

## Chapter

# Capital Account Liberalization in Emerging Markets: Lessons from the Asian Currency Crisis

Shunji KARIKOMI<sup>1</sup>

Visiting Research Fellow  
Institute of Developing Economies,  
and  
Research Officer  
Fuji Research Institute

## 1. Introduction

Since its inception in 1989, Asia Pacific Economic Cooperation (APEC) has developed against the backdrop of the robust economic growth of member economies and deepening economic interdependence within the Asia Pacific region. However, the Asian currency crisis that broke out in 1997 and the increased uncertainty throughout much of the region that followed has forced APEC to face some difficult questions. APEC has not been able to, and perhaps never can, fully cope with every situation, in particular one like the recent crisis. Hence, some people are now questioning APEC's *raison d'être*. In light of the present situation we should look back on the *raison d'être* of APEC and the Bogor Declaration of 1994 that called for "the liberalization and facilitation of trade and investment in the APEC region." The region is characterized above all by diversity—economies of various levels of development, earnings and factor endowment participate in the regional economy. APEC as a whole has benefited from the merits obtained from this diversity by promoting liberalization of *trade and investment* in the region.

However, can the same be said with respect to the liberalization of finance and

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<sup>1</sup> The interpretations and opinions expressed in this paper are my own and do not reflect the official position of the institutions with which I am associated, namely the Institute of Developing Economies and Fuji Research Institute.

capital? The flow of capital throughout the APEC area, East Asia in particular, increased considerably after the second half of the 1980s. Liberalization of capital flows lured money into the region from the developed countries, where investors were seeking higher rates of return for their money. Consequently, high growth in many APEC economies became possible without capital becoming scarce, even if domestic funds were insufficient and a country was running a current account deficit. APEC was considered to have enjoyed the benefits from the diversity in the region with respect to capital movements because such flows helped achieve an efficient allocation of resources.

However, after the Asia currency crisis in 1997, it became clear that the economies that had liberalized capital markets the earliest and the furthest were the hardest hit by the crisis. As a result, skepticism has spread in the emerging economies about opening up their financial and capital markets to the outside world. It is necessary, therefore, to examine how the emerging countries should consider the issue of financial and capital liberalization. This study considers this question based on an examination of the Asian currency crisis, in particular the events in the so-called ASEAN 4 countries—Indonesia, Malaysia, the Philippines and Thailand.

## **2. Asian Currency Crisis as a “21<sup>st</sup> Century-Type” Currency Crisis**

### **2.1. The development of the Asian currency crisis**

The Asian currency crisis was sparked by the collapse of the Thai baht in July 1997.<sup>2</sup> The crisis then spread throughout Asia, inducing financial and economic crises in the process.<sup>3</sup> The exchange rate volatility, financial instability and depression of

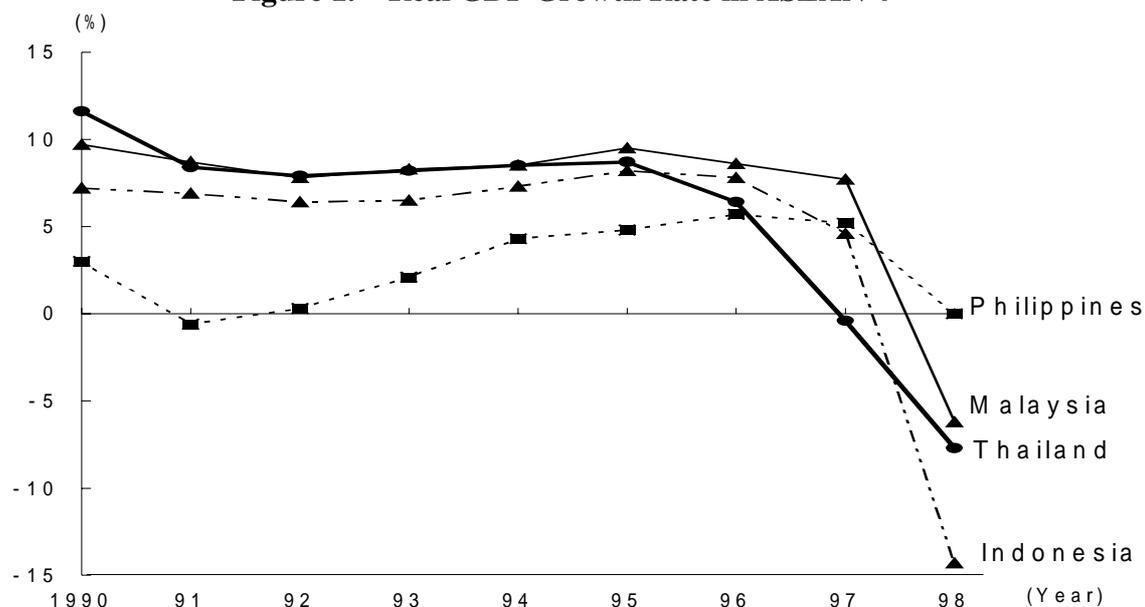
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<sup>2</sup> The crisis had a serious impact on the entire world economy, not just the Asian economies. Although the global consequences of the crisis deserve careful attention, this paper concentrates on the Asian crisis. For a detailed study of the global effects of the Asian currency crisis refer to Takii and Fukushima(1998).

<sup>3</sup> In this paper, the terms “currency crisis,” “financial crisis,” and “economic crisis” are used as follows. First, a currency crisis means that the value of a currency falls drastically in spite of a government’s effort to prevent the fall through such means as intervention in exchange markets. Second, a financial crisis is a situation where the abrupt and sharp decline in the value of a currency is connected to the run on banks, or widespread bank failures, and the financial system essentially stops functioning. Third, an economic crisis

domestic consumption brought on by the crisis have led to negative or sharply lower growth rates in many East Asian countries (Figure 1). Such economic malaise has sometimes resulted in social hardships like falls in real income and higher unemployment.

**Figure 1. Real GDP Growth Rate in ASEAN 4**



Note: The figures for 1998 are forecast by IDE.

Source: IDE, *1999 Economic Outlook for East Asia*.

In Indonesia, in particular, the economic crisis was closely linked to civil rebellion and played a large role in the resignation of President Suharto. Moreover, this crisis was not limited only to East Asia. As the currency crisis evolved into an economic crisis, it affected the entire world economy through a decrease in trade volumes and a sharp fall in primary commodity prices. The crisis spread to other emerging markets such as Russia and Central America in 1998, and Brazil in 1999. We have yet to see any clear indication that the crisis has completely run its course.

It is beyond the scope of this paper to look at all aspects of the global spread of the crisis, but the roots of the crisis can be studied by considering the development of the currency crisis in East Asia. This process can be divided into three stages: 1) the crisis in Thailand, 2) the spread of the crisis throughout the whole of East Asia, and 3) the

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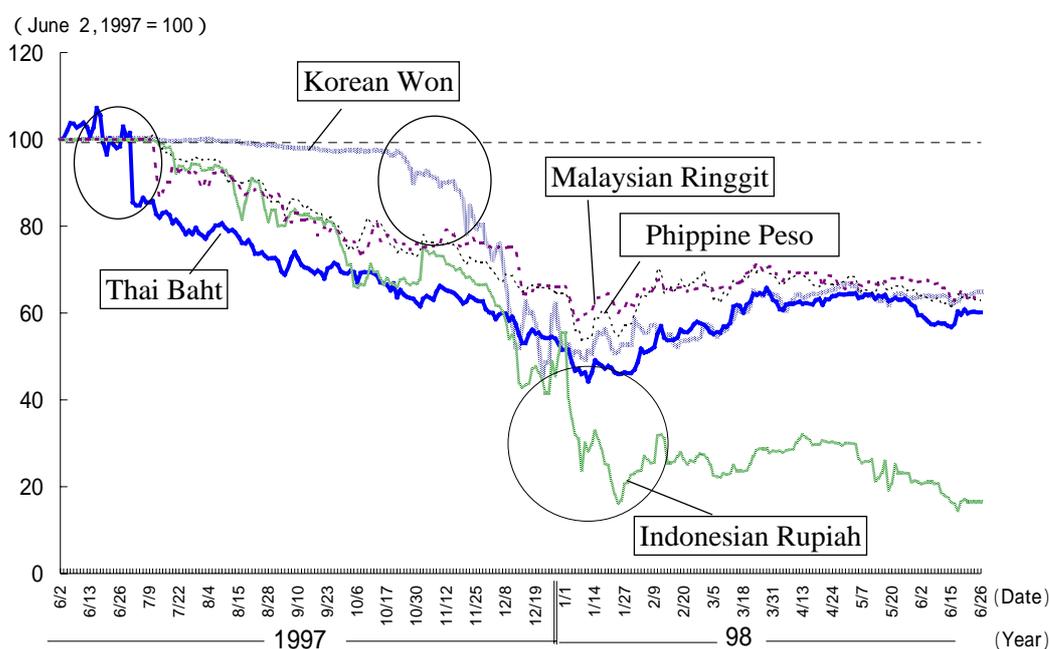
means a crisis-situation covering the whole economy, such as rapid depression of economic growth, etc., with a monetary crisis caused by a currency crisis. (*97/98 Asian economy crisis*, p.1, the Institute of

intensification of the crisis in Korea and Indonesia.<sup>4</sup>

### ***Break out of the currency crisis in Thailand***

From the middle of 1996, there was concern that an overheated Thai economy was heading towards danger because of large current account deficits along with falling stock and real estate prices. Consequently, the Thai baht frequently faced selling pressure from the beginning of 1997. Thai monetary authorities responded to the sell-off of the baht by raising short-term interest rates and intervening in the exchange markets. Speculation on the Thai baht intensified from the beginning of May 1997 and the Thai authorities took measures to separate the onshore and offshore markets, raised interest rates again and endeavored to defend the currency as much as possible. However, after a substantial exhaustion of foreign reserves, the monetary authorities

**Figure 2. Exchange Rates**



Source: Data stream

announced on July 2 that they were unable to maintain the baht's *de facto* peg to the US

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Developing Economies, topic report).

<sup>4</sup> While Korea is mentioned here for comparative purposes, the main focus of this paper is the so-called ASEAN 4 countries—Indonesia, Malaysia the Philippines and Thailand. Most of the figures and examples

dollar and would shift the exchange regime to a managed float.<sup>5</sup> The baht plunged suddenly, declining by about 40 percent by January 1998 when it reached its lowest level against the dollar (Figure 2).

### *Contagion to other parts of East Asia*

In the span of a few weeks, the confusion in currency and financial markets in Thailand quickly spread to Indonesia, Malaysia, the Philippines and other Asian countries which were linking their currencies to the dollar. The currencies of Indonesia, Malaysia and the Philippines weakened and share prices dropped. The Philippines was not able to defend the peso by raising interest rates and intervening in the exchange markets, so the government was forced to let the peso float on July 11. Simultaneously, restrictions on futures trading by nonresidents were strengthened. In Indonesia, the government widened the band in which the rupiah was allowed to trade on July 11 and let the currency float on August 14.

The impact of the weaker currencies in the ASEAN countries hit the Asia NIES (Taiwan, Hong Kong, Korea and Singapore) within a few months and spread to encompass the whole of East Asia. The Taiwan dollar began to depreciate at the end of October. In Hong Kong, since the monetary authorities raised interest rates to defend the Hong Kong dollar, stock prices plummeted. Consequently, the exchange rates of ASEAN countries that appeared not to have been affected at first by the crisis were also exposed to downward pressure. Moreover, the impact of the crisis on even an internationally acclaimed financial center like Hong Kong led to increased instability in world stock markets, including a sharp drop in stock prices in New York. Institutional buyers with international interests became sensitive to the risks of investment in emerging markets after the currency crisis in Thailand and were inclined to pull their money out quickly to avoid losses. Korea, in particular, directly suffered the fate of such sensitivity.

