about 10 percent of GDP (Figure 5).
- <sup>11</sup> Arminio Fraga (2000: 16), the current governor of the Central Bank of Brazil, argues: "The background to Brazil's financial crisis in early 1999 included both fiscal and balance of payments weaknesses ... Then, as often happens to vulnerable countries, an economic crisis erupted: after Russia defaulted on its debt in August, capital flows to Brazil came to a halt."
- <sup>12</sup> The budget of the central government was in surplus in 1993-1996. The current account deficit remained small until 1995 (0.9 percent of GDP, on average, in 1993-1995), soared to 4.7 percent of GDP in 1996 and declined to 1.8 percent of GDP in 1997 (World Bank, World Development Indicators CDROM).
- <sup>13</sup> According to the Korean Ministry of Finance and Economy (1999: 2), "the bankruptcies of conglomerates [in 1997] were interpreted as a sign that the government would no longer provide its implicit guarantees, further eroding investor confidence."
- <sup>14</sup> Berg (1999: 40) argues on Asia: "The evaluation of appropriate equilibrium exchange rates (is) a particularly difficult exercise. Nonetheless, most observers have concluded that devaluations went well beyond any degree justified by long-run fundamentals. The substantial appreciations observed in 1998 for some countries, particularly for Thailand and Korea, are consistent with this view".
- <sup>15</sup> In this context, it may be noted that the reactive approach of major sovereign rating agencies frequently intensified boom-and-bust cycles (Reisen and von Maltzan 1999).
- <sup>16</sup> For a detailed assessment of European direct investment in Asia, see European Commission and UNCTAD (1996) and Nunnenkamp (2000b).
- <sup>17</sup> The argument of EMEs against obligatory burden sharing is that it will render borrowing in international credit markets more expensive (Fernández-Arias and Hausmann 2000a). This argument is not convincing, considering that excessively generous bank lending is widely regarded to have fueled speculative investments prior to the Asian crisis.
- <sup>18</sup> For example, Ecuador is dollarising; Argentina maintained its currency board in spite of the major devaluation of the Real in Brazil, which is Argentina's major trading partner.

- <sup>19</sup> In 1997, ten EMEs (in descending order: China, Brazil, Mexico, Singapore, Argentina, Russia, Colombia, Chile, Malaysia and Venezuela) accounted for about 70 percent of FDI flows to all non-OECD countries (World Bank, World Development Indicators CD-ROM).
- <sup>20</sup> In Asia, for example, FDI flows to Cambodia and Vietnam amounted to about 7 percent of GDP in 1997, while the corresponding ratio was about 5 percent in China and Malaysia.
- <sup>21</sup> Chile reduced implicit taxation of short-term capital inflows to zero in September 1998. For a sceptical assessment of the effectiveness of Chile's approach, see Buch et al. (1998).

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## Towards a New International Financial Order: Why Reform Progress Is So Slow

### Abstract

It is increasingly questioned that international financial markets function efficiently. Various reform proposals notwithstanding, little has been achieved so far in reforming the international financial architecture. This is partly because the reform debate has centered on moral hazard induced by the IMF. Empirical evidence on IMF lending, presented in the paper, does not support the view that recent financial crises were due to moral hazard. The paper analyses the trade-offs which almost every step towards reform involves. These trade-offs are of immediate concern for defining the future role of private banks and international financial institutions, especially the IMF, with respect to crisis prevention and crisis resolution.

## Ke Arah Susunatur Kewangan Antarabangsa yang Baru: Kenapa Kemajuan Reformasi Begitu Lambat

### Abstrak

Kemajuan yang dibuat setakat ini dalam usaha mereformasi susunatur kewangan antarabangsa memang terbatas, sungguhpun pelbagai cadangan reformasi telahpun diajukan. Kemajuan begitu lamban, disebabkan setiap langkah ke arah reformasi melibatkan *trade-offs* yang serius, yang mesti dianalisis dengan teliti sebelum reformasi dilaksanakan. Beberapa *trade-offs* memang penting dalam jangka dekat untuk mendefinisikan peranan institusi kewangan antarabangsa, khususnya IMF, dalam hubungan dengan pencegahan krisis dan penyelesaian krisis.

