HOW TO PREVENT THE NEXT CRISIS:

Lessons from Country Experiences of the Global Financial Crisis

Edited by Aniket Bhushan
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The North-South Institute (NSI) is Canada’s leading non-profit, non-partisan, independent think tank dedicated to improving people’s lives in the developing world through research that engages policymakers and influences action. For more than 30 years, we have partnered with researchers in developing countries to generate research that supports poverty reduction, social justice and NSI’s vision of research for a fairer world.

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Telephone: 613-241-3535
Fax: 613-241-7435
E-mail: nsi@nsi-ins.ca
Web: www.nsi-ins.ca
# CONTENTS

About The North-South Institute ................................................ iv

Author Bios ................................................................. vi

Acknowledgments .............................................................. vii

Acronyms and Abbreviations ................................................ viii

Introduction
How to Prevent the Next Crisis: Lessons from Country Experiences of the Global Financial Crisis
Aniket Bhushan .............................................................. 1

Chapter One
Australia and the Great Recession
Chris Barrett ................................................................. 13

Chapter Two
Ireland: From Good Example to Major Warning
Declan Dineen, Julie Kennedy and Donal Palcic ......................... 29

Chapter Three
India’s Experience of the Crisis and Key Lessons
Indira Rajaraman .......................................................... 55

Chapter Four
How Malaysia Weathered the Financial Crisis:
Policies and Possible Lessons
Mah-Hui Lim and Soo-Khoon Goh ................................. 73

Chapter Five
South Korea’s Experience with Global Financial Crisis
Hyekyung Cho ............................................................ 93
AUTHOR BIOS

Chris Barrett

Chris Barrett is Australia’s Ambassador and Permanent Representative to the OECD since 1 August 2011. Before this, he was the Australia Scholar at the Woodrow Wilson International Center for Scholars, Washington DC. Mr Barrett was Chief of Staff to Treasurer Wayne Swan from 2007 to 2010. He served in the Victorian Department of Premier and Cabinet from 2003 to 2007, culminating in the position of Deputy Secretary of the Policy and Cabinet Group. He has also worked as a management consultant with the Boston Consulting Group in Melbourne. Mr Barrett has Masters degrees from Princeton University (public policy) and the University of Melbourne (international relations) as well as a Bachelor of Commerce and a Bachelor of Arts (Hons) also from the University of Melbourne.

Aniket Bhushan

Aniket Bhushan is Senior Researcher with The North-South Institute. His research has focused on domestic resource mobilization in sub-Saharan Africa, financial sector policy, governance reform of the international financial system and the relationship between growth and socio-economic outcomes. Mr. Bhushan leads NSI’s work on the Canadian International Development Platform (CIDP), a data and analytical platform on Canada’s engagement with the developing world (http://cidpnsi.ca/). His current research focuses on technology and development, specifically how the application of big data and analytics is affecting how we think about data in international development. His recent publications include a chapter on “Big Data” in USAID’s Frontiers in Development (2012).

Hyekyung Cho

Hyekyung Cho is a research fellow at the Financial Economy Institute in Seoul, South Korea. Prior to that she was a visiting fellow at Max Planck Institute (MPIfG) in Cologne, Germany in 2011, visiting fellow at Watson Institute for International Studies, Brown University (2006-2007), and visiting professor at Institute of Korean Studies, Free University of Berlin (2005-2006). Her research interests are in political economy of financial system development, financial markets, institutions and regulatory reforms. She received her PhD in Political Science from Free University of Berlin, Germany in 2004 and was the recipient of the Heinrich Boell Foundation Doctoral Scholarship.
Declan James Dineen
Declan James Dineen has been a lecturer in economics at the University of Limerick, Ireland, since 1999, where he teaches econometrics, macroeconomics, monetary economics, and quantitative methods in economics. He previously worked at University College Cork. His research interests include macroeconometric and computable general equilibrium modelling, monetary economics and the economics of growth. He has published papers in national and international journals as well as contributing chapters to books. Over the past 15 years, he has also worked as a consultant for the Irish Government, Irish semi-state companies and for many private sector interests. He has written on issues related to regulation, competition, the labour market, and macroeconomic performance. His most recent work looks at Ireland’s debt crisis and economic reversal, and seeks to identify policy responses to stimulate sustainable recovery in Ireland’s ‘real’ economy. In addition, another current stream of research looks at the regulation and internal risk management of the Irish retail banking sector, and places this in a cross-country comparative perspective.

Julie Kennedy
Julie Kennedy is an economics PhD student in the University of Limerick, Ireland. Julie graduated from UL with a First Class Honours, Bachelor of Business Studies (BBS) 2005, where she majored in Economics. Julie was employed for three years with Bank of Ireland in the areas of retail strategy marketing and pensions, before returning to UL to register for a Doctoral programme in September 2008. Her research focuses on benchmarking Irish retail banking regulation against key regulatory instruments in other jurisdictions. She is currently in the final year of completing her PhD and has returned to Bank of Ireland where she is employed in Retail Strategy and Development.

Soo-Khoon Goh
Soo-Khoon Goh is a Senior Lecturer at the Centre for Policy Research and International Studies in Universiti Sains Malaysia (Science University of Malaysia), Penang, Malaysia. She received her PhD in Economics from the University of Melbourne, Australia. Her main research interests lie in macroeconomics and international economics.

Mah-Hui Lim

Mah-Hui Lim is a senior visiting fellow at the Socio-economic and Environmental Research Institute (SERI) in Penang, Malaysia. He is also a city councilor for Georgetown, Penang, a world heritage city. He worked in major international banks that included Credit Suisse, Deutsche Bank, Standard Chartered Bank and Asian Development Bank in various parts of Asia and the United States. Prior to his banking career he did research and taught political economy and sociology at Duke University, Temple University and University of Malaya. In 2010, he published a book on the global financial crisis titled Nowhere to Hide: The Great Financial Crisis and Challenges for Asia.

Donal Palcic

Donal Palcic is a Lecturer in Economics at the University of Limerick. His research interests include public sector reform, telecommunications policy and productivity analysis. He recently co-authored a book on Ireland’s privatisation experience which was published by Palgrave Macmillan and he has published a number of refereed journal articles on the subject of privatisation.