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used in this paper refer to these four countries.

<sup>5</sup> The Bank of Thailand tried to defend the baht by selling dollars in the future exchange markets. However, a substantial amount of foreign currency had dried up due to intense speculation on the baht at the beginning of May 1997. The outstanding balance of dollar futures was \$23.4 billion, compared to \$32.4 billion of foreign reserves at the end of June 1997.

***Worsening of the crisis in Korea and Indonesia***

Starting with the bankruptcy of a leading South Korean steel maker, Hanbo Steel Corp., at the beginning of 1997, a succession of large-scale bankruptcies shook the Korean economy and even the Kia Group (the eighth largest *chaebol* or business conglomerate) failed in July of that year. Banks and other financial institutions that were lending financial support to these big businesses in turn suffered from a succession of corporate failures. Consequently, when it became clear that the rollover of short-term foreign currency borrowing by Korean banks was becoming difficult at the end of October, Korea's credit rating quickly depreciated. Money flowed out of the country, driving down the Korean won and stock prices. On November 21, the Korean government was forced to ask for financial assistance from the International Monetary Fund (IMF).

Korea agreed to accept the IMF's economic adjustment program on December 3, but this was not enough to stop the won from falling due to the uncertainty that had arisen over the coming presidential elections. After the election of a new president in December, however, a new reform program was made in the middle of that month. Moreover, at the end of December, an agreement was reached between Korean authorities and private banks from Japan, the US, and Europe to roll over short-term loans to Korea. These responses helped stop the slide of the won and the currency began to recover in the beginning of 1998.

Entering 1998, the exchange rate of every country in East Asia began to recover, except the Indonesian rupiah, which continued to suffer downward pressure. While the condition of its foreign reserves was not that serious, Indonesia had requested support from the IMF in October 1997 to prevent its foreign reserves' situation from getting any worse. At first, the depreciation of the rupiah was relative to other ASEAN currencies. However, subsequent government policies damaged market confidence and overseas investors quickly began to pull capital out of the country.<sup>6</sup> In addition, increased public dissatisfaction with President Suharto caused a flight of domestic

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<sup>6</sup> For example, the budget proposal announced in January was contrary to the demands of the IMF, which called for spending cuts and did not include measures to address the debt problems as specified by the IMF.

capital.<sup>7</sup> At its lowest point, the Indonesia rupiah depreciated an astounding 80 percent compared to the rate before the currency crisis (Figure 2).

One special characteristic of the Asian crisis is the way it began in Thailand and spread throughout Asia so quickly with such devastating effects in what is often called contagion. In the case of Thailand, while few analysts were able to predict the severity and timing of the crisis itself, symptoms like declining stock prices and increasing pressure on the baht indicated that the time was ripe for an adjustment. It appears that at least some economists were aware of the problems in Thailand and the possibility of a crisis.<sup>8</sup> However, no one expected the crisis in Thailand to spread to other ASEAN 4 economies (Indonesia, Malaysia and the Philippines) and to some extent the whole of East Asia. Other ASEAN countries appeared to have had healthier economic fundamentals than Thailand.

The unexpected spread of the crisis is one reason why it can be considered a new type of currency crisis—or a so-called “21<sup>st</sup> century-type” currency crisis. If we are to draw any lessons for the future from the Asia crisis, it is vital to analyze and consider the process after the crisis occurred—the way it which it spread to other economies—and not just the conditions that created the crisis in the first place.

## 2.2. The mechanism of crisis contagion

A currency crisis develops when it becomes difficult for a monetary authority in a country that has adopted a fixed or tightly managed exchange rate system to maintain the currency's exchange rate near at a desired level. If the country suffers from a large current account deficit and if the financing of that deficit becomes, or even appears to become, difficult for some reason, speculation about a devaluation of that currency

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<sup>7</sup> Widespread riots were sparked by protests to hikes in public utility rates and the unrest spread to a national scale in May. The riots were particularly violent in Jakarta where the shops and houses of ethnic Chinese were burnt and people were shot. The instability developed into a situation where the national army was called in and led to the resignation of President Suharto.

<sup>8</sup> The Japanese Economic Planning Agency analyzed the situation in Thailand as follows: “Because the dependence to short-term funds is rising, the risk of a sudden reversal of capital flows is also on the increase. If a shock like increasing political stability, fears of a devaluation, or a default on debt occurs and the flow of capital reverses suddenly, the radical fluctuation of exchange or interest rates would have a considerable impact on the real economy. In the worst possible instance could result in a currency crisis.” *Asia Economy 1997*, Economic Planning Agency(Japan), May 1997.

inescapable spreads, leading to a sell-off of the currency. The selling pressure of the currency is often unbearable because the means to defend the currency—higher interest rates or government buying of its own currency in foreign exchange markets—often have devastating effects on a country's domestic economy and foreign exchange reserves. Consequently, management of its currency becomes impossible and the system crashes, followed by a currency realignment and, in numerous cases, an unavoidable abandonment of fixed exchange rates.

In a conventional currency crisis, the inability to finance a shortfall in the current account becomes difficult because of the enlargement of that deficit. In the case of Thailand, the current account deficit had expanded to a level that was difficult, if not impossible, to finance (7.9 percent of GDP in 1996). However, in other ASEAN countries and in Korea, the shortfall in the current account as a percentage of GDP was not on a rising trend. Moreover, the deficits—no more than 5 percent of GDP—were not as great as in Thailand.

This suggests that, for South Korea and for the ASEAN countries other than Thailand, the currency crisis was not necessarily caused by unsustainable current account deficits. Rather, the crisis was triggered when a sharp reduction of capital inflows or a rapid outflow of capital made it difficult to maintain the current account deficit. Although huge amounts of private-sector capital flowed into the Asian countries from the second half of the 1980s, the flows reversed in 1997 and the capital rushed out from the region. According to the Institute of International Finance (IIF), in the five nations (Thailand, Indonesia, Malaysia, Philippines and Korea) that suffered the most from the Asian crisis, the net inflow of private-sector capital in 1996 was \$93.8, but shifted to an outflow of \$6 billion in 1997 and an estimated outflow of \$24.6 billion in 1998 (Table 1). In other words, from 1996 to 1998, a total of \$120 billion in funds reversed flow in these five countries.

While the conventional type of currency crisis can be called a “current account” crisis stemming from problems in the current account, the currency crisis of ASEAN countries except Thailand can be called a “capital account” crisis as it originated due to problems in their capital accounts. Theoretically, in a free financial market, the amount of capital that flows into a country will be relative to the profitability of the investments

**Table 1. Five Asian Economies : External Financing**

	(billions of dollars)				
	1994	1995	1996	1997 <i>e</i>	1998 <i>f</i>
<b><i>Credit account balance</i></b>	-24.5	-41.0	-54.5	-26.3	59.9
<b><i>External financing, net</i></b>	45.2	86.3	91.2	25.0	3.7
<i>Private Flows</i>	37.9	83.8	93.8	-6.0	-24.6
<i>Equity Investment, net</i>	12.1	15.9	17.4	-0.2	8.0
<i>Direct Equity</i>	4.7	4.9	5.8	6.5	6.9
<i>Portfolio Equity</i>	7.4	11.0	11.6	-6.8	1.1
<i>Private Creditors, net</i>	25.8	67.9	76.4	-5.7	-32.6
<i>Commercial Banks</i>	23.4	58.0	58.3	-29.0	-30.5
<i>Nonbank Private Creditors</i>	2.4	9.9	18.1	23.3	-2.1
<i>Official Flows</i>	7.3	2.5	-2.6	30.9	28.3
<i>Int'l Financing Institutions</i>	-0.4	-0.3	-2.0	22.6	22.4
<i>Bilateral Creditors</i>	7.7	2.9	-0.6	8.4	5.9
<i>Resident Lending/other, net</i>	-15.2	-31.3	-17.4	-29.4	-23.2
<i>Foreign Currency Reserves</i>	-5.4	-14.0	-19.3	30.7	-40.4
<b><i>Memo: Short-term Credits, net</i></b>	7.3	45.1	36.0	-36.6	-49.9

Note: 1. Thailand, Indonesia, Malaysia, Philippines and Korea.

2. e= estimate, f = IIF forecast

3. " - " indicates an increase. Excluding gold.

Source: Institute of International Finance, *Capital flows to emerging market economies. Sep., 1998.*

in that country. Because that profitability is unlikely to change in an instant, a sudden capital flight should not happen.<sup>9</sup> However, capital flows are sometimes influenced merely by investors' evaluation of the situation (optimism or pessimism). Once a crisis arises in one country, investors often reappraise investment in other countries that are similar in economic structure or in the same region. In the Asian crisis, for example, investors began to question whether the situation in Indonesia was all right considering what happened in Thailand. Consequently, even if there is no great change in the economic fundamentals of a country, investors become more sensitive to risks and will shift their money to safer investments. This is often referred to as a "flight to quality" and this phenomenon occurred extensively in the currency crisis that started in Thailand.

Much of this sudden pullout from Asia stems from the fact that investors did not fully grasp information about the region's economies. In a situation of imperfect information, the degree to which an investor reacts to other investors' actions is often exaggerated. For example, if stock prices fall, a fund manager may accelerate sales in

order to cope with cancellation of contracts. Because other investors also rush to sell in response to the former selling, the stock market will decline much more. In the case of international investment, there is a tendency to look at portfolio investment as a benchmark of most investment. When an appraisal of a fund manager changes, it often accelerates a herd mentality and affects the loans and investments of the concerned area through the stock market. Moreover, in portfolio investment, detailed information of each country's performance for investment choices is not always considered important, but rather an entire region is considered a monolithic whole. The emerging market funds, the Asia fund, the ASEAN fund and other such mutual funds created in European and American countries are typical examples of this trend. When the prospects look bright these funds demonstrate 'band wagoning' or 'herding' tendencies and follow other funds into the emerging markets, but also rush out of the markets just as easily when they feel the situation is getting worse.

### **2.3. The factors behind contagion**

In order for the contagion to spread to many countries, there should be a common factor in the background of the crisis. What was that factor in Asia? In retrospect, we now know that it was a reflection of the levels of the external debt of East Asian countries. The private sector had amassed huge external debts before the crisis and the risk of default based mainly on the private sector debt developed into the currency crisis.<sup>10</sup> Looking at the levels of the external debt of East Asian countries (the amount of external-debt vis-à-vis the value of exports), they were high in Thailand, Indonesia and Korea (Table 2). Moreover, in these countries, short-term capital inflows continued and the share of the current account financed by short-term capital was increasing.<sup>11</sup>

Indonesia was considered to have had fairly solid economic fundamentals before the crisis, but was a typical country influenced by Thailand's currency crisis. Although

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<sup>9</sup> Komine (1998), IMF (1998).

<sup>10</sup> The accumulated-debt problems of Central America in the 1980s and the Mexico crisis in 1994 were a result of government debt problems.

<sup>11</sup> Such a capital inflow structure is not a problem as long as capital is flowing in. However, when short-term funds begin to rapidly flow out, the authorities have great difficulty trying to manage foreign currency debt. The greater the dependence on short-term funds to finance the current account, the weaker a financial system can be said to be.