## Towards a New International Financial Order: Why Reform Progress Is So Slow

### The Need for Reforming the International Financial Architecture

There appears to be a growing discrepancy between the growth, sophistication and integration of international financial markets on the one hand, and the limited capacity at the national and multilateral level to control and regulate these markets on the other hand. This would not be problematic at all if international financial markets were working efficiently, i.e., if market failure was absent. Such a heroic assumption is increasingly questioned, however (Reisen 1999).

It is not too difficult to find major local roots of currency and financial crises in emerging markets in the 1990s, starting with the Mexican crisis in late 1994. Yet, international lenders share responsibility with banks, business and policy-makers in emerging markets. The former tended to ignore risks and fuelled the boom in capital flows into emerging markets, which typically preceded a crisis. Once crisis was looming, foreign lenders (as well as local investors) rushed for the exits. The dramatic consequences of sudden shifts from euphoria to panic are well known by now. We have witnessed crisis to spread from one country to another, partly because the affected countries were plagued by similar fundamental problems, but partly also because different emerging markets were put into the same basket by foreign lenders.

This suggests that herding behavior and contagion are not just “nasty words” (Folkerts-Landau and Garber 1999), i.e., unreasonable expressions for a basically rational behavior of foreign lenders. These expressions rather point to the failure of international financial markets in achieving a better allocation of world savings through cross-border capital transfers without, at the same time, giving rise to boom-and-bust cycles that are difficult to manage especially for emerging markets. For example, a sudden shortfall in capital inflows tends to undermine weak financial systems in emerging markets, with the ensuing credit crunch leading to the breakdown of basically sound enterprises.

To be sure, the affected countries can protect themselves against the vagaries of international financial markets by pursuing sound economic policies, by consolidating domestic financial markets, and by enforcing prudential standards. But the bunching of currency and financial crises has also to do with the institutional void prevailing at the global level, which is the topic of this paper. This institutional void has several dimensions:

- An international lender of last resort does not exist. As argued below, the International Monetary Fund (IMF) cannot – and, under current conditions, should not – pursue this role. This means that fighting systemic risk, i.e., a crisis threatening the global financial system, is more difficult at the international level than it is at the national level, where central banks play the role of the national lender of last resort.
- Similarly, institutional mechanisms in analogy to national bankruptcy proceedings do not exist at the international level. None of the existing multilateral organizations has the legal power of a national bankruptcy court judge, who can stop the run of creditors on a firm's assets by imposing a standstill until a reasonable solution, including financial burden sharing, is worked out (Siebert 1999).
- Financial market regulation is seriously deficient. Some internationally active financial intermediaries completely escape regulation. Highly leveraged hedge funds, frequently deemed to be involved in speculative transactions, are a case in point. Where regulation exists, it is often flawed or even counterproductive. For example, the capital adequacy regime codified in the Basle Accord has led to regulatory distortions (Reisen 1999). According to *The Economist* (1999: 73), the accord, originally passed in 1988 to make banks safer, “is so outdated that it may actually do the reverse.” The current scheme of setting aside capital against different loan categories encourages short-term lending to emerging markets and cross-border interbank lending, i.e., exactly those loan categories that caused considerable problems in Asia.

The obvious challenge in reforming the international financial architecture is to overcome this institutional void. This is easier said than done, however. As we will see, the limited progress made so far cannot be attributed to insufficient reform-mindedness of the institutions involved or to a lack of reform proposals in the literature. Rather, progress is slow as almost every step towards reform involves serious trade-offs, which

must be analyzed carefully before reforms are implemented. Some of these trade-offs are of immediate concern for defining the role of international financial institutions, notably the IMF, with respect to crisis prevention and crisis resolution.