Indira Rajaraman

Indira Rajaraman is Honorary Visiting Professor, Indian Statistical Institute, Delhi from February 2010. She was a Member of the Thirteenth Finance Commission from 2007 to 2009. From 1994 until her retirement in 2007 she held the Reserve Bank of India Chair at the National Institute of Public Finance and Policy, Delhi, and from 1976 to 1994 she was on the Economics faculty of the Indian Institute of Management, Bangalore. She obtained her PhD in Economics from Cornell University in January 1974. Dr. Rajaraman's research papers have appeared in journals and books published by Elsevier, Springer Verlag, John Wiley, the Brookings Institution and Oxford University Press, on a wide range of development issues. A paper on the fiscal impact of trade tariff reform is forthcoming in Global Policy, a Wiley-Blackwell journal. She was a member of a major financial sector transparency assessment conducted jointly by the Government and the Reserve Bank of India, the report of which was issued in six volumes in 2009. She has been a columnist in the Indian financial press since 2001, and has been an occasional contributor to http://www.indiapolicyforum.org, a moderated forum for exchange of research-based policy analysis and commentary.
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Special thanks go to the project leader Roy Culpeper and team members John Foster, Pablo Heidrich and Hugues Létourneau. Thanks also to Tony Porter for his contribution to the discussion on the factors behind Canada’s resilience throughout the financial crisis. And thanks to those who participated in our workshops and were so generous with their time. The workshop in New York would not have been possible without the partnership of the Initiative for Policy Dialogue. Likewise, we are grateful to the International Institute for Sustainable Development for its support towards the Geneva workshop.

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## ACRONYMS AND ABBREVIATIONS

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>APRA</td>
<td>Australian Prudential Regulation Authority</td>
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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>BOK</td>
<td>Bank of Korea</td>
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<tr>
<td>CD</td>
<td>certificate of deposit</td>
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<td>CDS</td>
<td>credit default swap</td>
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<td>CEO</td>
<td>chief executive officer</td>
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<td>CGS</td>
<td>Commonwealth Government Securities</td>
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<tr>
<td>CGT</td>
<td>capital gains tax</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>EU-15</td>
<td>European Union (15 Member States between 1 January 1995 and 30 April 2004)</td>
</tr>
<tr>
<td>EMU</td>
<td>Economic and Monetary Union</td>
</tr>
<tr>
<td>FSA</td>
<td>Financial Services Authority</td>
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<tr>
<td>FDI</td>
<td>foreign direct investment</td>
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<tr>
<td>FSC</td>
<td>Financial Supervisory Commission</td>
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<tr>
<td>FTA</td>
<td>Free Trade Agreement</td>
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<tr>
<td>FX</td>
<td>foreign exchange</td>
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<tr>
<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<td>G20</td>
<td>Group of Twenty</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<tr>
<td>GNP</td>
<td>gross national product</td>
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<tr>
<td>GSDP</td>
<td>gross state domestic product</td>
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<tr>
<td>IFSRA</td>
<td>Irish Financial Services Regulatory Authority</td>
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<tr>
<td>ILO</td>
<td>International Labour Organization</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<td>--------------</td>
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<tr>
<td>KOSPI</td>
<td>Korea Composite Stock Price Index</td>
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<td>LIBOR</td>
<td>London interbank offered rate</td>
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<tr>
<td>LTV</td>
<td>loan to value</td>
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<tr>
<td>MSS</td>
<td>Market Stabilisation Scheme</td>
</tr>
<tr>
<td>MOFAT</td>
<td>Ministry of Foreign Affairs and Trade</td>
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<tr>
<td>NAMA</td>
<td>National Asset Management Agency</td>
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<tr>
<td>NBER</td>
<td>National Bureau of Economic Research</td>
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<tr>
<td>NBJP</td>
<td>Nation Building and Jobs Plan</td>
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<tr>
<td>NPA</td>
<td>non-performing assets</td>
</tr>
<tr>
<td>NPL</td>
<td>non-performing loan</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OSFI</td>
<td>Office of the Superintendent of Financial Institutions</td>
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<tr>
<td>PRISM</td>
<td>Probability Risk and Impact System</td>
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<tr>
<td>RBA</td>
<td>Reserve Bank of Australia</td>
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<tr>
<td>RBI</td>
<td>Reserve Bank of India</td>
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<tr>
<td>REER</td>
<td>real effective exchange rate</td>
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<tr>
<td>RM</td>
<td>Malaysian ringgit</td>
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<tr>
<td>SME</td>
<td>small and medium enterprise</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>URR</td>
<td>unremunerated reserve requirement</td>
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<tr>
<td>US</td>
<td>United States</td>
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<tr>
<td>VAT</td>
<td>value-added tax</td>
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<tr>
<td>W</td>
<td>South Korean won</td>
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<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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HOW TO PREVENT THE NEXT CRISIS:
LESSONS FROM COUNTRY EXPERIENCES OF THE GLOBAL FINANCIAL CRISIS

Aniket Bhushan
HOW TO PREVENT THE NEXT CRISIS: LESSONS FROM COUNTRY EXPERIENCES OF THE GLOBAL FINANCIAL CRISIS

Aniket Bhushan

In 2010, the North-South Institute brought together a group of experts from developed and emerging countries to discuss experiences of and lessons from the ongoing global financial crisis. The workshop, the third and last in a series titled Policy Responses to Unfettered Finance which began in late 2008, when the crisis was in its early stages, focused on how different countries were addressing the effects of the crisis in two main areas: macroeconomic policy, and banking and financial sector regulation.¹

This electronic book comprises contributions made following the workshop. It covers experiences of and lessons from the 2008 financial crisis from the perspectives of five countries. These include two developed countries with very different experiences, Australia and Ireland, and three emerging countries that faced similar challenges at different stages, India, Malaysia and South Korea.