Indonesia had a current account deficit, it was not exceptionally high (3.4 percent of GDP in 1996). Moreover, the Indonesian rupiah had depreciated against the US dollar at a rate of 2-5 percent per year throughout the 1990s until the crisis. This corresponded to the difference of price levels between Indonesia and other foreign countries. Exchange rate adjustments had been made to reflect the real exchange rate and the rupiah was not necessarily overvalued. However, the external private debt of Indonesia, especially the levels of a short-term debt, was high (Table 2). Once the crisis occurred, the devaluation of the Indonesian rupiah caused an expansion of external debt when dominated in local

**Table 2. External Debt in East Asian Countries(1996)**

	Current account/ GDP	Total external debt/ export	Total external debt/ GDP	Short-term debt/ total debt
Thailand	-7.9	120.5	50.1	49.9
Indonesia	-3.4	221.4	56.7	55.3
Malaysia	-4.9	42.4	40.1	11.8
Philippines	-4.2	97.6	48.7	18.9
Korea	-4.9	87.8	23.2	42.6
Singapore	15.5	6.5	10.7	1.3
Hong Kong	N. A.	16.5	21.2	7.2
Taiwan	4.0	20.8	10.1	14.2
China	0.9	71.3	15.6	14.1

Note: year-end.

Source: ADB, *Key indicators* (1998), World Bank, *Global Development Finance* (1998), various issues.

currency. This led investors to pull out funds due to doubts about borrowers' ability to repay their loans. In addition, new selling pressure on the rupiah developed because of demand for dollars in order to hedge against foreign exchange risk, further depleting foreign currency reserves. Finally, economic fundamentals that were fairly sound before the crisis suffered from the burden of external debt that increased because of the rapid devaluation of the currency.

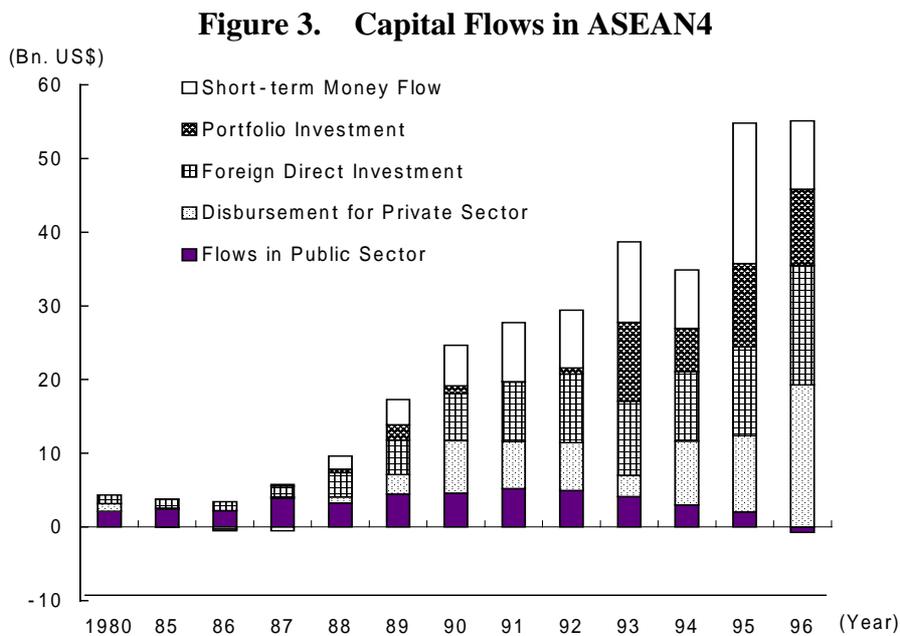
It was natural that the financial institutions and investors in industrialized countries withdrew their capital from Asia when they thought ill at ease about the future condition of the Asian economies. Massive capital outflows from the region, however, would not have occurred unless massive capital had flowed into the region in the first

place. It is necessary, therefore, in the next section to verify the reasons behind these massive capital inflows.

### 3. The Mechanism of External Debt Accumulation

#### 3.1. Capital flows into the ASEAN 4 countries

The most recent complete data showing the flow of net capital into the ASEAN 4 countries (Indonesia, Malaysia, the Philippines and Thailand) can be found in the World Bank's *Global Development Finance* figures for 1996 (Figure 3).

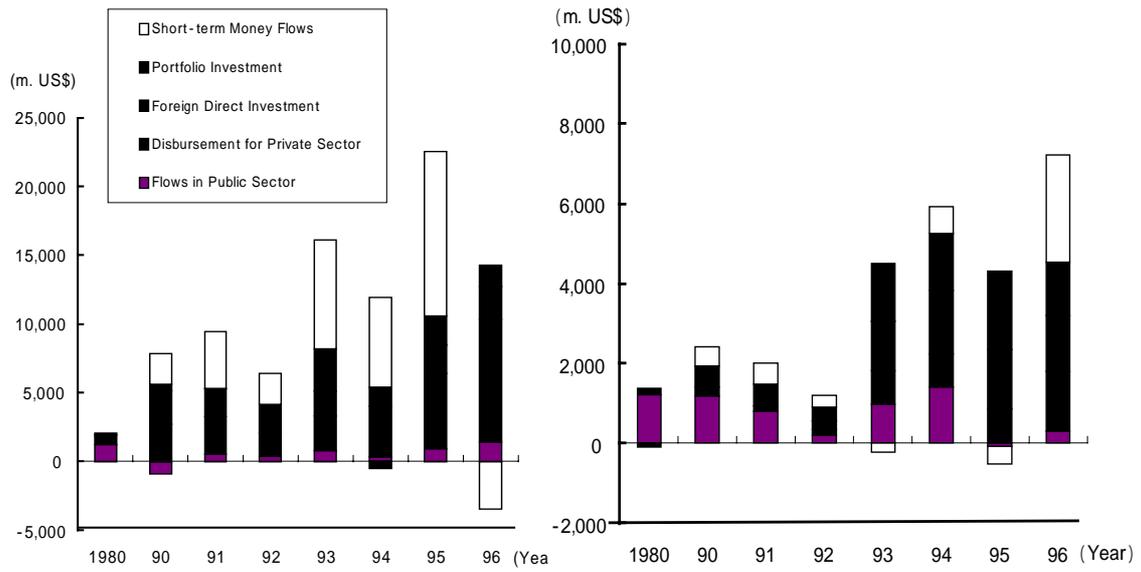


Source: World Bank, *Global Development Finance*.

**Figure 4. Capital Flows in ASEAN4 by Country**

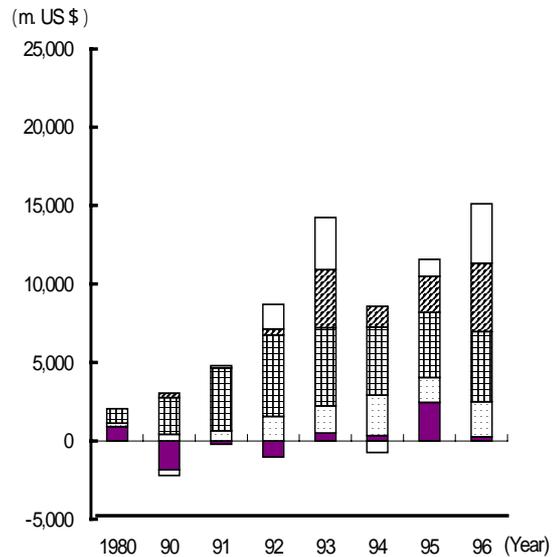
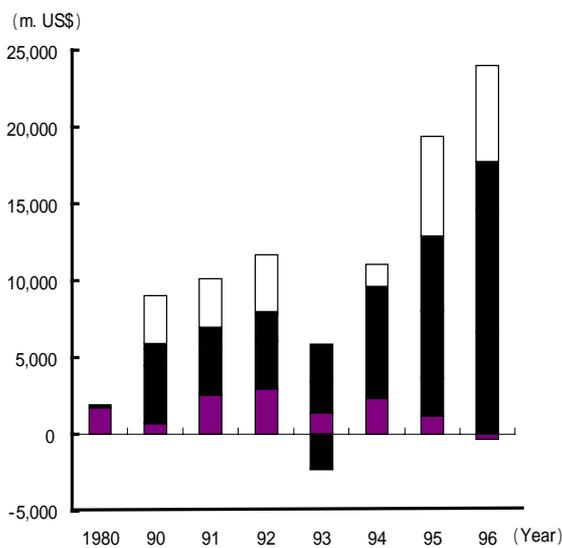
[ Thailand ]

[ Philippines ]



[ Indonesia ]

[ Malaysia ]



Source: World Bank, *Global Development Finance*.

Looking at capital flows into these countries, loans to the public sector accounted for most flows in the 1980s. However, capital flows to the private sector, mainly in the form of foreign direct investment (FDI) increased rapidly after the second half of the 1980s. Consequently, the sudden expansion of inward capital flows in 1996 (\$55

billion) was an increase of about 11 times the value of 1985 (\$5 billion). Looking at the composition of capital flows into the private sector, FDI occupied the largest share. FDI had been flowing in smoothly as a whole in and after 1988. However, FDI inflows did not necessarily increase at the same stage for each of the ASEAN 4 countries. At first, FDI increased into Thailand and Malaysia, then shifted to Indonesia and the Philippines from the early- to mid-1990s (Figure 4).

At the same time that FDI increased, capital inflows into the private sector via banking loans also increased. Although government guarantees were required for many of the loans to the private sector until the 1980s, private loans without government guarantees began increasing in the 1990s because of, among other factors, the increased creditworthiness of Asian business enterprises. In addition, capital flows to the public sector began to decrease after the middle of the 1990s for two reasons: 1) because more funds were flowing to the private sector, the government did not need any new external financing; and 2) governments were starting to pay down their existing debt.

From 1993, portfolio investment (investment in equities or bonds) also increased, and the type of capital inflows diversified. As a result of greater lending to the private sector and a diversification of capital flows, the inflows of short-term funds increased notably in the 1990s, especially between 1995 and 1996. Figure 4 shows the capital inflow trends in the ASEAN 4 countries. The characteristics of those flows are as follows:

### ***Thailand***

Looking at the transition of capital flows into Thailand, FDI levels remained almost the same throughout the 1990s, while other capital inflows increased. Hence, the share of FDI as a share of total capital inflow decreased. In the 1990s, the main inflow came via the banking sector. Inflows of short-term capital increased remarkably after 1993 and the majority of this was capital inflow through the banking sector. Capital inflows as a result of portfolio investment were not that great because bond markets were underdeveloped and equity investment by non-residents was restricted in Thailand.

***Malaysia***

Capital flows into Malaysia were not as extensive as in Thailand or Indonesia. Throughout the 1990s, FDI's share of capital flowing into the country was high. Capital inflow via the banking sector was relatively small because the government was concerned about an increase in external debt. Between 1990 and 1992 there was a net outflow of capital in the public sector because the government paid off external debt, using earnings raised in the privatization of state-owned enterprises.

***Indonesia***

In Thailand, Malaysia and the Philippines, the main source of capital inflow into the private sector in each country was FDI at first, and then through the banking sector and portfolio investment. In Indonesia, on the other hand, FDI inflows increased in earnest only in 1995 and 1996. Until that time, the main capital inflow was through the banking sector. Portfolio investment increased after 1993 and short-term capital inflows sharply increased between 1995 and 1996.

***The Philippines***

Capital flows into the Philippines were smaller than in Thailand, Malaysia and Indonesia because of external debt problems and political unrest until 1993. Capital inflows went mainly to the public sector in the early 1990s. After 1993 when Fidel Ramos was inaugurated as President, all types of capital flows (FDI, bank lending and portfolio investment) into the Philippines began to increase.

The increased flows of capital into the ASEAN 4 countries came mainly from the financial institutions and investors of developed countries. Rapid economic growth in Asia led to flourishing demands for capital to meet the needs of private enterprises and large-scale infrastructure projects and the ASEAN 4 countries were able to raise funds because of higher credit standings due to their good economic performance. According to country-risk assessments released by research institutes, Thailand and Malaysia, in particular, were given credit ratings near those of the Asian NIES (Hong Kong,

Singapore, South Korea and Taiwan).