## The IMF under Attack

Among international financial institutions, it is mainly the IMF which is blamed for having failed in preventing financial crises in the first place, and in fighting the deepening and spreading of crises once they had erupted. The critique of the IMF has been harsh and widespread with regard to the policy conditions attached to financial support to troubled countries in Asia. The critique has been most fundamental, though not undisputed in the economics profession, when it comes to moral hazard. Accordingly, financial support by the IMF has induced reckless behavior on the part of emerging markets and their private lenders, and, thereby, added to the likelihood of financial crises. Some critics, including Lal (1998) and Meltzer (1998), consider the Asian crisis to be the logical consequence of IMF support granted to Mexico in 1995. To them, the existence of IMF lending is the major problem, rather than part of the solution to financial crises in emerging markets.

The moral hazard critique is central to the reform of the international financial architecture in general, and the future role of international financial institutions in particular. On analytical grounds, there is nothing to quarrel about the moral hazard argument. IMF support in times of crisis may be anticipated by both IMF borrowers and private lenders. As a consequence, governments of borrowing countries would be tempted to pursue economic policies that involve a higher risk of financial crisis, the costs of which will be partly covered by the international community. Likewise, private lenders would be tempted to ignore risk and to overlend, expecting that bailouts will reduce or even eliminate potential loan losses.

However, the critics of the conventional crisis management have not come up with evidence on the empirical relevance of IMF-induced incentive problems. Quite the contrary, a recent attempt to assess the empirical relevance of moral hazard suggests that incentive problems tend to be overrated in the ongoing debate on reforming the international financial architecture (Nunnenkamp 1999a). Major findings of this study are summarized here, as they have important implications for the future role of the IMF:



- The prominent and exceptionally large rescue operations in Mexico (1995), Russia (since 1996), East Asia (1997) and Brazil (1998) tend to obscure that overall IMF resources are probably too small to create serious incentive problems on a broader scale. Even during the boom of IMF lending in 1995-1997, annual average drawings of all developing countries on IMF resources amounted to just 0.3 per cent of their GNP. At the same time, IMF lending was also marginal when related to the claims of BIS reporting banks vis-à-vis all developing countries (about 2 per cent).

- In contrast to widespread belief, IMF lending has not increased steadily since the mid-1970s (Figure 1). Longer-term developments reveal cycles in IMF lending, with major crises (e.g., the Latin American debt crisis of the early 1980s) resulting in temporary lending springs. It is difficult to conceive that high IMF lending during earlier crisis episodes could have been reduced to pre-crisis levels for a fairly long period of time if it had added significantly and permanently to moral hazard.

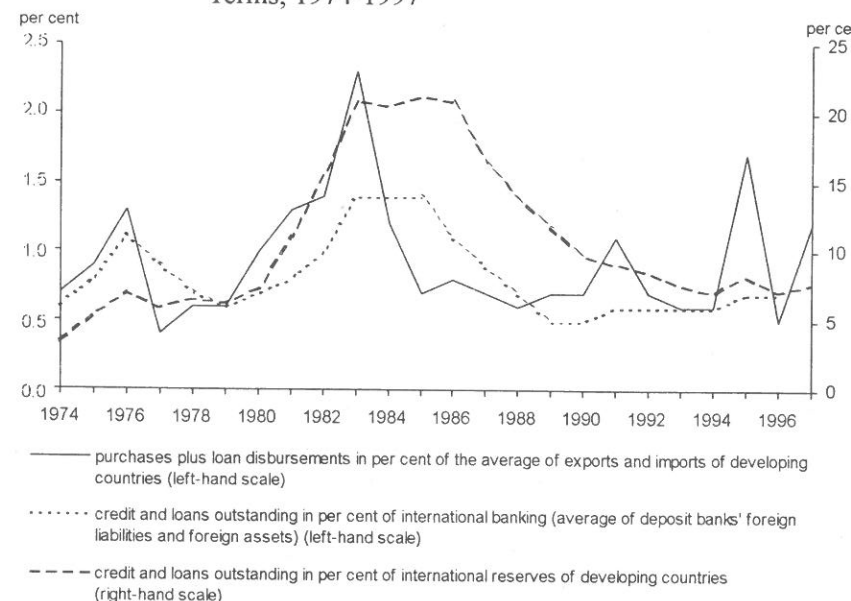
- In longer-term perspective, IMF lending (in per-capita terms of the recipient countries' population) was not biased towards large emerging markets, which is again in conflict to what has been concluded from a few big deals recently. In other words, "too-big-to fail" considerations related to country size do not appear to have played a major role, even though they may have influenced IMF lending in particular instances.