The insights offered by the studies are unique, written as they were in the midst of an unfolding crisis. Little did we know that halfway through 2012 we would still be in the midst of the crisis, though at a different epicentre. All eyes are now focused on the euro zone crisis and possible spillovers. Complexities created by the currency union aside, the euro zone crisis involves underlying weaknesses common across many advanced economies. The deleveraging process for households is far from complete and is complicated by the impending deleveraging in both the financial and government sectors. Fiscal consolidation is proving to be extremely challenging and there is widespread public discontent with austerity. In most advanced economies, fiscal budgets (excluding interest payments) would need 20 consecutive years of surpluses exceeding 2 percent of gross domestic product (GDP), starting now, just to bring debt-to-GDP ratios back to pre-crisis levels (BIS, 2012).

Banking and financial sector regulatory reforms have progressed in fits and starts. In the euro zone there is momentum on unification of banking

¹ The first workshop took place in New York at Colombia University in partnership with the Initiative for Policy Dialogue, the second in Geneva in partnership with the International Institute for Sustainable Development, and the third in Ottawa hosted by The North-South Institute. The main findings of the workshops were highlighted in a policy brief (http://www.nsi-ins.ca/images/documents/nextcrisis_v7.pdf) released in the lead-up to the Seoul G20 Summit in late 2010.
supervision, but the timeline for this remains unclear. On the other side of the Atlantic, so-called “too-big-to-fail” financial institutions have in fact become bigger and are more reliant on risky trading income. Despite massive recapitalizations, many banks remain highly leveraged and many that appear well capitalized have outsized derivative exposures. Crucially, financial sector balance sheets are still not adequately recognizing losses associated with impaired assets.

At the time of writing, two headlines dominate financial sector news and speak to how little things have changed since the early days of the crisis. J.P. Morgan Chase and Co., not only the largest but also supposedly one of the strongest US banks, has been caught in a cover-up involving losses related to derivatives trades. Management signed off on changes to risk models which allowed traders to increase risky credit derivative exposures. In April 2012 losses were estimated at around US$350 million and dismissed by CEO Jamie Dimon as a “tempest in a teapot”. By June 2012 those same losses were estimated to be closer to US$6 billion and required restating past earnings. This latest episode speaks to the same failures in internal risk management, aggressive marking of derivative positions, and reluctance in owning up to failures until absolutely unavoidable seen in the early days of the crisis (WSJ, 2012).

In an even wider scandal, at least 15 global financial institutions have been accused of manipulating the London interbank offered rate (LIBOR), to which more than US$800 trillion in securities are linked. This has taken the confidence crisis to the very heart of the financial system. The CEO, chairman and other senior management of at least one systemically important financial institution, Barclays, have all resigned following the scandal, which is by no means over (BBC, 2012).

There are also new risks that are emerging as a consequence of reaching the limits of the tools deployed as part of the crisis response. The efficacy of fiscal stimulus is being hampered by the slowness of the deleveraging process. Additional income derived from stimulus measures is being used to repay debt rather than to spend or invest. Even more worrisome are the risks on the monetary policy side. In its latest report, the Bank for International Settlements highlights that at 30 percent of global GDP, central bank assets are now double the share of global GDP they were a decade ago. Escalating stresses, particularly in the euro zone, are further manifested in adverse feedback loops between sovereign debt and banking sector funding problems (IMF, 2012). Real interest rates remain negative in most major advanced economies. Central banks have had to step in to make up for insufficient action by governments in addressing structural issues. The global economy
is now at a tipping point where positive effects of monetary stimulus may be shrinking and negative side effects are growing (BIS, 2012).

Negative real interest rates and almost unconditional liquidity support may be weakening incentives for fiscal and structural adjustment. The size and scale of unconventional measures could complicate eventual exits from monetary stimulus. Every time the global recovery seems to fizzle out, as is again the case now with growth faltering in both developed and emerging countries, the pressure for further monetary stimulus increases with little reference to actual effects. Policymakers often look to financial markets as a forward-looking gauge of the strength of the recovery. And financial markets seem to have become addicted to monetary stimulus. This is creating a vicious cycle that is proving increasingly harder to break.

SUMMARY OF COUNTRY STUDIES

AUSTRALIA

The first country study, authored by Chris Barrett of the Woodrow Wilson International Center for Scholars, is on Australia. The country, much like Canada, appears to be a “winner” with regard to how it entered and is managing the effects of the crisis. During the crisis, the Canadian banking system has been rated the strongest in the world by the World Economic Forum for three years in a row. Elsewhere we analyzed the reasons for Canada’s success, which have parallels in the Australian story.2 These include a strong fiscal position entering into the crisis, comprehensive and unified banking and financial sector regulation and supervision that is based on principles and focused on outcomes, a relatively depoliticized and swift response by authorities in the early days of the crisis, a concentrated and insular bank-dominated financial sector (six Canadian banks account for over 85 percent of financial sector assets and until recently had limited overseas exposure), and a strong culture of risk management and learning (particularly from past crises) within regulatory authorities.

Several of these factors are also present in the case of Australia. Barrett highlights four main elements that explain Australia’s success: a sound starting position (including a strong fiscal position and a flexible exchange rate that can absorb large external shocks), robust financial regulation, a swift fiscal

2 For a detailed analysis of Canada’s experience please see papers by Tony Porter, Roy Culpeper, Pablo Heidrich and Aniket Bhushan (http://www.nsi-ins.ca/catalog/Policy_responses_to_unfettered_finance-58-1.html) prepared as part of the project.
policy response, and of course good fortune (the China factor). As Barrett shows, strong financial regulation was a key factor in Australia’s success because it allowed policymakers more time to focus on real economy effects. Regulation is unified within the Australian Prudential Regulation Authority much like it is in Canada, which has the Office of the Superintendent of Financial Institutions. A concern that remains for policymakers on the financial sector front, again with parallels to the Canadian case, is the dependence of major banks on offshore wholesale funding markets.

If there is a key lesson that stands out from Barrett’s analysis, it is on the fiscal policy front. The crisis shows that the earlier consensus that discretionary fiscal policy is ineffective for managing economic growth was excessively restrictive. As he puts it, “a blanket denial of the potential effectiveness of fiscal policy deprives policymakers of options at the precise time they are most needed”. His advice, then, is that countries can be more prepared on the fiscal front: “Governments must have fiscal stimulus packages fully formed in their top drawers”.