In the first half of the 1990s, the financial institutions and investors of developed countries were less interested in investing in developed markets because of lower returns in those countries. Investments into the ASEAN countries, however, were expected to offer higher rates of return compared with the developed countries, so investors from the developed countries were eager to provide funds for the regions, flourishing capital requirements through loans and investments. In addition, the ASEAN countries were eager to promote the inflow of foreign capital to meet their capital requirements, so they made the necessary policy changes to create an environment in which capital could easily flow into their economies.

### **3.2. Capital liberalization and the increase in external debt**

After the 1980s, financial liberalization (abolition of credit rationing, liberalization of business activities, liberalization of the banking sector including foreign capital injections, stock market reform, etc.) was carried out in the ASEAN 4 countries. In the 1990s, while the extent of liberalization varied, financial systems were opened further to the outside and the ASEAN 4 countries also advanced liberalization of capital transactions. For instance, the ASEAN 4 countries had removed exchange controls on current account transactions by the mid-1990s and had all assumed IMF Article VIII status by that time.<sup>12</sup>

Capital transactions were liberalized because it was thought that, in the process of export-oriented industrialization, such restrictions were becoming a constraint on economic development. As mentioned above, there were huge capital requirements for infrastructure demand and private capital investment, as well as an urgent need to build a corresponding system to meet those requirements. The ASEAN 4 countries increased the channels in which capital could flow into their economies. In a shift away from government borrowing, private borrowing and portfolio investment from overseas was expanded. At the same time, domestic financial systems were liberalized to allow them

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<sup>12</sup> The IMF stresses that full currency convertibility is one of the necessary conditions to promote world trade. When a country agrees to accept the conditions of the IMF's Article VIII, it agrees to place no discriminatory restrictions on its currency. The ASEAN countries ratified the Article VIII in the following

to function as a conduit for foreign funds into the domestic financial system.

Because the introduction of capital from overseas became possible, creditworthy businesses increased fund raising by issuing syndicated loans or eurobonds. Funding from international financial markets increased more than threefold from \$15 billion in 1985 to \$50 billion in 1996. Although borrowing in ASEAN countries was mainly from syndicated loans in the 1980s, the issuance of bonds increased after 1993. However, the domestic companies that could raise funds in international financial markets were limited to the ones that had high credit ratings or government guarantees, and the number of such companies was not great. Since it was hard for many domestic companies to borrow from overseas directly, they raised funds from overseas through banks, both foreign and domestic, located in their respective countries.<sup>13</sup>

In the investigation of capital flows into the ASEAN 4 countries, we should consider two points: 1) how the ASEAN 4 countries promoted capital liberalization, and 2) what type of capital flowed into these countries.

#### ***Thailand: Liberalization of capital flows and constant interest rate differentials***

Thailand had very strict foreign exchange controls until the 1980s. After Thailand accepted the obligations of the IMF's Article VIII in 1990, the government hastened capital liberalization by relaxing restrictions on foreign exchange controls from 1990 to 1992. In 1990, Thailand freed foreign exchange trade related to the current account and then eased foreign exchange trade related to the capital account drastically from 1991 to 1992. This series of deregulatory moves aimed mainly to promote trade and investment by increasing the free movement of capital. The most drastic deregulations took place in April 1991 and liberalization in principle was made on: 1) residents' foreign currency deposits; 2) domestic banks' foreign currency lending (whether resident or non-resident); and 3) residents' external investments. In addition, residents were able to borrow foreign currency funds from non-residents (i.e. offshore loans) easier. At that time, domestic companies, mainly large firms, raised funds dominated in US dollars

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years: Malaysia (1968), Indonesia (1988), Thailand (1990) and the Philippines (1995).

<sup>13</sup> There is an asymmetry of information that exists between the lender and borrower before emerging countries mature, so the emerging countries are bound to be dependent on banks with the ability to

aggressively from money markets in Singapore or Hong Kong, since the cost of funds dominated in US dollars was lower than baht loans.

The establishment of the Bangkok International Banking Facilities (BIBF) in 1992 allowed domestic companies to raise such funds more actively. While this was an offshore market, the BIBF allowed non-residents to participate in the domestic financial market.<sup>14</sup> The types of transaction permitted in the BIBF included:

1. OUT-OUT transactions, which permitted loans to non-residents from deposits dominated in a foreign currency or baht.
2. OUT-IN transactions, which allowed deposits or loans from non-resident could be used for loans to residents.
3. Cross currency foreign exchange transactions.

The ultimate goal of the BIBF was to become the international financial center on the Indochina peninsula by creating a kind of “baht zone.” However, in reality OUT-IN transactions of the BIBF were actively used to raise funds from overseas to meet demand in Thailand alone. Since the minimum limit of OUT-IN loans was reduced to \$500,000 in 1994, not only large companies, but also small and medium enterprises were able to aggressively borrow funds denominated in foreign currencies.<sup>15</sup> In addition to these new borrowers, borrowers who has already raised funds from overseas markets converted their funds into BIBF accounts because domestic companies that borrowed funds through the BIBF enjoyed special tax breaks. Thai authorities also came up with a policy that gave foreign banks with BIBF experience a full-banking license, according to the volume of deposits and loans in the BIBF. As a result of these changes, foreign banks with a BIBF license increased their deposits and loaned aggressively.<sup>16</sup>

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process information and manage risk.

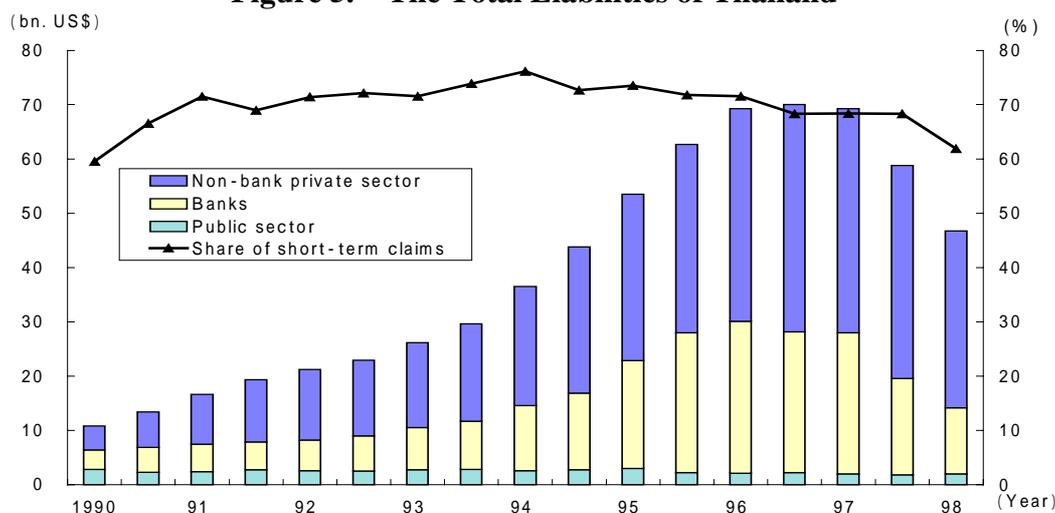
<sup>14</sup> The Thai government decided to open the BIBF in September 1992. In March 1993, licenses were given to 15 local banks, 12 foreign banks that had branches in Thailand and 20 new foreign banks for a total of 47 banks. Dealings in this market were recorded in offshore accounts separate from domestic accounts and were given preferential tax treatment.

<sup>15</sup> Many SME borrowed funds from the BIBF without hedging against exchange rate risks. Even large companies, did not hedge well. Many large companies only began to raise their hedges after the mid-1996 when there was increasing speculation of devaluation.

<sup>16</sup> In 1996, the authorities allowed seven foreign banks that held BIBF licenses to set up full-banking

Lenders (foreign banks) provided funds to the BIBF because there was consistently a large interest rate gap between Thailand and overseas. For example, there was almost always a 5 percent gap between US Treasury Bonds and Thailand's deposit rate (3 months) from 1990 to 1996. Because of the *de facto* peg of the Thai baht to the US dollar, there was little exchange risk for lenders, so it was natural for "free rider" funds to flow into the country aimed at interest arbitrage dealings.<sup>17</sup>

**Figure 5. The Total Liabilities of Thailand**



Source: BIS, *Statistics on External Indebtedness*.

According to the Bank for International Settlements (BIS), the rate of increase of liabilities of Thailand's banks began to rise from 1993 and the stock increased constantly until 1996 (Figure 5). Looking at the type of borrowers, the liabilities of both the banking sector and non-banking sector increased. This reflected the fact that foreign currency loans through the BIBF increased. That is, the funds of non-residents were borrowed by domestic banks and companies in Thailand through the BIBF. Consequently, the total external debt of Thailand more than doubled from \$37.9 billion at the end of 1991 to \$82.6 billion at the end of 1996 and the ratio of total external debt to GDP also increased from 38.3 % to 49.3 % in the same period. Because many of the

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facilities. This was the first time since 1962, when the banking law was revised, that foreign banks were allowed to conduct business in baht.

<sup>17</sup> A financial manager from a Japanese trading company offers a typical experience. The company would raise dollars in Hong Kong or Singapore, swap them into Thai baht, place them in term deposits in large Thai banks and receive 1-2 percent interest on the money that they borrowed from offshore. *Financial Problems in Thailand*, Institute for International Monetary Affairs, pp. 15-16.

foreign currency funds in the BIBF were in the form of inter-bank loans, a great portion was short-term funding. Hence, short-term external debt increased from \$12.5 billion at the end of 1991 to \$37.6 billion at the end of 1995.<sup>18</sup>

***Malaysia: Conservative capital liberalization & low levels of foreign debt—inflows from portfolio investment***

Malaysia ratified Article VIII of the IMF in 1968. In the worldwide trend of capital liberalization, there was a growing tendency towards capital liberalization in Malaysia as well. However, Malaysia maintained a basically conservative attitude. For instance, in 1990, the Labuan offshore center was established to lure foreign financial institutions aggressively. Although the center permitted OUT-IN transactions like the BIBF in Thailand, it was difficult for domestic companies to finance from the offshore center because of strict restrictions. Moreover, Malaysia eased its foreign exchange retention scheme in December 1994 and allowed foreign currency deposits by residents to some extent. However, foreign deposits were limited to payment received from exports. Malaysia's stance on exchange control has been that long-term capital inflows should be attracted while short-term capital inflows should be avoided. Out of concern over the bad influence on the domestic economy by volatile capital inflows and outflows, Malaysia often carried out direct regulation of capital flows.<sup>19</sup>

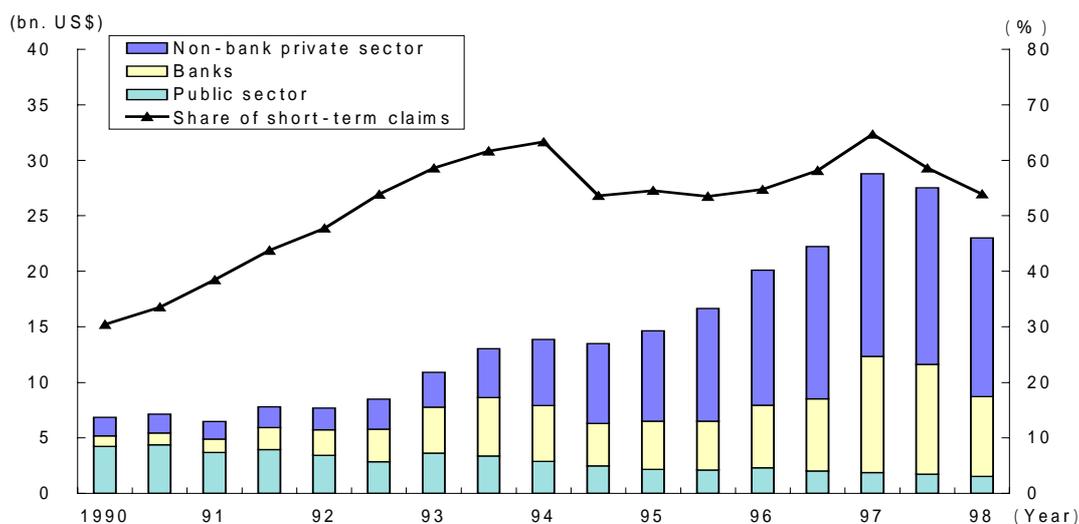
In Malaysia, loans from overseas to residents were limited because Malaysia paid attention to an increase in external debt. Loans from overseas for domestic companies were granted under the condition that borrowers were limited to companies—like those that exported—with the ability to acquire foreign currency, public enterprises and a few big companies involved in infrastructure projects. In addition, the term of borrowing had to be more than three years. As a result, the liabilities of Malaysian banks were lower than in Thailand and Indonesia (Figure 6).

