THE INTERNATIONAL CAPITAL MARKET AND ECONOMIC LIBERALIZATION IN LDCs

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OVERBORROWING in the course of an economic liberalization program, is a problem with which our profession has become acutely aware from the recent experience of Southern Cone countries: Argentina, Chile, and Uruguay. Chile is a very good example of an economy that liberalized seemingly correctly from 1976 to 1979. Tariffs and quotas were eliminated from foreign trade; the fiscal deficit was turned into a fiscal surplus; interest rate ceilings were removed, and bank-reserve requirements were reduced. But then overseas borrowing by the newly liberalized private sector became enormous, and swamped the economy with external debt.

However, the case of the Southern Cone in the 1970s and early 1980s is hardly very pure; in this period virtually all less developed countries overborrowed, and then got themselves into a debt crisis. This era was complicated by recycling from the oil shock on the one hand, and then what I consider to be a major breakdown in the public regulation of the risk-taking of Western commercial banks on the other. The result was gross overlending by banks in the world economy at large and to the Third World in particular.

A. *The Korean Experience of the Mid-1960s*

A neater capsule experience we could study, without these other distractions, is the Korean liberalization experience of the mid-1960s. Korea prior to that time had an export/GNP ratio of less than 3 per cent—almost all foreign exchange earnings were U.S. military counterpart or funds from USAID (United States Agency for International Development). Inflows of private foreign capital were negligible because foreign bankers considered the repressed Korean economy to be risky and unprofitable. Joan Robinson and the Cambridge group used to compare North Korea very favorably to South Korea as a successful model for economic development!

Under pressure from USAID in 1964, there was a major set of trade reforms in Korea, a unification of the currency associated with a large exchange-rate devaluation, and some liberalization of imports. But then in 1965, under the influence of my colleagues Edward Shaw and John Gurley, there was a major financial reform. The domestic capital market, which had been totally moribund, was suddenly brought back to life when interest rates were taken from very low pegs and put into very high pegs. This was accompanied by a major fiscal reform: no change in the tax law but a different director was put in charge of the tax-collection mechanism. Tax revenues doubled in the course of a year.

So these reforms were very important, and they laid the basis for the Korean success in subsequent years.

By the end of 1965 when these reforms had taken hold, and exports had begun to grow rapidly, the domestic price level was actually stable. Both the financial and foreign trade reforms were very successful. By the end of 1965, international lenders sharply changed their assessments of Korea's prospects. At the time of the major liberalization in foreign trade and finance, the profitability of the economy increases as perceived by foreign lenders and domestic borrowers. These sharp shifts in portfolio preferences are not smooth—apparently because of the great herd instinct among international bankers.

So beginning in mid-1966, a large inflow of short-term capital suddenly hit the astonished Koreans. An acute dilemma resulted for macroeconomic policy. If the Korean government simply let the exchange rate appreciate, of course that would hit Korea's nascent export industries very hard, something they found unacceptable. If the government just hung on with the fixed exchange rate, while being inundated with finance capital, it would lose control over the money base: inflation would come back, which it did. The real exchange rate would still turn against exporters as the prices of nontradables were bid up; but the change would not be so precipitate.

Once lost, price stability in Korea was never regained (although recent events in 1983–84 look more promising). In subsequent years, inflation and eventually devaluation proceeded, along with some degree of regression in their financial liberalization. The burden of foreign indebtedness was troublesome in the 1970s —although manageable in the Korean case.

B. *Market Failure in the Adjustment of International Asset Portfolios*

The question is, what should the Koreans have done in 1965, and the Chileans have done in 1977–79, when confronted with large capital inflows? Why, in a sense, did the international capital market fail in each period?

Once you undertake a successful stabilization cum liberalization program, where the profitability of the economy suddenly rises, then there is a once-and-for-all attempt by foreign lenders to get a piece of the action and increase their claims on the newly liberalized economy. This inundation with foreign capital is possible even in the case of a pure trade liberalization when there was not a major financial stabilization occurring at the same time. But if there is a major financial stabilization where you move interest rates from low pegs to high pegs as the Koreans did, or remove interest ceilings altogether in the Chilean mode, then the inflow of capital is greatly exaggerated.