IRELAND

The second country study, by Declan Dineen, Julie Kennedy and Donal Palcic of the University of Limerick, is on Ireland. In many ways the Irish experience captures the essence of the financial crisis. The authors pose the following question: how did an economy, in which employment and real gross national product (GNP) quadrupled between 1990 and 2006, come to have GNP contract by 17 percent in late 2009? The key to understanding the Irish case—the swiftest and deepest contraction suffered by a Western economy since the Great Depression—according to the authors is realizing that the sustained growth from 1991 to 2006 stemmed from two very different sources. The export-led growth of the 1990s “Celtic Tiger” period gave way to a property bubble based on credit-led consumer spending financed by net external borrowing after 2000. Remarkably, if the construction sector is subtracted from national output, Ireland has been in recession since 2001.

Dineen, Kennedy and Palcic contrast the two periods and provide a detailed account of the emergence of the property bubble and its relationship with the fiscal, banking and public debt crises, as well as regulatory failures along the way. Regarding banking and financial sector regulation and supervision,

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3 The Chinese announcement in November 2008 of US$600 billion in fiscal stimulus (and a large expansion of bank lending) which benefited the Australian economy very substantially was certainly an element of good luck.
Ireland is a good example of why the conduct of regulation is far more important than the institutional, legal or policy framework. Like Australia and Canada, the country has a single regulatory authority. Prudential regulation of the Irish financial sector is consolidated under the Irish Financial Services Regulatory Authority. The regulator too follows a principles-based risk-minimizing approach. However, Irish retail banks took full advantage of the discretion that principles-based regulation allows; bank lending to households and non-financial firms ballooned to almost 200 percent GDP by 2008. The authors argue that throughout the boom period the regulator was operating in an environment where excessive emphasis was placed on fears of upsetting the competitive position of domestic banks, even at the expense of prudential considerations.

Today Ireland perhaps best represents the “austerity-growth dilemma” faced by policymakers in several advanced economies. It was one of the first countries to introduce tough budgetary austerity. But despite deep cuts it still has one of the highest deficits in the European Union (EU). As the authors note, the problem is clear: when a government cuts spending it loses tax revenues from people who earn income from that spending. Moreover, the newly employed seek benefits, so spending cuts in one category are partly offset by more spending in another. In the absence of growth the deficit still looms large. The growth rate is also critical for the international investor community which is still trying to work out whether Ireland can return to a growth path fast enough to make its debt levels sustainable. With borrowing costs at around 5.8 percent, support from the EU and International Monetary Fund (IMF) is unlikely to improve Ireland’s long-term debt situation since the interest rate will very likely be higher than nominal annual growth during the period of the loan, thus paradoxically increasing the real value of the debt.

INDIA

The case study of India by Indira Rajaraman, honorary visiting professor at the Indian Statistical Institute, is the first of the emerging country studies. It begins by discussing the pre-crisis international policy consensus that urged developing countries to lift all barriers to capital flows, much like they were already doing with barriers to goods and services trade. Even unilateral liberalization was promised to bring advantages. As Rajaraman puts it, “the intellectual structure of [financial] globalization was projected as fully thought through”. The only permissible direction for the capital account regime was towards liberalization. In the aftermath of the Asian financial crisis in 1997, the policy instructions given to emerging countries
was predicated on the importance of transparency—particularly monetary policy transparency—which affects the expectations and actions of financial market players.

As the author shows, while India did not flout the ban on the temporary imposition of capital controls, it did engage in sterilized purchases of dollars to hold down the appreciation of the Indian rupee, thereby flouting the received definition of monetary policy transparency dictated by stylized models. Thanks to this India was able to meet the global financial crisis with sizeable foreign exchange reserves and a relatively buoyant export sector. The other key lesson from the Indian experience is in the area of banking and financial sector regulation and supervision, specifically the dual role played by the Reserve Bank of India (RBI), which acts as both central bank and banking regulator, in managing the housing bubble.

Much of India’s experience can be summed up as a victory of pragmatism over received wisdom that may not be suited to particular country contexts. A significant change in the policy dictate aimed at emerging countries that can be attributed squarely to this crisis is the stance on the temporary imposition of capital controls in countries facing volatile surges of capital flows. In 2010 both the IMF and Bank for International Settlements publicly announced their acknowledgement of the need for emerging countries to establish temporary capital controls as a last line of defence against volatile and excessive flows. The author shows that a narrow focus by a developing country central bank on prices in the market for goods and services alone can be devastating when the exchange rate is all-important. This is the reason why RBI intervention was crucial in dampening the transmission of the crisis.

The main conclusion Rajaraman draws is that macroeconomic policy transparency cannot be equated to rigidity in central bank targets and instruments, since outcomes ultimately determine credibility. Transparent functioning of a central bank, then, should be redefined to permit flexible responses to unforeseen eventualities. This makes supervisory discretion under Pillar 2 of the Basel II accord critically important. Rajaraman also concludes that macro-prudential regulation, in other words taking a system-wide view of risk management, is as important as micro-prudential regulation. The institutional framework of regulation will be different in different countries. Policy competition to bring forth the best ideas in regulation should be desirable. For instance, the decision to allow or restrict financial innovations should be left up to the national regulator. There was huge pressure on the RBI, as the banking regulator, to permit the unfettered growth of securitization of housing loans, along the lines of the pre-crisis US model.
The RBI did not ban the practice but subjected it to strict regulations. The regulator also introduced sector-specific risk weights and provisioning which proved vital in curbing the housing bubble.

MALAYSIA

The next emerging country case study, by Michael Lim Mah-Hui and Goh Soo Khoon, is of Malaysia. The country, along with other Southeast Asian countries, suffered the worst of the 1997 Asian financial crisis. The experience of that crisis had not faded when Malaysia entered the 2008 crisis in a relatively strong position as far as government and corporate balance sheets were concerned. Following the Asian crisis, the country famously went against IMF dictates and instituted selective capital controls, pegged the exchange rate of the ringgit, banned offshore trading of the currency, and pursued aggressively expansionary monetary and fiscal policies. A number of financial and non-financial institutions underwent significant restructuring. Again, much like in India’s experience, Malaysia’s strategy following the Asian crisis was very much a victory of pragmatism. Thanks to its combination of policies, Malaysia experienced a strong export-led recovery after that crisis.