**Figure 6. The Total Liabilities of Malaysia**

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<sup>18</sup> At the end of 1995, the BIBF portion of total short-term external debt was 57.7 percent.

<sup>19</sup> In 1994, measures were taken to cut off the inflow of short-term capital out of fears of over-liquidity. In addition, direct controls were placed on funds flowing out of the country.



Source: BIS, *Statistics on External Indebtedness*.

In Malaysia, while emphasis was given to controlling capital inflows through the banking sector, restrictions on portfolio investments were not as strict because of a desire to foster a vibrant securities market. Malaysia has had a stock market for quite some time, but financial reforms made in 1987 permitted non-residents to invest in Malaysian equities, with the aim of further developing the securities market.<sup>20</sup> With the exception of 1995, the amount of trading in the Kuala Lumpur stock market achieved high levels after 1993 and foreigners invested funds into the stock market aggressively in response to these developments.

The reason why the ringgit fell sharply cannot be explained simply by looking at level of Malaysia's external debt. Instead, Malaysia was experiencing an asset bubble, in which real estate and stock prices were rising considerably before currency crisis. A great deal of portfolio investment from overseas, especially short-term funds, flowed into the stock market before the crisis. In March 1997, Malaysia strengthened regulations on lending by financial institutions for investment in stocks and real estate in an attempt to restrain the asset bubble.<sup>21</sup> Malaysia carried out such a tightening policy just as the economy was affected by the Thai baht crisis. Real estate and stock prices dropped sharply, leading to a so-called "asset crisis." Moreover, foreign investors

<sup>20</sup> In the Malaysian Bumiputra policy, which gave preferential treatment to ethnic Malays, foreigners were restricted to under 30 percent ownership of any one company, but foreigners' investment in the Kuala Lumpur Stock Exchange was portfolio investment that was actively carried out under this 30 percent limit.

<sup>21</sup> Malaysia announced restrictions in March and April 1997 on bank lending, limiting loans to the real

withdrew their funds from the stock market in one sweep out of fears that Malaysia would be caught in the wake of the crisis. This outflow of funds in turn sparked the ringgit's fall and intensified the asset crisis.

***Indonesia: Complete liberalization of foreign exchange and increased borrowing in the non-banking sector***

Indonesia removed foreign exchange controls in principle in 1971. Accordingly, there is no comprehensive law to restrict foreign exchange transactions.<sup>22</sup> The IMF admits the Indonesian rupiah is a completely convertible currency. Indonesia promoted capital liberalization earnestly after it ratified Article VIII of IMF in 1988.

In Indonesia, financial liberalization proceeded in two steps, in 1983 and 1988. In the second liberalization step in 1988, Indonesia allowed foreign banks to enter the domestic market for the first time in twenty years. Permission was granted for joint ventures between foreign and domestic banks, while foreign banks already operating in Indonesia were allowed to open new branches in seven locations. In 1989, the government lifted limitations on financial institutions' foreign currency exposure. In addition, offshore rupiah futures in US dollars were admitted in 1990, while commercial paper and bonds were approved in 1993.

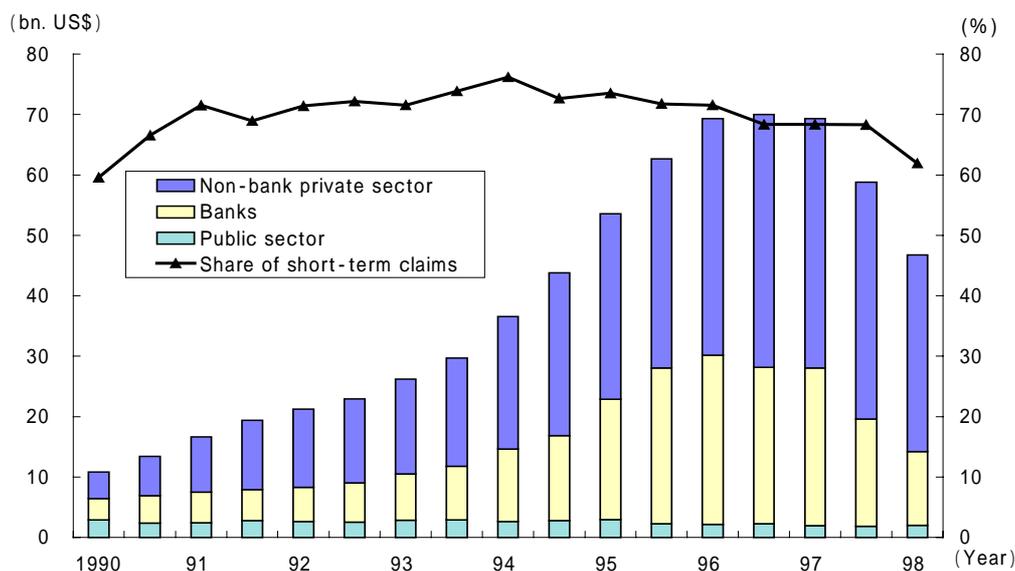
Looking at capital flows in the banking sector, it is clear that external borrowing began to increase in 1994, mostly by non-bank financial institutions (Figure 7). In Indonesia, many creditworthy companies raised foreign currency denominated funds from overseas because of high domestic lending rates.<sup>23</sup> In particular, after 1994 when interest rates in the United States rose, Indonesia raised domestic interest rates sharply in an attempt to avoid capital flight. Accordingly, domestic companies chose to raise funds denominated in foreign currencies, in particular the US dollar. Unlike the Thai

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estate sector to 20 percent of all lending (previously 30 percent).

<sup>22</sup> Bank Negara Indonesia has detailed rules related to foreign exchange transactions for foreign exchange banks and money exchangers. While there are several ordinances, such as president ordinances and the official notices of Bank Negara Indonesia, however, these restrictions did not apply to the entire financial sector.

<sup>23</sup> Companies raised funds not only from banks, but also by issuing bonds and stocks. Overseas bond issuance and investment in domestic stocks expanded rapidly. The number of companies listed on the Jakarta stock exchange was 24 in 1987, but by 1997 it had reached 282 firms. Trading volumes skyrocketed from \$3 million to \$32.1 billion in the same period.

**Figure 7. The Total Liabilities of Indonesia**

Source: BIS, *Statistics on External Indebtedness*.

baht that was effectively fixed to the US dollar, the Indonesian rupiah was allowed to float to a certain extent, so most companies in Indonesia hedged their exchange risks when they raised funds dominated in a foreign currency. To do this, domestic companies would raise funds dominated in dollars and then the funds were swapped into rupiah. This greatly reduced the cost compared with raising rupiah funds directly and also avoided exchange risk. But these were short-term dealings of 3 to 6-month terms, most only 3 months.<sup>24</sup> Hence, companies had to hedge against exchange rate risk every time they paid back US dollar loans. After the currency crisis in Thailand occurred, domestic companies not only had to buy dollars to repay funds dominated in foreign currency, but also had to hedge against further exchange risk. Consequently, the value of the Indonesia rupiah plummeted due to a sharp increase in demand for dollars.

Here, we should also mention that the rupiah was popular in currency trading among non-residents. In 1990, not only in Jakarta, but also non-residents in Singapore—mainly European and American foreign banks—were actively involved in rupiah trading. There were many instances when large trades in Singapore greatly affected the value of the rupiah. The volume of rupiah trading rose to \$4 billion a day in

<sup>24</sup> This is because there are very few buyers for 6-month or longer currency futures. *Asian Currency Handbook*, International Treasury Division, the Fuji Bank, 1998.

mid-1997.<sup>25</sup> When the Thai baht fell, dealers accelerated sales of the rupiah. The considerable trading in rupiah, which was not always directly related to actual demand arising from foreign trade and investment, is another reason for the rupiah's fall.<sup>26</sup>

Moreover, it appears that Indonesia did not fully grasp the situation concerning its external debt. Although state-owned enterprises and banks in Indonesia had to report their external borrowing to monetary authorities, the private sector, except the banking sector, did not need to report its external assets and liabilities. Because foreign exchange was not controlled, monetary authorities could not grasp the actual situation of external debt held by the private sector. This is thought to be one of the reasons why Indonesia as a country suffered from a foreign currency liquidity shortage.

### ***The Philippines: Liberalization of capital controls to lure investment***

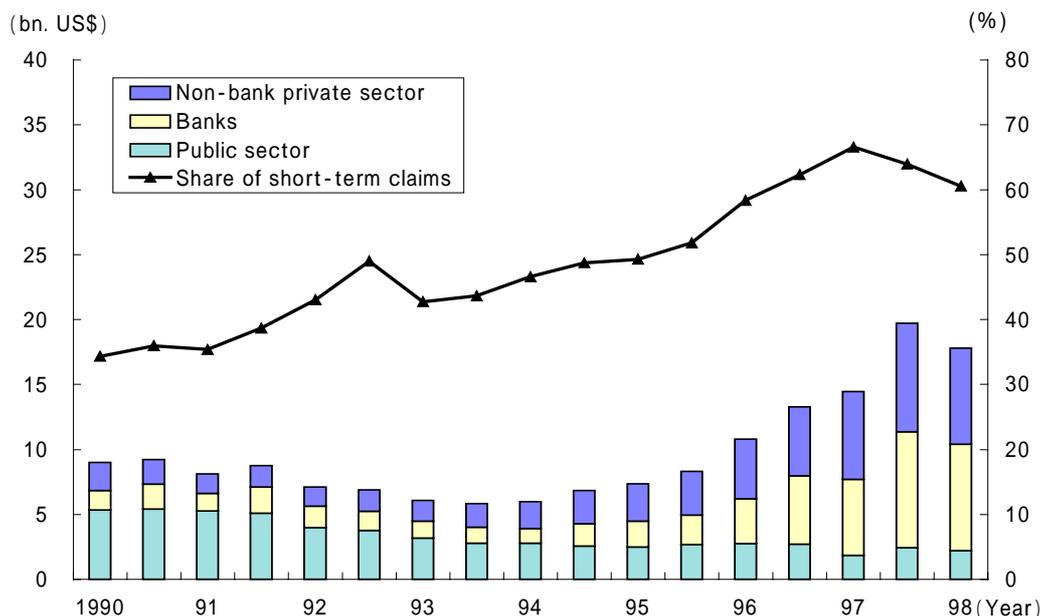
As a result of an external debt crisis in the 1980s, the Philippines was almost shut out of international capital markets until the early 1990s. It was after the inauguration of the Ramos administration in 1992 that international capital began to flow back into the country. As a result, there was relatively little accumulation of foreign debt in the private sector, as indicated in Figure 8. The Philippines drastically eased foreign exchange controls in 1992 in an effort to attract more investment. Exporters were no longer required to make a priori notification to the central bank and were allowed to use foreign currency freely. In addition, exporters were no longer required to report export transactions to the central bank.