- It seems unjustified to blame the IMF for having encouraged borrowers to pursue misguided economic policies. Taking the inflation rate as an indicator of the soundness of macroeconomic policy, the correlation with drawings on IMF resources turns out to be insignificant. Furthermore, IMF lending was not biased towards countries with inflexible exchange rate regimes, which are widely considered to be a major cause of recent currency and financial crises.

- Likewise, there is no convincing evidence supporting the view that imprudent bank lending to developing countries is largely because IMF rescues have been anticipated by foreign creditors. It is inconsistent with this view that the structure of external financing of developing countries has shifted significantly towards equity financing and away from loan financing, although equity investors are most unlikely to

benefit from bailouts. Correlation analyses reveal that the IMF and international banks decided independently from each other on their lending to developing countries, if bank exposure and IMF operations are adjusted for country size (Table 1). Put differently, IMF lending does not seem to have been motivated by bailing out foreign creditors in the first place.

FIGURE 1 IMF Operations in Developing Countries in Relative Terms, 1974-1997



Source: IMF (var. issues); BIS (1998).

All this suggests that moral hazard has been a minor problem in the past. This leads us to reject the radical proposal to put an end to IMF lending, advanced by some critics of the IMF in order to eradicate moral hazard. Even if these critics were right in arguing that there would be fewer crises in the absence of emergency lending by international financial institutions, there would still be some. Without a safety net, the remaining crises are likely to have more dramatic international repercussions than we have witnessed in the past. In other words, eradicating moral hazard tends to increase the systemic risk of crisis contagion. Hence, the relevant question is not whether a safety net is needed, but rather how to improve the existing crisis management.

TABLE 1 Cross-country Distribution of IMF Financing and Bank Lending to Developing Countries: Correlation Results<sup>a</sup>

	Outstanding Claims of BIS Reporting Banks (as of June 1998)		
	in absolute term	in per-capita terms <sup>b</sup>	in percent of GNP <sup>c</sup>
Accumulated purchases plus loan disbursements, 1974-1997			
- in absolute terms	0.74** (114)	-	-
- in per-capita terms <sup>b</sup>	-	0.15 (114)	-
- in per cent of GNP <sup>c</sup>	-	-	-0.12 (104)
IMF credit and loans outstanding, end 1997			
- in absolute terms	0.69** (110)	-	-
- in per-capita terms <sup>b</sup>	-	0.17* (110)	-
- in per cent of GNP <sup>c</sup>	-	-	0.141(103)

<sup>a</sup>Number of observations in parentheses; \*\* and \* denote significance at the level of 1 and 10 per cent, respectively (two-sided test). – <sup>b</sup>Population of borrowing countries as of 1996. – <sup>c</sup>GNP of borrowing countries as of 1996.

Source: IMF (var. issues); BIS (1998).

### Crisis Prevention and Crisis Resolution: The Future Role of the IMF

Why not empower the IMF to act as a true international lender of last resort if moral hazard has been a less serious problem than much of the current discussion suggests? The obvious advantage of having an international lender of last resort would be that fighting systemic risk would become easier (Fischer 1999). Currently, the IMF cannot perform this role. Usable IMF resources are “a trickle if an extended crisis develops, for instance if Japan or Euroland would need financial assistance” (Siebert 1999: 5). As a true international lender of last resort, the IMF would have to command over essentially unlimited resources.