By 2005, however, as the authors show, in large part due to the success of its strategy Malaysia became highly integrated into the global economy through both trade and financial linkages. Exchange rates and capital flows were almost completely liberalized, and the current account accumulated large year-on-year surpluses that were unmatched by requisite capital account deficits, necessitating further liberalization of capital outflows.

A key factor contributing to Malaysia’s ability to respond to the 2008 crisis was the buildup of ample foreign exchange reserves. Given its lower exposure to foreign debt, there was little currency mismatch (unlike South Korea, discussed below). The authors conclude that in order to derive benefit as well as shield their country from increasingly deeper integration into the world trade and financial system, Malaysian policymakers will need to remain open to pragmatic and flexible policies. These include targeting asset inflation and a willingness to “lean against the wind”. Like India, Malaysia has resisted exposure to fancy financial innovations in derivatives markets and emphasized the maintenance of a sound financial sector. While government and corporate balance sheets are healthy, household balance sheets are an area of concern. The ratio of household debt to disposable income in Malaysia, driven by an increase in house prices and a deterioration of the housing affordability index in major urban centres, is higher than in the US.
How to Prevent The next Crisis: Lessons from Country experiences of the Global financial Crisis

South Korea

The emerging country case study of South Korea (hereafter Korea), authored by Hyekyung Cho of the Hallym University of Graduate Studies, brings the discussion full circle. The November 2010 Group of Twenty (G20) Summit in Seoul marked an important milestone as Korea became the first emerging country to host a leader-level G20 summit. Korea has positioned itself as midway between the developing countries in the G20 and the advanced economies, thus representing the concerns of both. In many ways its experience of the crisis is one of a country in transition from emerging to advanced economy status.

Cho argues the Korean experience must be placed in historical context to fully understand the impact of the crisis and the government’s response to it. Like Malaysia, Korea experienced a severe banking and currency crisis during the Asian financial crisis. That was a product of experiments with liberalization, which go back as far as the early 1980s. Prior to the 1980s, Korea had been pursuing a largely export-driven development model. A system of state-led financial repression, in which the banking and financial sector was subservient to the needs of the export model, was the main force behind the Korean economic miracle. Given the dependence on exports, the clear overarching financial priority was maintaining currency stability. Free capital mobility had therefore never been a priority. Decades of pursuing this model resulted in underdeveloped capital markets. Since 1997 Korea has tried to balance financial liberalization with currency stability, with the Asian crisis and consequent IMF intervention representing a watershed moment.

While Korea was not directly exposed to the US subprime sector, the global credit crunch following the collapse of American investment bank Lehman Brothers had a severe impact on the country by way of a foreign and domestic liquidity crisis and a collapse of the Korean won. In the second half of 2008, the won fell a whopping 60 percent against the US dollar (the second worst depreciation after the Icelandic krona). The Korean experience of the crisis, coming as it does further along the path of liberalization than Malaysia and India, shows that even large currency reserves offer little protection against currency instability and financial crisis. Korea also provides a good example of the seemingly contradictory positions policymakers can be forced into when muddling through crises.

Following the Asian crisis, Korea pursued aggressive financial liberalization according to IMF policy prescriptions. Its financial markets have rapidly developed and expanded during this period. Outcomes of this include household debt-driven asset bubbles and heightened foreign exchange
market volatility. In line with the government’s ambition to make Korea an Asian “financial hub”, the currency market for the won has grown at a rapid rate, with daily turnover far exceeding (about 10 times) that of the stock market. Further in line with its strategy, Korea liberalized foreign investment in domestic bond markets. This led to a sharp increase in capital inflows, driving a sharp rise in the dollar-won exchange rate (in both 2009 and 2010). In an ironic turn, the authorities pushing for liberalization and the Asian “financial hub” project found themselves advocating on behalf of the need for selective capital controls at the Seoul G20 summit.

The Korean experience is salutary in that it highlights some of the policy dilemmas faced as a consequence of greater financial integration into an increasingly unstable global financial system. Actions at one end of the system have consequences for economies at the other end. Linkages between capital markets, through liberalized capital flows, tend to magnify movements both to the upside and downside. Tools which may have been viable at one stage could well prove too costly at another. Rapid financial integration has tended to shrink the transition period between stages. This is a valuable lesson from the Korean experience for emerging countries such as India and China which have not yet moved as far along the path of financial liberalization.

CONCLUSION

The aim of this e-book is to bring together lessons from a diverse set of country experiences of the ongoing global financial crisis. Readers will find detailed, at times first-hand accounts of the steps policymakers have taken to mitigate the impacts of the crisis on their countries, and the rationale behind them.

The analyses presented here and discussions during the workshops of the North-South Institute’s Policy Responses to Unfettered Finance project offer several important generalizations:

• This crisis has shown the importance of fiscal policy and its role in supporting aggregate demand. In recent years fiscal policy has played second fiddle to monetary policy considerations, specifically the price stability objective. Countries that weathered the storm demonstrated that countercyclical fiscal policy is particularly important because it frees up room to respond in a crisis.

• The global economy is being supported by unprecedentedly accommodative monetary policy. It is currently at a tipping point where negative risks from further monetary stimulus are beginning to outweigh
potential benefits. Country experiences suggest that, going forward, the traditional toolkit of interest rates and capital requirements will need to be complemented by macro-prudential tools such as caps on leverage, liquidity measures and reserve requirements, administrative and sector-specific curbs on lending (specifically to the construction and housing sectors), and selective controls on volatile capital flows. A consensus in some of these areas is emerging fast.