There have been two main avenues for the inflow of funds of foreign currency into the Philippines: 1) the Offshore Banking Unit (OBU), and 2) the Foreign Deposit Currency Unit (FDCU). The FDCU scheme is the main source. The OBU was only one tenth the volume of the FDCU even though the OBU was established in 1977, while the FDCU was introduced in 1992. In the FDCU scheme, both residents and non-residents can deposit foreign currency funds, while loans can be made to both as well. The amount of total deposits increased from \$2.56

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<sup>25</sup> It is estimated that at times trading reached \$8 billion a day. 'Clamping down on speculators,' *Asian Business*, Feb.1997, p.10.

<sup>26</sup> After the currency crisis in Indonesia, most rupiah trading was conducted on actual demand arising from trade and investment, so trading volumes dropped considerably. In early 1999, rupiah trading was

**Figure 8. The Total Liabilities of the Philippines**

Source: BIS, *Statistics on External Indebtedness*.

billion in 1990 to \$14.52 billion in 1996.

Unlike the BIBF in Thailand, non-residents were not the main source of FDCU. A large part of the deposits were from residents—exporters and remittances from overseas workers—amounting to 87 percent of deposits in 1996. In addition, borrowers were mainly exporters, not domestic companies without the ability to acquire foreign currency.

In 1995, the Philippines achieved IMF Article VIII status. In addition, the Philippines allowed foreign banks to participate in the domestic financial sector in 1994 following a proposal made by the IMF.<sup>27</sup> Although 13 foreign banks had entered the Philippines by 1996, they did not have a great presence because their business was strictly restricted. In 1996, foreign banks' share of total deposits was 1.7 percent and the share of total lending was 3.5 percent.

### 3.3. Macro control in an open-economy

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estimated to be about \$100 million a day.

<sup>27</sup> This was aimed at raising the efficiency of the financial system by allowing foreign banks into the domestic market.

***Management of quasi-fixed exchange rates***

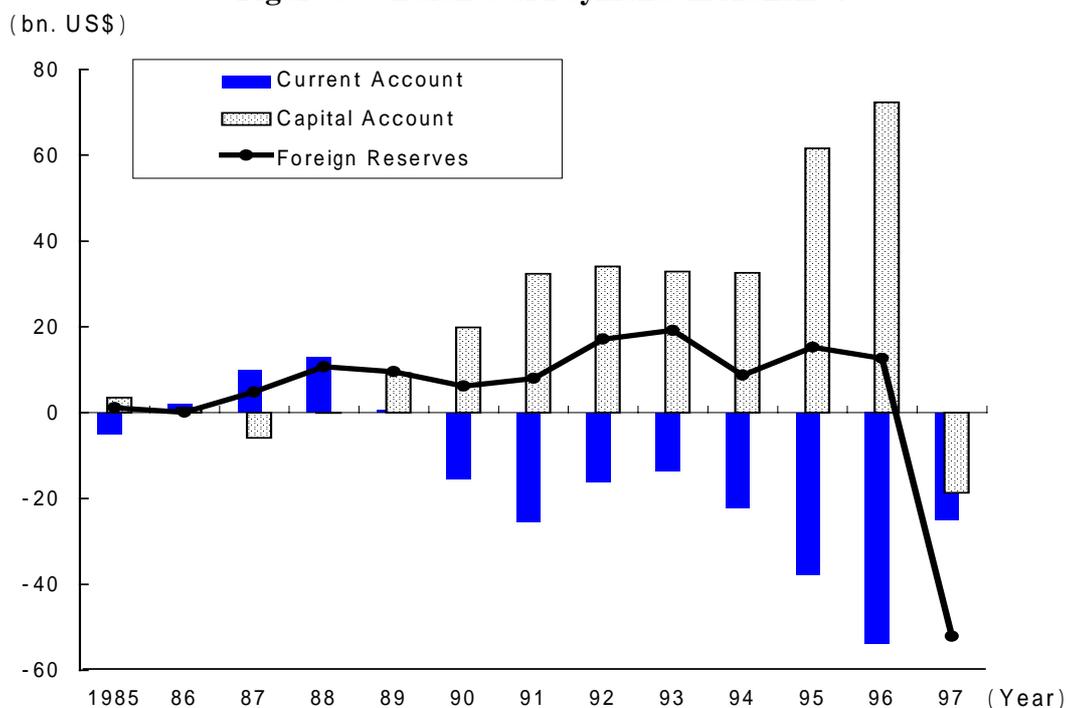
As is frequently shown in economic textbooks, the three goals of the free movement of capital, fixed exchange rates and discretionary financial policies cannot be attained simultaneously. When capital is allowed to move freely, it is impossible to stabilize exchange rates and make discretionary financial policies at the same time, although it is possible to seek two of the three policies. As is well known, the ASEAN 4 countries linked their nominal exchange rates to the US dollar. In a developing country that is greatly dependent on trade—especially with a specific country and specific area—the first priority may be in many cases the stability of exchange rates. Therefore, if a system of fixed-exchange rates is desired, the country will be faced with a decision between the choice of free capital movements or financial policy flexibility. In this case, what choice should a developing country make?

If restrictions are placed on capital flows, the country is assured a great deal of flexibility in economic policy. The policy that Japan pursued during its high-growth period from the late 1950s to the early 1970s is a good example of this. Japan was prudent in the liberalization of capital movements, while opening up its economy in other areas, especially trade. Since the flow of capital from overseas was restricted, the flexibility of financial policy was secured and Japanese authorities were able to concentrate on holding down inflation. When the economy continued to perform well for a while, capital shortages were financed through current account deficits, but only up to the level of foreign currency reserves (\$2 billion) that came from trade surpluses and not capital inflows. When inflationary pressure gradually built up, the government was forced to implement deflationary policies. In other words, although the country was part of a free trading system, financial policy was performed by controlling exchange rates while watching the level of the current account, with the amount of foreign reserves acting as a guideline.

Contrary to Japan, many ASEAN countries liberalized capital movements. In the 1990s, capital inflows were greater than current account deficits and foreign currency reserves increased as a result (Figure 9). However, this situation restricted ASEAN countries' financial policies because they chose to liberalize capital movements and maintain fixed or strictly managed exchange rates. Restrictions on financial policy constantly generated

interest rate gaps between their economies and others, increasing the inflow of short-term funds.

**Figure 9. Balance of Payments in ASEAN4**



### ***Liquidity control***

Under a quasi-fixed exchange rate system, an increase of capital inflow puts upward pressure on the domestic currency.<sup>28</sup> In order to keep exchange rates constant, a monetary authority needs to buy up foreign exchange and sell its own currency in the market place. Consequently, the base money increases along with foreign exchange reserves. An increase in base money may be connected with an increase of money supply, which results in excess liquidity. A monetary authority performs sterilization to

<sup>28</sup> In the developing countries where marginal growth rates are high, interest rates are also higher than the developed nations since the rates reflect the rate of expected earnings. When a developing country's market is opened to foreign capital, money flows in from the advanced countries in quest of higher returns. This continues until the domestic interest rate converges on the real interest rate level. If quasi-fixed exchange rate management is taken, nominal interest will serve as the rate of expected earnings.

offset the effects of increased foreign reserves on the domestic economy. In order to sterilize capital inflows, tightening measures are taken, such as selling securities held by the central bank or increasing reserve requirements. Figure 10 shows the assets denominated in foreign currencies and the base money of the central banks in the ASEAN 4 countries. The increase of a central bank's assets denominated in foreign currency can be said to reflect foreign currency purchases in the exchange markets. Compared with the increase of foreign currency, the expansion of base money is small. The increase of base money of each country was kept down, except in the Philippines. Through sterilization, monetary authorities in ASEAN tried to contain money supply growth and hold inflationary pressure down. They were successful, to some extent, in eliminating the effects of money market relaxation accompanied by capital inflows.

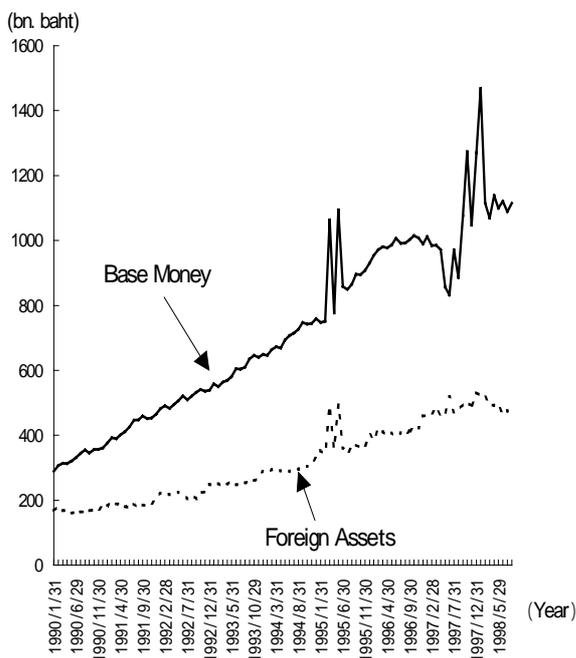
However, sterilization resulted in consistently high domestic interest rates, which attracted further capital inflows. Generally, if sterilization is not performed on capital inflows, domestic interest rates fall due to easier monetary policy—lower interest rates reduce the attractiveness of assets denominated in the domestic currency and additional capital inflows usually stop.<sup>29</sup> However, the tightening effects of sterilization often push up interest rates. In this way, a high level of domestic interest rates as a result of continuous capital inflows creates interest rate gaps between home and abroad.

#### **Figure 10. Base Money in ASEAN**

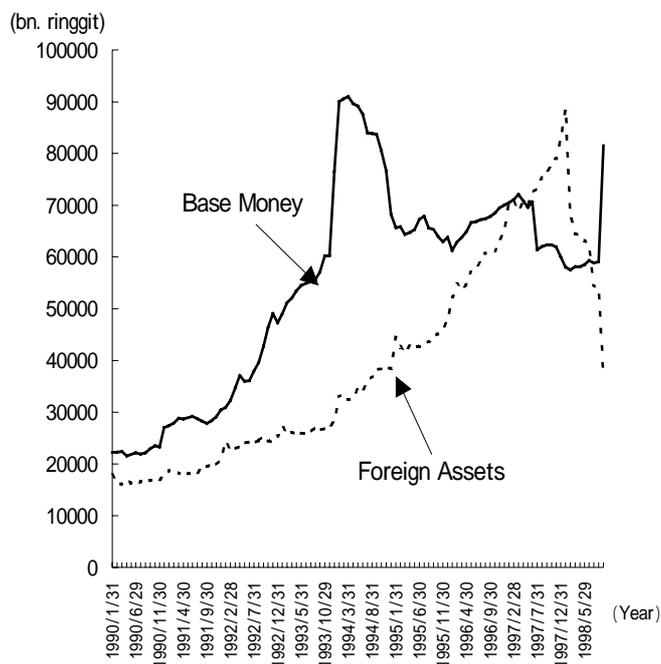
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<sup>29</sup> If a country's currency is allowed to appreciate, the relaxation of monetary policy will not take effect.