However, it is rather unrealistic to assume that this will happen in the foreseeable future: “Policy-makers of the big countries will prevent

it” (Wolf 1998). They have good reasons not to supply the IMF with unlimited resources:

- An international lender of last resort could be justified only if potential borrowers accept high standards of external oversight and discipline (Wolf 1998). These standards would have to cover financial regulation, bankruptcy legislation and enforcement, disclosure of information, and macroeconomic policies. The Asian crisis clearly revealed that these prerequisites are currently far from being fulfilled.
- An international lender of last resort should counter only a liquidity crisis threatening the global financial system. However, it is notoriously difficult to distinguish between “illiquidity” and “insolvency” in the international context (Litan 1998). In contrast to national lenders of last resort, the IMF does not lend to markets but to governments running into trouble or threatening default. Given the difficulties in defining a systemic crisis, unlimited IMF resources may increase the risk that the IMF will become “a funding agency for countries in self-made trouble, so to say the troubled countries’ global bank” (Siebert 1999: 3).
- More generous IMF lending may render it more difficult to achieve two desirable goals of reforming the international financial architecture, namely (1) dissuading countries from excessive reliance upon exchange rate pegs and (2) inducing private lenders to take their share in orderly debt workouts (Lipton 1999).

In summary, unlimited IMF lending would run the risk that moral hazard problems will become more serious than they have been in the past. Defining the future role of the IMF thus involves a fundamental dilemma. The conflict is between dealing forcefully with emergencies that come along by providing sufficiently large and timely support in order to fight systemic risk, and discouraging emergencies from happening in the first place by credibly refusing official support to governments and foreign lenders which are in self-made trouble. Crisis mitigation may require more IMF lending, whereas crisis prevention calls for limited IMF lending.

There is no easy way out of this dilemma. Consequently, the IMF is likely to remain “neither fish nor fowl” (Wolf 1998). The only firm conclusion to be drawn from the previous discussion is that two extreme positions are to be rejected: While those who suggest to abolish the IMF altogether ignore the systemic risk of crises that would still come along,

the suggestion of having a true international lender of last resort under-rates the ensuing moral hazard problems.

Striking a balance between crisis prevention and crisis resolution is the intricate task of reformers of the international financial architecture. Trade-offs abound when it comes to finding a reasonable middle course in defining the future role of international financial institutions. Two practical steps towards reform may serve as examples: the Contingent Credit Line (CCL) of the IMF and active signaling by international institutions. The IMF's Executive Board agreed to create the CCL in April 1999.

This new facility shall prevent the spreading of financial crises by offering precautionary credit to countries that may suffer contagion, although their economic situation is fundamentally sound. IMF members will have to prequalify for CCL assistance. They have to meet "some minimum standards of information disclosure and transparency, as well as of economic health" (Edwards 1998). By providing support *ex ante* (and not *ex post*, as the IMF has traditionally done), the CCL may help restore confidence before it is too late. By assisting only eligible countries, the CCL may provide for the right set of incentives and minimize moral hazard.

Yet it is open to question whether the CCL will achieve its objectives; it may even give rise to new risks (Eichengreen 1999a: 99 ff.; Golder 1999; Siebert 1999). The CCL seems to be prone to adverse selection, since applications for CCL support are likely to come from vulnerable countries with – possibly disguised – economic problems in the first place. At the same time, the prequalification mechanism may create an illusory security on the part of private lenders that could lead to a misallocation of international capital flows. Most importantly perhaps, the CCL may precipitate further crises if economic policies in prequalified countries take a turn for the worse so that the IMF would have to revoke its preapproval.

Likewise, the request for more active signaling by international institutions to financial markets that borrowing countries are encountering economic problems involves serious trade-offs. It is striking indeed that the Asian crisis has led to opposing comments on the IMF's information policy. In the Korean context, for example, Sachs (1997) argued that "a better approach would have been for the IMF to stress the strengths rather than the weaknesses of the Korean economy, thereby calming the markets rather than further convincing them of the need to flee the country". It is highly questionable whether a strategy of hoaxing financial markets would have succeeded in mitigating the Asian crisis. It is equally questionable,

however, whether "blowing the whistle" early on (Siebert 1998) will do the trick in preventing crises in the future. True, the threat of public disclosure of emerging problems by the IMF and other international agencies provides the country concerned with stronger incentives to correct misguided policies before it is too late. On the other hand, active signaling by authoritative bodies such as the IMF may be the trigger to crises that could have been prevented otherwise.