• Countries that have fared better are distinguished by a comprehensive banking and financial regulatory regime based on well-articulated principles, under a single independent regulator with a clear mandate but ample discretionary room to attain broad stability objectives. The crisis has shown the importance of paying attention to the conduct of regulation, and not merely what is or is not in the rule books. A focus on systemic risks, a high degree of coordination among various regulatory authorities, and a strong capacity to learn from past failures are key characteristics of regulatory authorities that have performed well throughout the crisis.

While highlighting lessons is important, it is impossible not to be struck by how little has really changed. Be it underestimated losses on credit derivatives at J. P. Morgan Chase and Co. or the LIBOR scandal, the irresponsible actions of the banking and financial sector, now over four years into the crisis, are only deepening the confidence crisis. Momentum for financial reform seems to have stalled as immediate concerns in the euro zone show few signs of a credible solution.

As advanced economies continue to pursue expansionary policies, including unconventional monetary policies, emerging countries are forced to re-evaluate their own stances, further complicating potentially adverse feedbacks that are nearly impossible to predict or model. At the very moment that greater coordination is at a premium, there are signs that the G20 has not only lost its way but is losing the confidence of citizens.4 The euro zone crisis shows what teetering on the brink of coordination failure looks like. In these trying times rife with uncertainty, we hope that careful country studies such as those presented in this e-book will inform debates about how best to prevent the next crisis.

REFERENCES


AUSTRALIA AND THE GREAT RECESSION

Chris Barrett
AUSTRALIA AND THE GREAT RECESSION¹
Chris Barrett

INTRODUCTION

Few people with an interest in economics will soon forget the extraordinary events of the global financial crisis and what is often termed the “Great Recession” of 2008–9. For those involved in policymaking during this period—as I was as Chief of Staff to the Australian Treasurer Wayne Swan between late 2007 and 2010—memories will fade even more slowly. Australia, famously, was virtually alone among International Monetary Fund (IMF) advanced economies in not experiencing a recession during this period, and had the strongest growth of any of these economies in 2009. This performance merits examination for what it can tell us about the contribution policy decisions made to this outperformance. This paper considers the most extensively debated of Australia’s policy interventions: the fiscal stimulus packages announced in October 2008 and February 2009. It is timely to look back on the latest data and analysis to draw some conclusions about the impact of fiscal stimulus during this period, and ask two questions. First, did fiscal stimulus prevent an Australian recession? And, if so, why was it effective in Australia and not in other countries?

DID FISCAL STIMULUS PREVENT AN AUSTRALIAN RECESSION?

Australia’s fiscal policy response came in two tranches: in October 2008, the government announced cash payments to lower-income households of over A$10 billion, paid out in early December of 2008. Then, in early February 2009, the government announced a second and larger fiscal stimulus of A$13 billion in tax bonuses to households, A$22 billion in school infrastructure and public housing, A$4 billion to insulate housing and A$3 billion in incentives for business investment.

Figure 1 shows how this stimulus affected the path of growth. It derives a “no fiscal stimulus” gross domestic product (GDP) path by subtracting the estimated impact of stimulus from the actual GDP path observed in the economy during the crisis period. The impact of stimulus has been calculated by allocated spending as close as possible to when stimulus funds were actually spent (not budgeted or allocated) gleaned from the reports of

¹ (This is an edited extract from the paper “Australia and the Great Recession” available on the website of the Woodrow Wilson International Center for scholars: www.wilsoncenter.org/index.cfm?topic_id=1462&fuseaction=topics.event_summary&event_id=682814)
How to Prevent the Next Crisis: Lessons from Country Experiences of the Global Financial Crisis

Figure 1: Real GDP level with and without fiscal stimulus (seasonally adjusted) in Australia, September 2008–December 2009 (A$ billions)

![Real GDP level with and without fiscal stimulus](image)

Source: Author’s analysis of ABS, Australian Treasury and CCG data.

the Commonwealth Coordinator-General (CCG, 2009), and applying fiscal multipliers consistent with the work of the IMF and the Organisation for Economic Co-operation and Development (OECD) and with the results of a micro study of Australia’s cash payments in 2009 (Leigh, 2009).

Figure 1 shows the level of GDP and the estimated impact of stimulus. We can deduce the GDP growth impact from the slope of the different lines. They show a slightly deeper downturn in the December quarter 2008 (-1.2 percent versus actual -0.9 percent), basically no growth in the March 2009 quarter (0.1 percent versus actual 0.9 percent) and then a second and much larger fall in the June quarter of 2009 (-1.4 percent versus actual +0.4 percent).

This tells us something very important. Ever since Australia’s growth surprised on the upside through the crisis, there has been a current of opinion that fiscal stimulus was not required in the country after all, and that looser monetary policy, a lower exchange rate and China’s stimulus were sufficient for it to avoid recession. All of these factors are of course present in the “without stimulus” path of GDP above. But my analysis suggests Australia would have suffered two large negative quarters of growth without fiscal stimulus. In fact, the figure for the 2009 June quarter of a 1.4 percent fall in GDP is greater than the worst negative quarter of the early 1990s recession (-1.3 percent in March 1991).
As noted above, this analysis has been carried out using fiscal multipliers supported by both empirical evidence and international bodies such as the OECD and the IMF. But since fiscal multipliers themselves are a matter of academic dispute, I performed another version of the analysis, looking at the amounts spent by government and the final path of GDP, and deriving from these variables the multipliers for which stimulus was (or was not) decisive in Australia’s avoiding recession. From September 2008 to December 2009, there was a cumulative A$7 billion (accounting for negative and positive growth) added to GDP (ABS, 2011a), yet the stimulus entering the economy during this period was A$40 billion. We would have to believe the weighted multiplier for this spending was below 0.18 for fiscal stimulus not to have been decisive in maintaining positive growth over these five quarters. This is implausibly low in the company of estimated Australian multipliers of 0.7 from the OECD (OECD, 2009) and 1 from the IMF (IMF, 2009). This comparison does not surprise—the idea that four-fifths of a total stimulus of A$40 billion would not make its way through into economic activity stretches credulity in all but the most extreme circumstances, and, in fact, the extreme global economic circumstances in this case suggest higher fiscal multipliers, not lower ones.