So what is the nature of the market failure here? Initial expectations of future profitability turn out to be wrong. People look at the real exchange rate and interest rates immediately after the reform, and project them into the indefinite future. They look at profitability myopically as individual lenders and borrowers, not taking into account what will happen if they all transfer foreign capital

simultaneously. What seems profitable for any one of them, will become less profitable within a few years.

You might say that this is irrational. People should be able to solve this system, and understand that the real exchange rate will turn against exporters once capital inflows increase at the macroeconomic level. But these were once-in-a-lifetime experiences for the Koreans in the 1960s and Chileans in the 1970s, and for most of the international lenders in each episode. Individuals cannot easily see through what will happen to the general equilibrium of the economy in the future.

This problem is made more acute insofar as the financial flow into LDCs, even though it may be financing longer-term projects, is usually very short term. When the real exchange rate starts to turn adversely against exporters, at that juncture you might have to repay the short-term finance. So, if this myopia exists in the international capital market, there is a very good case for doing what the Chilean government tried to do, namely, keep out short-term funds while allowing longer term borrowing. However, the Chilean government was not stringent enough in preventing the accumulation of short-run indebtedness by Chile's private sector.

In addition, we know that in any *purely private* capital market each individual borrower faces an upward sloping supply curve for finance. That is not really a distortion. The more that is borrowed, the riskier the loan gets at the margin. The upward sloping supply curve imposed by private lenders accurately reflects the increasing riskiness of the private borrower as he increases his exposure.

Consider instead, the world of the 1970s and 1980s where governments guarantee all credit flows. The host government in the borrowing country guarantees private foreign credits—either officially or unofficially. In the lending countries we have official export-import banks and deposit insurance for the commercial banks. Consequently, the normally upward sloping supply curve for finance did not face *individual* private borrowers in the Third World in the 1970s. Because of the government guarantees that were involved, they could then borrow at a virtually flat rate of interest.

If you combine this microeconomic distortion with the macroeconomic myopia, capital inflows by private borrowers are further magnified at the time the liberalization occurs. Overborrowing in the Southern Cone in the 1970s was an order of magnitude worse than what happened to Korea in the mid-1960s: the (impossible) attempt to absorb large amounts of foreign capital very quickly.

C. *Encouraging Liberalization without Absorbing Foreign Capital*

Where do we come out on this for policy? At the very minimum, official agencies such as the World Bank or the International Monetary Fund should *not* try to buy a trade liberalization by giving aid. Never try to *bribe* someone into liberalizing, because you are injecting capital at the time the liberalization occurs, and you make that liberalization much harder to sustain. The abortive efforts to liberalize trade in Pakistan and India in the 1950s and 1960s, where

aid was sometimes used as a lever to induce governments in the subcontinent to expand the flow of imports into the economy, may have indeed failed for this reason. If you allow this capital to come in, the real exchange rate turns against exporters and firms competing with imports, and makes it unduly hard for them to adjust to the removal of protection.

As far as possible, trade liberalization and financial stabilization should be a "bootstrap" operation that a country does for itself—possibly with technical assistance from agencies such as the World Bank. Exports and imports should remain in normal balance. However, a big injection of official capital at the time the liberalization occurs finances an unusual bulge in imports, and throws out the wrong price signals in private markets. Because private lenders often magnify any such official injection by the World Bank or IMF, free inflows of foreign financial capital should only be allowed at the tail end of an otherwise successful program of liberalization. During liberalization stringent controls on suddenly increased inflows of short-term capital are warranted.