The delicate task of signaling may be handled best if various international agencies share responsibility in providing relevant information in their respective areas of competence, while leaving it up to financial markets to evaluate this information and to draw appropriate conclusions. The IMF's Special Data Dissemination Standard represents one step in this direction. Improved debt recording by the Bank for International Settlements is another one. Regular reporting should also cover institutional aspects of financial sector soundness, such as legal provisions and actual enforcement of prudential standards. A clear division of labor among international institutions, as well as between international institutions and financial markets, would prevent the IMF from becoming a global rating agency. It would definitely be too much to demand from one single international institution what various private rating agencies have failed to deliver, namely timely and comprehensive risk assessments.

### Burden Sharing: How to Involve the Private Sector?

It should be evident by now that the reform of the international financial architecture must go beyond redefining the role of multilateral agencies. The unpleasant trade-offs discussed above imply that the institutional void characterizing global financial markets cannot be overcome by multilateral agencies alone. That is why private sector involvement in the international crisis management represents another major issue in the current reform debate. It may not come as a great surprise that progress in this area is as difficult to achieve as with respect to multilateral agencies.

Most of the recent proposals to involve private lenders in crisis resolution attempt designing mechanisms that may compensate, at least partly, for the lack of bankruptcy procedures concerning sovereign borrowers. The principal objective is to achieve a fair burden sharing, by "bailing in" the private sector once crisis is looming. Underlying is the

widespread belief that foreign lenders have been sheltered from losses so far, even though their boom-and-bust behavior has contributed significantly to recent crises. Proposals range from ad hoc measures agreed upon voluntarily to fairly draconic measures such as “automatic haircuts” for all private lenders engaged in a country experiencing payment problems. Two ways of private sector involvement can be distinguished: The US government and the international banking community favor a discretionary approach under which agencies such as the IMF encourage lenders and borrowers to restructure debt on a case-by-case basis, whereas a rules-based approach to debt workouts and restructuring is preferred by most European governments.

The former approach has been adopted in Korea, for example. Foreign banks and the Korean government negotiated the restructuring of debt “under the stewardship and with the moral suasion of G-7 central banks” (Eichengreen 1999b). This agreement is credited for having facilitated Korea’s rapid return to international capital markets. However, foreign banks have not shouldered any financial burden; they merely agreed to extend the maturity of their claims, and were compensated for this concession. Furthermore, various lenders had left the country well before negotiations started. In other words, the agreement was not effective in bailing in the private sector. The approach taken in Korea is likely to prove still less effective in countries with a large number of heterogeneous lenders (and not just a few banks as in Korea). It will then be extremely time consuming, if not impossible, to reach a consensus on ad hoc measures. This suggests that debt workouts must be rules-based, to some degree at least, in order to achieve a fair burden sharing.

This is not to say that the European approach would be without costs. Two proposals may exemplify the rules-based approach. First, Buiters and Sibert (1999) have proposed a universal debt-rollover option with a penalty (UDROP). The idea is that all foreign-currency debt should have attached to it an option, exercisable at the discretion of the borrower, to roll the liability over for some months at a penalty rate of interest. Second, as concerns bond contracts, it has been suggested to include majority voting and sharing clauses and to design rules on collective representation of bondholders, in order to facilitate the restructuring of bonds. These provisions would help overcome collective action problems and would prevent litigation by individual bondholders.

The rules-based approach may be flawed in two major respects (Eichengreen 1999b). First, if loan agreements and bond contracts were

to include standard provisions making it easier for borrowers to restructure their debt, foreign lenders may fear that borrowers will make use of the restructuring option arbitrarily. Hence, foreign lenders may withdraw at the first sign of trouble and, thereby, precipitate a crisis. Second, such provisions may result in adverse selection. For example, UDROPs are unlikely to be used extensively on a voluntary basis, since only borrowers expecting a high probability of having to restructure their debt may wish to include them in their loan contracts. Creditors anticipating that demand will be from risky borrowers in the first place, will not offer UDROPs since the option cannot be priced adequately.