Further, the analysis here has asked whether fiscal stimulus made the difference between positive and negative growth. That is important for the technical debate about whether there would have been an Australian recession without fiscal stimulus, but of course the intent of policymakers should never be to get growth as close to zero as possible. If fiscal stimulus was overdone, as many critics argue, it is incumbent on those critics to explain why growth of just 1.7 percent between September 2008 and December 2009 (ABS, 2011a) was too high and should have been lower. Such an explanation should also take account of the fact that unemployment rose by 1.1 percentage points over this period (ABS, 2011b).

WHAT EXPLAINS AUSTRALIA’S SUCCESS?

The second key question relates to which factors explain the success of fiscal stimulus in Australia compared with other countries. In my view, four elements explain the better outcome for fiscal policy in Australia’s case:

1. A better starting position;
2. Good fortune, independent of any Australian action;
3. Better financial regulation in the years preceding the crisis; and
4. A better fiscal policy response to the crisis.

Let me deal with these elements in turn.
A BETTER STARTING POSITION

In terms of a better starting position, as the crisis hit, Australia had a number of advantages, chiefly:

- A flexible exchange rate that could help absorb a large external shock;
- A flexible labour market that allowed working hours to absorb much of what would otherwise have been job losses;
- A strong fiscal position that allowed a substantial fiscal response; and
- An independent central bank that rapidly cut interest rates and made other policy accommodations.

This is an impressive legacy of more than two decades of economic reform, but it is one shared by two very similar economies—Canada and New Zealand. Yet Canada's economy shrank by 3.3 percent between December 2008 and June 2009, and New Zealand's by 3.8 percent between March 2008 and March 2009. Both countries’ experiences strongly suggest that the quite unusual combination of structural economic advantages Australia enjoyed on the eve of the crisis were not decisive on their own for Australia’s outperformance.

GOOD FORTUNE

There was also an element of good luck—chiefly the Chinese announcement in November 2008 of US$600 billion in fiscal stimulus (and a large expansion of bank lending) which benefited the Australian economy very substantially. This raises an intriguing question: could Australia have benefited by “free riding” on the Chinese stimulus, and should we have done so, given the Chinese package was announced before Australia’s second stimulus package?

This was a question we grappled with at the time, but which decision makers ultimately rejected for two specific reasons. First (and this is very easy to forget from today’s vantage point), there was widespread scepticism within government and more generally about just how much real stimulus there was in the Chinese announcement. Second, Australia faced some very specific weaknesses in domestic sectors (especially in construction), which would not be assisted by the Chinese stimulus and which would likely add significantly to unemployment.

The analysis of the impact of stimulus detailed in Figure 1 above provides a good sense of where free riding on the Chinese response would have left Australian growth—in a recession. And while the recession may have been
shallower than would have been the case without China’s stimulus, the Chinese stimulus was not sufficient to fill the Australian output gap.

BETTER FINANCIAL REGULATION

A further reason fiscal policy was effective during the crisis was the relatively robust state of the Australian financial system. Australia was required to guarantee bank deposits and bank wholesale funding during the crisis, but this was more a consequence of similar actions in other countries than a specific weakness identified in the Australian financial system. The relatively healthy Australian financial system sustained stronger underlying economic activity than those in countries such as the US and the UK, and left policymakers with more time to focus on real economy effects.

What were the reasons for the healthier state of the Australian financial system? I posit two in particular.

First, cash rates in Australia had been held higher for longer than in many other countries, as a consequence of both stronger economic growth in Australia and the underlying concern to limit the growth of a bubble in house prices. This reduced the incentives to search for yield in riskier financial instruments. Second, Australia had created a separate prudential regulator for financial institutions, the Australian Prudential Regulation Authority (APRA), in 1998. This created a stronger culture of micro-prudential regulation, which was highly effective in preventing the emergence of subprime mortgages and ensuring the capital adequacy of Australian banks through comprehensive stress testing in the years before the crisis.

The combination of these two factors meant that domestic subprime exposures by Australian banks were negligible on the eve of the crisis. Mortgage arrears and defaults were low at the outset of the crisis, and remained low throughout (largely because unemployment remained relatively low). There were some exposures to offshore toxic assets, but these turned out to be relatively small and, despite some nervous moments during 2008, were disclosed by the Australian banks and appropriately provisioned for.

The principal concern for policymakers on the financial front was the dependence of our major banks on offshore wholesale funding markets to sustain their own business and, by extension, satisfy the strong investment appetite underlying Australia’s current account deficit. Despite the strength of Australia’s banks, they risked being pushed to the back of the queue for wholesale funding, behind much more troubled foreign banks suddenly enjoying sovereign guarantees. This was why the wholesale funding guarantee was required in October 2008. In late 2010, the Treasurer moved...
to help banks diversify their funding sources, for example by allowing the issuance of covered bonds (Swan, 2010).

AN EFFECTIVE FISCAL RESPONSE

Finally, there is the question of what was distinctive about the Australian response. A useful framework for thinking about this is through the standard (and still highly relevant) critique of Keynesian demand management. This critique holds that lags in (1) recognising a recession is underway, (2) deciding what to do in response and (3) implementing this decision mean fiscal stimulus will be ineffective at anything other than inflating the next boom.

Let me demonstrate the lag issue: I charted the growth figures for both the US and Australia during the global financial crisis (the solid black lines), and then overlaid the estimated impact of stimulus (columns) from the Congressional Budget Office in the US case (CBO, 2009; 2010) and from the Treasury Department in the Australian case (Gruen, 2009).

The very significant lag in fiscal action is immediately apparent in the US case. The National Bureau of Economic Research (NBER)—the body tasked with dating recessions in the US—now concludes the US recession began in December 2007 (NBER, 2010). And yet Figure 2 makes it clear that a sustained fiscal response sufficient to support economic growth did not take effect until the June quarter of 2009. All told, there was more than

Figure 2: US growth and stimulus, September 2007–September 2010 (% GDP)

Source: Author’s analysis of Bureau of Economic Analysis and CBO data.
a year between the US economy’s entry into recession and the passage of a substantial and sustained fiscal stimulus.