In order to reduce the apparent need for external aid to begin liberalizing, it is quite helpful if the liberalizing economy is running a fiscal surplus rather than a deficit. I realize the Chilean experiment ultimately broke down, as all Latin American economies got themselves into trouble in the early 1980s, even though Chilean fiscal policy was sound. However, there is a strong case for not requiring a big fiscal prop from some outside lender.

The need to bribe a country into opening its trade accounts often occurs because they have an uncovered fiscal deficit; the international agency covers it for them if they agree to liberalize. This is a bad combination if any liberalization is to be sustained for more than a few months or a year. Fiscal policy should be brought under control before or along with, the move to liberalize foreign trade and the *domestic* capital market. Liberalization of the capital account of the balance of payments then comes last.

D. *Reforming the International Capital Market*

Apart from these macroeconomic control problems within individual LDCs, there is the failure of the institutions of the international capital market per se. Government guarantees—both in the industrial economies which do the lending and in the borrowing countries—have created massive incentives to misallocate capital. How can one succinctly characterize the distortions involved?

(1) Neither private lenders in industrial countries, nor private borrowers in LDCs, see normal commercial risks. Good or bad projects get the same government credit guarantees; and

(2) Commercial banks in the industrial economies have been unregulated in their risk-taking in international lending relative to much tighter regulations governing their domestic lending.

This inadvertent regulatory loophole was, in part, associated with the development of the Eurocurrency market in the late 1960s. Moreover, public agencies in the industrial countries, such as the U.S. Federal Deposit Insurance Corpo-

ration, gives commercial banks undue incentive to take risks in the *unregulated* part of their loan portfolios without worrying about a run on their deposits. Consequently, commercial banks have completely preempted the inherently risky lending to LDCs. The dominance of commercial banks in the international capital market is an artifact of unbalanced regulatory policies in the industrial countries.

(3) Mainly, as a consequence of (1) and (2), there has been virtually no development of a "normal" long-term primary securities market: where borrowers in LDCs sell bonds or equities to individual lenders in the wealthier economies.

Clearly, the private international capital market today looks very different from what it was prior to World War I. Then, the building of American or Argentinian railways was financed largely by the issue of long-term sterling bonds in London. Tea or rubber plantations were financed by the floatation of equities. A major bankruptcy in, say, a railway project, would put the bond holders out of pocket without jeopardizing the solvency of any major bank or the monetary system. Commercial banks were confined to discounting short-term trade bills associated with identifiable inventories or goods in transit. Merchant banks did the (risky) underwriting of bonds or equity floatations, and on occasion provided risk capital directly to overseas investment projects.

Although sounding anachronistic, I think that the international market in private financial capital in the 1980s should be encouraged to evolve back to something closer to its late nineteenth century format. This would happen naturally, of course, if official guarantees of private credits were phased out, deposit insurance was circumscribed, and the regulation of the commercial banks' international and domestic activities were brought into better balance with respect to loan-loss provisions, capital restraints on lending heavily to one borrower (or guarantor), and so on. Commercial banks, which are the custodians of the national money supply and the international payments mechanism, should not be in the business of long-term, highly risky, lending.

Unlike what actually existed in the nineteenth century, however, official agencies such as the World Bank or IMF would still play an important role for those countries who remained poor credit risks if and when the private flows of international finance was so liberalized. The World Bank's technical assistance and long-term project support for poor countries would remain invaluable, as would IMF's role as an international crisis manager on a shorter-term basis. Both would nicely complement the evolution of an active long-term international market in bonds and equities—from which deposit-taking commercial banks were largely absent.

Of course, getting commercial banks out of the long-term international capital market cannot be accomplished any time soon. The existing debt-overhang in less developed countries is so large that only the banks have the capability—and strong enough vested interest—refinancing it. In 1984, the commercial banks must keep lending to prevent widespread defaults in LDCs and the breakdown of their foreign trade.

That said, one need not implicitly assume that the commercial banks should dominate the international capital market in the 1990s as they did in the 1970s. To avoid recurrence of another cycle of overlending by banks—similar to that of the 1970s—major changes in bank regulations are long overdue.