However, both problems do not appear to be insurmountable and international agencies may help overcoming them. Moral hazard on the part of borrowers is reduced, though not eliminated, since restructuring options such as UDROPs can only be exercised by the borrower at a penalty. Moreover, the experience with British-style bonds, which (in contrast to the predominant American-style bonds) incorporate many of the proposed collective action provisions, is rather encouraging: “It does not appear that issuers (of British-style bonds) succumb to the temptation to reschedule at the first sign of trouble. Moral hazard may exist, but there is no sign that it is overwhelming” (Eichengreen 1999b: 13 f.). Hence, it is rather unlikely that borrowers would suffer significant costs, in terms of larger interest rate spreads or impaired access to bond markets, if collective action clauses were applied universally.

Adverse selection can be minimized in several ways. Safe borrowers such as major industrialized countries may set a precedent and incorporate collective action clauses into their own bond contracts. Emerging markets may take a joint initiative, rather than moving ahead individually. The IMF may support such an initiative, and provide incentives by lending at relatively favorable interest rates to countries issuing bonds with collective action clauses.

### Crisis Prevention at Different Levels

Compared to crisis resolution and burden sharing, the case for private sector involvement may be less obvious with respect to crisis prevention. Major responsibility for crisis prevention rests with policymakers in borrowing countries and international regulators. The former have various instruments at their disposal to reduce the risk of currency runs and financial crises: fiscal and monetary policy to ensure macroeconomic soundness, flexible exchange rates to discourage speculative currency attacks,



foreign reserves management to prevent a shortage of international liquidity, debt management to avoid excessive reliance on short-term borrowing, sequencing capital account liberalization to promote long-term capital inflows, supervision of banks to enforce prudential standards, as well as information disclosure to stabilize market expectations.

International regulators face an immense task in enforcing transparency and accountability, including disclosure requirements for offshore financial centers, non-bank financial institutions, and for transactions involving highly leveraged institutions. Multilateral bodies such as the Basle Committee on Banking Supervision need to develop and implement practices for supervising hedge funds and financial relations of banks with these funds. They must address the shortcomings of existing standards on banking supervision. It is open to question whether merely amending the evident regulatory distortions created by the 1988 Basle Capital Accord will do the trick. Critics are concerned that minor changes in the guidelines, e.g., increasing the risk weights for certain loan categories, are an attempt "to fine tune a mechanism that has some fundamental flaws. ... The principal and defining defect of the Basle risk-based guidelines is that, ..., they are and always will be essentially arbitrary" (Calomiris and Litan 1999). These critics argue that incorporating market-based measures of bank risk into prudential regulatory standards is essential.

Yet private lenders, too, have a role to play in preventing crises to spread from one emerging market to another. For example, foreign banks may commit themselves *ex ante* to provide new credits to countries threatened by contagion (Feldstein 1999). Stand-by credit lines granted by banks to Argentina, Mexico and Indonesia represent a prototype of this kind of insurance against sudden reversals in capital flows. As any insurance, precautionary credit lines are prone to adverse selection and moral hazard. In addition, it cannot be ruled out that foreign banks reduce their other credit exposure when agreeing to precautionary credit lines (Eichengreen 1999b). However, these problems may be contained if emerging markets clearly signal their credit-worthiness, and if they are prepared to pay a penalty rate of interest when drawing on these credit lines.

Finally, private lenders may be obliged to set up and finance emergency funds for borrowing countries with relatively high default risk. Creditor councils would be responsible for collecting the contributions of individual lenders to these funds; contributions may be fixed as a certain percentage of capital transfers into the respective country. The IMF may draw on these private funds once crisis is looming. In this way, two prob-

lems could be tackled at the same time. First, more financial resources could be mobilized in the case of emergencies. The IMF would command over a larger pool of financial resources without inducing more serious moral hazard on the part of private lenders. The fight against contagion would no longer be delayed by time consuming *ex-post* coordination. Second, the obligation to set aside private funds *ex ante* for dealing with emergencies would strengthen the incentive of private lenders to pursue prudent lending strategies. This would help prevent speculative bubbles in the first place.