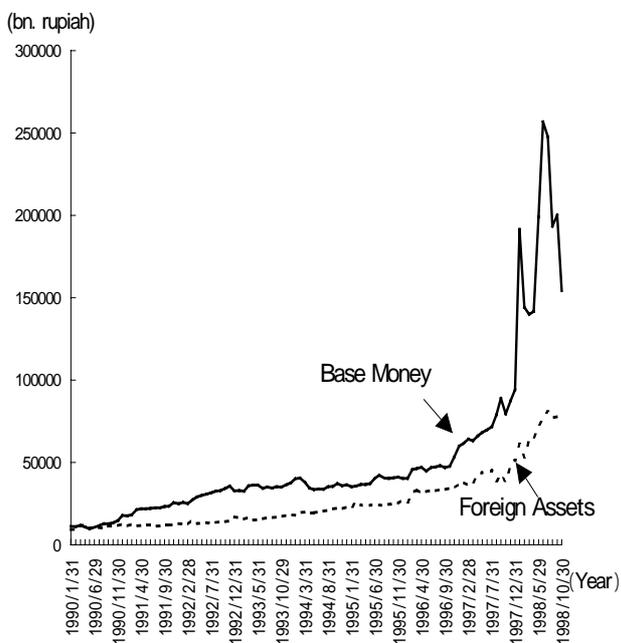
[ Thailand ]



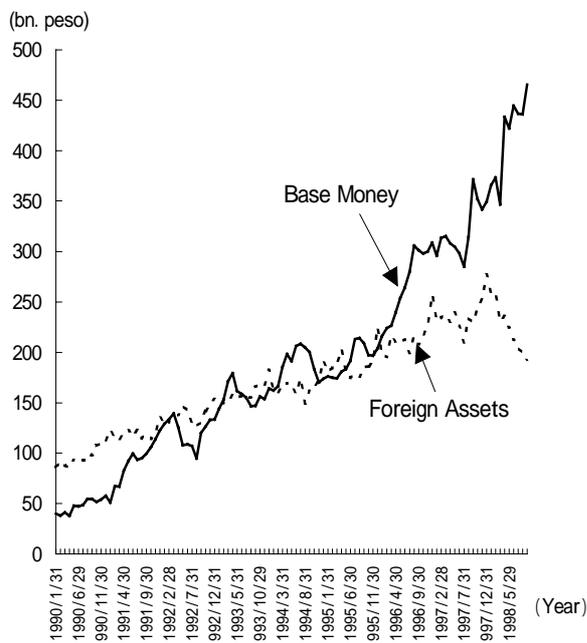
[ Malaysia ]



[ Indonesia ]



[ Philippines ]



Source: IMF, *International Financial Statistics*.

Throughout the 1990s, the domestic nominal interest rates in the ASEAN 4 countries were several percentage points higher than those in the United States. The

typical means to target interest rate gaps is through hot money (bonds, CD, CP, etc). Under a quasi-fixed currency regime, policy makers' liquidity control (sterilization) on capital inflows produced permanent interest rate gaps between home and abroad and accelerated the inflow of capital, especially of hot money. In addition, since too much capital had flowed in, the effect of sterilization policy became inadequate and in some ways it had the effect of boosting liquidity in the domestic economy. In the ASEAN countries, since bond markets are underdeveloped, the effect of re-offering central bank securities holdings is limited. For example, Bank Negara, the Indonesian central bank, purposely issued central bank debentures to carry out sterilizing operations. Kunimune (1998) explains that the effect of sterilization policy using central bank securities in Indonesia was insufficient from 1995 because the scale of sterilization was reduced. The monetary relaxation effect based on insufficient sterilization produced excess liquidity at home. Excess liquidity headed for unproductive investments such as real-estate investments etc., and in many cases caused a bubble.

#### **4. Lessons from the Asia currency crisis**

##### **4.1. Problems with ASEAN-style economic development?**

The ASEAN 4 countries accomplished very rapid economic growth until the crisis (Figure 1). Their industrialization policy that focused on export-led growth was a pillar of their economic success. In promoting an export-oriented industrialization policy, foreign capital, the inflow of which was positively promoted from the late 1980s, played a key role. After the Plaza Accord in 1985, the Japanese yen and, after some delay, the Taiwanese dollar and the Korean won, appreciated against the US dollar. ASEAN countries tried to keep their nominal exchange rates against the US dollar stable. For the countries like Japan that lost export competitiveness because of stronger domestic currencies, ASEAN countries like Thailand and Malaysia became a suitable place to shift production.

For the host countries, foreign direct investment (FDI) from developed countries,

mainly Japan, made a number of contributions to their export-oriented industrialization. First, FDI led to a greater increase of capital investment than was possible with domestic savings alone. Second, the marketing channels of foreign companies were utilized in expanding markets. Third, cultivation of an export sector boosted domestic consumption in the process. Finally, foreign companies created job opportunities, brought in the latest equipment and transferred skills and management know-how. This development pattern was first adopted in Thailand and Malaysia with great results. The Philippines and Indonesia then followed this pattern from the 1990s.

For a certain period of economic takeoff, economists generally agree that export-led industrialization made possible by FDI is effective. The question is how long inflows of direct investment by themselves can continue to support sustained economic growth. On the investment side, investment into one country is made when expected returns are higher than other countries. Therefore, if the benefits of investment are lost as a result of increased wages or lack of infrastructure compared with a third country, naturally, new investment into the original country will decrease. In fact, direct investment into Thailand and Malaysia was reaching a ceiling in the first half of the 1990s because of higher wages, while cheaper and more lucrative locations were created as newcomers like China were luring foreign investment. This suggests that direct investment should be primarily a primer for economic growth, as Otsuka (1998) noted. It is necessary to have a vision for sustained economic development after that primer has started the economy moving. However, such measures were not always taken in time in many ASEAN countries and the over-dependence on FDI began to reduce the momentum towards higher levels of industrial development.<sup>30</sup> The ASEAN countries appear to have reduced restrictions on capital transactions to promote capital inflows other than direct investment to address this issue.

### ***Excessive investments***

In developing countries, there are generally many potential areas that offer opportunities for investment, but domestic savings are often lower than investment potential because of the lack of capital accumulation. In a closed economy, the most

investment that can be realized is the total of domestic savings. However, by opening up a country to international capital markets, funds from abroad can make up for a domestic savings shortage to meet investment needs. Table 3 shows the real GDP growth rate from 1991 to 1996 and the investment-savings balance in different regions. For both savings and investment, the ratios to GDP of developing countries (average) are higher than those of developed countries. In particular, the investment ratios of the ASEAN 4 countries is prominent. The ratios of the ASEAN 4 countries (investment: 33.6%; savings: 29.2%) are higher than those of the total for the developing countries (investment: 28.1%; savings: 26.1%).

**Table 3. Real GDP Growth Rate, Invest-Savings Balance by Region**  
(%)

	Industrialized Countries	Developing Countries	ASEAN 4
Real GDP Growth Rate (Avg.)	2.1	6.2	8.7
Investment	20.6	28.1	33.6
Savings	20.4	26.1	29.2
I-S Balance	-0.1	-2.1	-3.8

Note: Average 1991-96

Source: IMF, *World Economic Outlook*, ADB, *Key Indicators*.

In many developing countries, one of the inhibitors to sustained economic growth is the lack of domestic capital accumulation because of an over reliance on foreign capital. One of the factors thought to be behind ASEAN-style economic development was the maintenance of high economic growth spurred on by investment-savings ratios that were higher than already high domestic savings rates. This was made possible only by capital inflows from overseas. It is clear that ASEAN enjoyed flourishing investment demand and high savings rates, but could not always realize the supply to meet that demand. The part of demand for funds for which there is no supply should have been a kind of “wish” that could not be fulfilled. In ASEAN’s case, however, projects that would normally only been a “wish” considering economic efficiency were actualized by a continuous inflow of foreign capital. This suggests that ASEAN suffered from over-investment and not a savings shortage. From a macro-economic point of view,

<sup>30</sup> Otsuka (1998), p. 38

therefore, one could say that there were excessive capital inflows.

Such excessive capital inflows were used for investments in unproductive areas. A typical type was investment in real estate or stocks, and such investment tended to generate a bubble. In general, if stock prices rise, capital will flow in seeking high rates of return accompanied by expected earnings. Consequently, high profits are gained and this will cause more capital to flow into the market in search of even higher profits. In this way, an illusion that high economic growth might be realized permanently is created and a bubble is formed. But it is natural that such unsustainable conditions will come to an end and the bubble will burst. Considering the crisis in Asia, financial authorities raised interest rates and intervened in foreign exchange markets to prop up their currencies. The internal liquidity crunch as a result of such policies slowed the domestic economy abruptly. Since investors who directed their attention only toward high returns became sensitive to risks, and stopped new investments or withdrew their funds. In this way, the “virtuous circle” stopped turning and the vicious one took over. Consequently, the risk that was hiding in the shade appeared in the wink of an eye and resulted in the financial crises.

### ***Flexible management of exchange rates***

The ASEAN-style development strategy was based on the condition that a continuous inflow of capital was needed for sustaining economic growth and thus forced ASEAN to adopt some restrictive economic policies like quasi-fixed exchange rate regimes. The developing countries’ adoption of exchange rate policies that link their own currencies to the US dollar is not necessarily a problem in itself. The problem in Asia was that many countries tried to maintain an effective peg of their nominal exchange rates to the US dollar over many years. They should have revised their exchange rates when the need arose. For instance, the flow of capital into Thailand increased greatly in the period 1994-95 to the point that net capital inflows exceeded the current account deficit and foreign exchange reserves accumulated. Because of the increased liquidity that this caused, the Thai baht should have been revalued in this period, but Thailand did not do so due to concerns over a loss of export competitiveness and slower economic growth. A revaluation of the baht in this period may have

prevented the massive inflow of short-term capital into Thailand after 1995.

Because the exchange rate was effectively fixed, both foreign investors and domestic companies could operate on the assumption that there would be little exchange rate risk. Consequently, massive inflows of short-term capital may have been prevented under a floating exchange rate system, because borrowers would have to be more prudent about exchange rate risk.

#### **4.2. Weakness of the financial systems**

From a macro-economic point of view, the excessive capital that had flowed into the ASEAN countries exacerbated the situation when it quickly flowed out as a result of the Asian currency crisis. As seen in Section 2, the great amounts of capital flowed through the banking sector. From a micro-economic view, it was a question of the massive capital inflows to the financial sector. One of the features of this crisis is that the currency crisis developed into a financial crisis, and the financial sector was influenced most seriously. It suggests that the financial sector had certain problems.

##### ***Too much risk taken in the financial sector***

In general, when financial systems are liberalized, it is important for financial institutions to manage their assets and liabilities to cope properly with various market risks. However, it is clear that the financial sectors in the countries affected in the Asian crisis could not cope properly. Many institutions loaned too much without accurately assessing the risks.

As financial liberalization and opening of domestic financial markets progressed, local banks had to compete with competitive foreign banks that advanced into the ASEAN countries. Foreign banks financed relatively low risk clients aggressively, such as multinational enterprises and large local companies, and local banks were often left with less opportunity to finance such clients. In order to make profits, local banks tended to loan to projects without making accurate risk assessments. For example, foreign banks in Thailand, mainly Japanese banks, financed Japanese companies and blue chip companies through the BIBF aggressively. Local banks were able to loan only

to local small and medium enterprises with poorer business prospects or to more risky undertakings in the real estate sector.

In addition, local banks made loans without taking into account exchange rate risk. In Thailand and Indonesia, domestic companies aggressively raised funds in US dollars for investment in plant and equipment as discussed in Section 2 because it was cheaper to raise (un-hedged) funds in US dollars than in local currencies. In these cases, the company which raised the funds assumed the exchange rate risks, whereas financial institutions apparently did not take on the risk. However, because companies had no ability to acquire foreign currency, the financial institutions assumed exchange rate risks indirectly. In other words, when a company's external debt burden increased rapidly because of a sharp drop in the value of local currencies, financial institutions were not able to collect on their loans. In the case of Thailand and Indonesia, the sharp drop in the value of their currencies increased domestic companies' external debt burden, forcing many companies into financial difficulties or even bankruptcy. The worsening performance of these companies had a severe impact on the financial institutions because they were stranded with a huge amount of non-performing loans, a problem which in turn triggered the financial crisis.<sup>31</sup>

Judging from the above situation, it is apparent that financial institutions accepted capital liberalization without fully understanding the significance of such liberalization because of weaknesses in their management. However, it must also be pointed out that financial authorities also fostered an environment in which the local financial sectors could easily take on risk. This environment consisted of three factors: the *de facto* peg to the US dollar, moral hazard and the lack of adequate financial supervision.

### ***De facto peg to the US dollar***

Both Thailand and Indonesia had fairly rigid systems for managing their exchange rates. The financial sectors in these two countries aggressively loaned to companies that

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<sup>31</sup> Malaysia and the Philippines handled this issue differently from Thailand and Indonesia. In Malaysia, foreign currency loans to residents were strictly limited. While the FDCU system in the Philippines was like Thailand's BIBF, in the Philippines all borrowers except exporters were in principle required to obtain permission from the central bank.

could not otherwise have had the means to acquire foreign currency, such as those in the real estate sector. As far as financial institutions were concerned, there was little or no exchange rate risk because their authorities reduced the risk through the management of exchange rates.

### ***Moral hazard***

Finance is based a system of credit. As the Asian crisis showed, when a financial crisis occurs, the impact is serious on the whole economy. Hence, the authorities cannot leave a crisis as is. In the ASEAN countries, the financial sector had been protected and often rescued in emergencies in the past.<sup>32</sup> As a result, financial institutions tended to feel that if competition in the financial sector intensified as a result of financial liberalization, financial institutions would not be allowed to go bankrupt. This belief that the government would bail out financial institutions in trouble created a moral hazard. If financial institutions count on the authorities to rescue them when a crisis occurs:

- the institutions tend to think that stockholders will not worry very much about the institution's management as long as the institution is making money;
- board members tend to manage without concern for risk; and
- depositors will make deposits in a poorly managed institution as long as it offers high interest rates.<sup>33</sup>

Considering the lack of transparency and the crony capitalism that existed in many ASEAN countries, such as enormous lending to influential politicians' family businesses, financial institutions tended to be the worst proprietors of this moral hazard. When competition was introduced into such a system prone to moral hazard, financial institutions took higher risks to take advantage of new opportunities without making efforts to assume responsibility in the event that the risks became a problem.<sup>34</sup>

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<sup>32</sup> In Thailand, everyone (depositors, investors and managers) considered that there were clear or tacit guarantees that "the authorities would not let banks and major financial institutions go bankrupt." Institute for International Monetary Affairs (1999), p.9.

<sup>33</sup> The "97-98 Asian economic crisis", p.44, the Institute of Developing Economies, topic report.

<sup>34</sup> It seems that foreign depositors and investors were also guilty of moral hazard. For example, in

***Lack of adequate supervision in the financial sector***

In order to sustain a financial system, it is necessary to have proper supervision and prudential regulation of financial institutions. Looking at the conditions in the ASEAN 4 countries, it is clear that every country had a framework for regulation in place. However, many foreign funds were allotted to non-profitable sectors (e.g. real estate) through the financial sector, so it is hard to say that these regulatory schemes fulfilled their functions. After financial and capital liberalization, such regulatory schemes were introduced in accordance with the regulatory regimes adopted in the developed countries. It is doubtful whether the authorities and financial institutions in the ASEAN countries truly understood the meanings of the regulations or whether they could work properly. For instance, although Indonesia introduced regulations on large-scale lending to corporations, the regulations were substantially meaningless because of the cozy relationship between corporate groups and the financial sector.

**4.3. Views on capital account liberalization**

The pursuit of liberalization of trade and investment inevitably runs into opposition forces, which makes liberalization a difficult and time-consuming process. Japan's refusal to agree to the early voluntary sectoral liberalization (EVSL) at the APEC Economic Leaders Summit in Kuala Lumpur in November 1998 was a prime example of the obstacles to liberalization.

On the other hand, what about liberalization of capital markets? Were there any forces objecting to liberalization of finance in the ASEAN countries before this crisis? As seen in the preceding section, the ASEAN countries actively promoted the opening of their capital markets to the outside world. Many of them pursued earnest capital liberalization in the span of only a few years in the 1990s, while it took decades for trade and investment liberalization. Undoubtedly, the global trend towards greater

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Indonesia in November 1997, 16 commercial banks had their businesses suspended. At the time, deposits were guaranteed only to a certain limit and not in full. Accordingly, there was a general feeling of unrest among depositors and they withdrew their deposits from not only from the suspended banks but also healthy banks all at once, hastening capital outflow.

liberalization worked as a factor in that capital liberalization.<sup>35</sup> However, considering the gradual progress of liberalization in trade and investment, we should ask how capital liberalization progressed so quickly in recent years. “Liberalization” is basically the easing and abolition of regulations and controls, and is promoted by those forces that feel they will gain from that liberalization. On the contrary, in liberalization there are parties that are bound to lose out and they can be expected to resist liberalization.

When a country’s financial markets are liberated, who originally resists these measures? One group, of course, is often local financial institutions. However, in the case of ASEAN’s liberalization of capital markets, there were no reports of domestic institutions powerfully objecting to the measures.

The financial sector did not resist liberalization for the two reasons. First, capital liberalization was advanced without greatly infringing on the vested interests of the domestic financial institutions. Despite liberalization of capital markets in the ASEAN countries, the domestic markets remained closed to direct participation by foreign financial institutions. Foreign institutions could make foreign currency loans to domestic companies as a result of the liberalization of offshore markets, but there were few foreign financial institutions that were permitted to loan in local currencies. In other words, the domestic market and the profits of the local financial institutions, especially transactions in local currencies, were closed to foreigners.

Secondly, the financial environment was such that liberalization was not recognized by financial institutions as a demerit even though liberalization should have infringed on the interests of local financial firms. This is related to what was discussed above concerning the reasons why financial institutions were able to take so much risk. Financial liberalization usually promotes competition between financial institutions. In particular, the opening of financial markets usually leads to competition with foreign financial institutions that bring with them advanced management skills. This should have become a big demerit for the domestic financial institutions in the ASEAN countries, but many financial institutions did not completely understand just what

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<sup>35</sup> International organizations including the IMF were positive liberalization-promotion theorists. But the IMF has itself pointed out the risk of back flows after large-scale inflows as a result of liberalization of capital transactions.

liberalization would entail because of their weak management systems. For example, there was a recognition in the financial sectors that the exchange rate risk would be small because of government's management of exchange rates and a moral hazard was created by the conviction that domestic banks would never fail even if competition intensified.

The liberalization of capital transactions in ASEAN progressed quickly. When the actual situation became clear, it was apparent that liberalization was carried out in an environment in which the local financial sector did not recognize the demerits of liberalization. Many analysts argue that capital liberalization of ASEAN countries was carried out too hurriedly. However, the pace of liberalization in itself is not enough to explain the situation. The problem was that liberalization was advanced in way that domestic financial sectors did not recognize that liberalization could be painful. Because liberalization of both domestic and offshore markets occurred so rapidly, the distortions in the domestic financial systems became more pronounced and intensified the impact of the crisis.

The Asian currency and later financial crisis leads to the question of how to treat capital liberalization in newly emerging economies. If expressed abstractly, capital liberalization must carried out under the premise that the financial sector understands the significance of that liberalization, including the merits and risks. In other words, policy makers must make financial institutions aware that liberalization means the introduction of market principles—institutions that do not manage risk properly will not make profits and may even fail. In order to increase this awareness, thorough information disclosure is required in order that the market mechanism can function properly.<sup>36</sup> Moreover, it is also important to prepare accounting systems and mechanisms to deal with bad debts, as well as a clearly defined and enforceable bankruptcy laws, in order to establish the principle of self-responsibility.

In reality, such measures will not proceed smoothly because the domestic financial sector will probably resist such liberalization if it really understands what liberalization entails. In addition, it will take a great deal of time for domestic financial institutions

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<sup>36</sup> There is also a need for information disclosure for hedge funds.

and regulators to understand such a system and master the skills to benefit from it. It appears unreasonable to have introduced market mechanisms into the ASEAN countries so hurriedly before the existence of a clear separation of ownership and management, which is necessary for proper information disclosure.<sup>37</sup>

It is said that there is an appropriate order in the process of liberalization of capital transactions. First, financial transactions are made across borders in a split second and the adjustment speed of financial activities is much more easily influenced than trade. Therefore, trade liberalization must precede capital liberalization. Second, liberalizing domestic finance must proceed the liberalization of international finance. If international capital transactions are liberalized when distortions in the domestic financial structure still exist, there is a possibility that the existing distortions may be further enhanced by inflows of capital from overseas. This is what happened in the ASEAN countries. This suggests that newly emerging countries must prepare an appropriate supervisory and regulatory environment as a prerequisite to liberalization of capital transactions.<sup>38</sup> In the ASEAN case it is quite clear that capital transactions should have been liberalized only after the supervisory and regulatory environment was ready.

Despite the hardships faced in many countries, this crisis provides an optimal opportunity to reorganize and strengthen the financial institutions of ASEAN. ASEAN countries have already introduced measures to tackle the crisis and have shown the inclination to do what is necessary to reconstruct their financial systems. The reinforcement of prudential regulation such as capital adequacy requirements has already been carried out. If market participants react positively to the systemic reforms they could greatly contribute to the recovery of ASEAN economies.

## **5. Concluding Remarks**

In the last decade or so, the big trend in international financial markets was "liberalization" until the Asian currency crisis occurred. The free movement of capital

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<sup>37</sup> J. Stiglitz (Senior Vice President and Chief Economist of the World Bank) refers to the situation like a row boat on the sea. When the weather is good it is wonderful to be out on the open water, but when the storm comes there is nothing that can be done even if one operates the boat properly.

<sup>38</sup> In relation to this, strengthening of the independence of financial supervisory bodies, including the central banks, is also important.

was expected to supplement capital shortages in countries that needed it and claims were made that such liberalization would lead to an optimum distribution of world resources. The majority opinion was that capital should move freely without regulation. Moreover, it was thought, theoretically, that under free capital markets capital would flow according to where it would achieve the greatest profits and sudden capital outflows could not happen. However, reality does not go like a textbook. The outflow and inflow of capital is sometimes governed by too much optimism or too much pessimism, rather than underlying economic factors. For this reason, free flowing capital can dangerously flow in and out of an economy in a very short period of time. The crises of the financial and capital markets of Asia were aggravated because of the volatility of international capital movements.

The opinion that capital movements should be regulated is gaining power and it is argued that capital liberalization in emerging countries is fundamentally different from trade and investment liberalization, so countries should proceed cautiously with regard to such liberalization of capital. However, as indicated in this paper, the problem in Asia was that capital liberalization was carried out in an environment in which the financial sector did not recognize and prepare for the risks. This crisis showed that liberalization allowed the market mechanism to work effectively, and in the process enhanced distortions that already existed in domestic financial systems. The lesson obtained from this crisis is that capital liberalization should not be performed in emerging countries while distortions are left in the market. They need to have financial and capital markets where the capital flows correspond to profitability and a sudden outflow of capital does not happen. For the ASEAN countries, foreign opening should have been performed after the environment was prepared and when the financial sector was able to maintain asset quality healthfully and actively. If foreign opening was done with the understanding of the market mechanism that nobody can acquire a profit without taking risks by his or herself, the aggravation of this financial crisis could have been avoided.

APEC member economies should promote capital liberalization in order to enjoy the benefits from the region's diversity. However, in the process of liberalization, it must be pointed out that there is a sequence that should be followed. If we consider the liberalization of trade and investment globally, such liberalization was also carried out

gradually, according to each country's stage of development. In order to promote trade and investment liberalization—the original *raison d'être* of APEC—the importance of economic and technological cooperation in the region must be emphasized. The same is true for capital liberalization. What the Asian crisis made clear is the need to prepare the market environment that is required to promote capital liberalization. In such a context, developed countries need to cooperate in human resource development and provide advice on how foster strong domestic financial markets in order for the developing countries to prepare themselves for freer international capital markets.

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