## Conclusions

Two years after the Asian crisis erupted in Thailand in July 1997, the progress achieved in reforming the international financial architecture is fairly limited. This is especially true as to the involvement of the private sector in the prevention and resolution of financial crises (IMF 1999). The institutional void, mentioned in the beginning of this paper, still exists, although experts have suggested various reforms and the agenda is discussed by various official bodies.

The principal reason for the rather poor outcome so far is that almost all steps towards reform involve trade-offs. The most serious trade-off is between mitigating crises that come along and preventing further crises. Especially international financial institutions, notably the IMF, are confronted with this dilemma. On the one hand, financial support by these institutions should be limited, in order to keep moral hazard low. On the other hand, more emergency funding may be needed to fight contagion forcefully.

Critics of the IMF tend to overshoot in two directions. Some of the attacks of those critics who blame the IMF for having aggravated, or even caused recent financial crises, may well be on target. Yet, abolishing the IMF would do more harm than good. Without an international safety net, remaining crises are likely to have still more serious global repercussions and may threaten the financial system as a whole. Other critics who claim that the IMF must prevent the next crisis, after having failed to prevent recent crises, tend to overcharge this institution. Note that the economics profession as a whole, not only the staff of the IMF, was caught with its foot in its mouth when the Asian crisis hit. It is far from obvious that the IMF will command over superior knowledge to anticipate the next crisis, which may again differ from the previous ones.

It follows that, even though international financial institutions do play a critical role in crisis resolution and crisis prevention, they cannot shoulder this task alone. Their efforts must be complemented by various other actors. First of all, national policymakers have to do their homework and must learn the lessons from recent crises (notably as concerns exchange rate policy, capital account liberalization and financial market supervision). Furthermore, multilateral bodies must systematically review financial regulatory standards. As it seems, this daunting task goes beyond merely amending obvious regulatory distortions.

Finally, private lenders must be more closely involved in crisis resolution and prevention. 'Bailing in' the private sector is a fairly tricky issue. Draconic measures aiming at a fair burden sharing may have unpleasant side effects; it may become more difficult or expensive for emerging markets to access international capital markets. Nevertheless, some basic rules on private sector involvement seem to be required, in order to avoid excessive lending in the future and in order not to let private lenders off the hook in times of crisis. In this way, 'bailing in' the private sector helps alleviate the dilemma confronting international financial institutions.

## Notes

- <sup>1</sup> On the point of crisis prevention, see, e.g., Siebert (1998); on the point of aggravating existing crises, see, e.g., Sachs (1997).
- <sup>2</sup> The IMF has defended its case in Lane et al. (1999). The appropriateness of policy conditions is not discussed here, as this issue is of less relevance in the context of this paper.
- <sup>3</sup> Note that moral hazard eludes quantification. It is unknown how IMF borrowers and private lenders would have behaved in the absence of IMF support. It is also impossible to determine the costs of misguided economic policies and the costs of overlending that could have been avoided if international financial institutions had abstained from bailing out emerging markets and their private lenders. Therefore the evaluation refers to indirect evidence derived from the pattern of IMF lending since the mid-1970s.
- <sup>4</sup> Claassen (1985) argued well before recent financial crises that a liquidity problem of internationally operating banks may not be handled effectively by national central banks. The division of labor between national central banks becomes "more complicated and thus less workable if the concerned central bank ... has to encounter a liquidity problem in terms of a currency other than its own. In that case, it may not possess sufficient international reserves" (Claassen 1985: 232 f.).
- <sup>5</sup> For a different view, see Fischer (1999) and Korea, Ministry of Finance and Economy (1999).

- <sup>6</sup> See also Golder (1999: 18) who pleads "for a decreasing involvement of the IMF in areas of less direct operational concern such as accounting, auditing, bankruptcy regulations as well as corporate governance".
- <sup>7</sup> For an overview, see Eichengreen (1999b). For a critical review from the perspective of international banks, see Institute of International Finance (1999).
- <sup>8</sup> See also Reisen (1999).
- <sup>9</sup> For an overview, see IMF (1999).
- <sup>10</sup> See also *The Economist* (1999).
- <sup>11</sup> For a detailed presentation of this proposal, see Nunnenkamp (1999b).

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