In Australia, the economy never entered recession, but it did experience a very sharp downturn in the December quarter of 2008. Initial stimulus (cash payments) was paid out in that same quarter (albeit only at the very end) and a further and more substantial stimulus package (the Nation-building and Jobs Plan, or NBJP) was passed in February 2009. Fiscal stimulus to all intents and purposes arrived at the same time as the downturn, and stayed long enough to see it off.

There are many reasons for this speedier and more effective Australian response, and many of them have to do with Australia’s good luck (or the US’s bad luck) depending on how one looks at it: Australia did not have the issue of national elections and a change of administration in the middle of our crisis response. Nor were our decision makers overwhelmed by the difficulties of our financial sector—they had time to focus on the real economy effects. But Australia’s response was not just faster than that in the US. It was faster than that in any number of countries without the US’s problems. So what are some of the factors that explain Australia’s speedier and more effective response?

There were in my view five elements of Australia’s response that worked to reduce the lags inherent in fiscal stimulus, which I now discuss.
Early warning

To begin with, Australian policymakers recognised the coming recession more quickly, because they were intensely engaged with international economic developments long before the collapse of Lehman Brothers in September 2008. From my perspective, the Treasurer’s trip to the US for the IMF/World Bank spring meetings on the weekend of 12 and 13 April 2008 was decisive. It seemed everyone the Treasurer met in Washington and New York told the same story, which was best summed up by a comment by Tim Stewart, a former Australian Treasury official and Senior Manager with Fortress Investment Group, who told the Treasurer that the collapse of investment bank Bear Sterns in March 2008 was not the end of the crisis, rather it was just the beginning. As a consequence, a number of planned budget cuts were shelved as the Australian government took out some insurance against the crisis that it turned out was just five short months away.

If the April meetings were part of the early warning, the Treasurer’s presence over the weekend of 11 and 12 October 2008 in Washington (for the IMF/World Bank autumn meetings and the emergency G20 Finance Ministers’ meeting) could not have been more important for the decisions the government was about to make on the crisis response. From Washington, the Treasurer phoned in to the Sunday morning deliberations of the Strategic Priorities and Budget Committee in Canberra on the fiscal stimulus and bank guarantee packages, and the discussions he had in Washington influenced the direction these packages took. To have a senior minister dial in to such a decisive meeting, from the epicentre of the crisis, was a remarkable example of real-time policy intelligence which served Australia very well during the crisis.

Preparatory work in the financial sector

Nevertheless, even when ministers are convinced of the need to act, there is a separate and just as difficult question of what action to take. In the Australian case, some decisions the Treasurer took in the first half of 2008 were important in preventing the crisis from affecting Australian markets more severely.

The first was the announcement on 20 May 2008 that the government would increase the amount of Commonwealth Government Securities (CGS) on issue (Swan, 2008b). He couldn’t say so at the time, but a major factor in the Treasurer’s consideration of this measure was potential future credit and bond market disruptions. Increasing CGS on issue was important to maintain liquidity and assist pricing in the bond and futures markets.
markets. He made less of an issue publicly of a much more important move the same day, which was to expand the investment powers of the Australian Office of Financial Management. What he specifically had in mind was the potential need for the government to be able to purchase residential mortgage-backed securities, should it become necessary to intervene to reopen that market (which by then had been shut since late 2007). This was subsequently realised when the Treasurer announced such an intervention on 26 September 2008—just 11 days after the collapse of Lehman’s (Swan, 2008a).

Even more important was the Treasurer’s decision, announced on June 2, 2008, but in the works for most of that year, to introduce a Financial Claims Scheme. The recommendation for such a scheme—to provide timely access to depositors’ funds in the event of a financial institution’s failure and also to strengthen regulators’ powers to deal with a failed institution—had been around since 2003, but was controversial within the industry. The Treasurer had a different take on this. He believed such a scheme was too important to leave in the bottom drawer, and instability on global markets made it prudent to act quickly. The legislation was introduced on 15 October 2008 in the flurry of activity following the bank guarantees announcement, but this obscures a point that those outside government readily underestimate: had the Treasurer not given the go-ahead for this months earlier, the complex legal drafting would not have been completed and refined for the introduction of the legislation.

Preparatory work in fiscal policy

A further factor that enabled an effective fiscal policy response was that the bureaucracy was rapidly able to provide advice to government on precisely which fiscal policies to implement. This was assisted by some forward planning for potential crisis undertaken by the Treasury in 2004. The most interesting paper from this war-games exercise threw up a series of possible responses to a slowing economy (McNamara, 2003). The fingerprints of this work show up in a few places in the government’s eventual crisis response. First, the paper is eloquent about the need to move quickly as the economy begins to turn and to be mindful of the slow reaction time in past crises. This was hardly a lesson those who had been in the Australian Treasury during the deep recession of the early 1990s needed to learn, and yet it was doubtless very useful for younger officials—who in this case would be anyone under about 45 years old! Second, there is a critical (and essentially counter-intuitive) insight about the different speeds at which monetary and fiscal policy can take effect:
“Changes in monetary policy have an impact on economic growth that is spread roughly evenly over about two years after the change […]. The impact of fiscal policy can be considerably quicker. Some fiscal policy actions can influence activity from the point of announcement, before they are implemented” (McNamara, 2003: 4).

Third, the paper on balance comes down in favour of one-off benefit payments to low-income households, and government consumption and investment expenditure, as opposed to tax cuts.

It’s easy to say much of this was stating the obvious, but this underestimates how contested this view is—witness the academics who to this day dispute that fiscal policy can be successful. It also misunderstands how governments make decisions: given the controversial nature of the advice and the very compressed timeframe in which decisions were being made, it was vital that these policy responses had been thought through and debated at official level to make them as robust as possible in the time available.

Implementation architecture

Once decisions were made, smooth and rapid implementation was vital. Australia was fortunate to have an established architecture for rapid payments to benefit recipients, but no such system existed for infrastructure investments. A big part of the explanation for the speed with which infrastructure stimulus dollars were transferred to the states and territories and spent in a timely manner lies in the Council of Australian Governments meeting, held just two days after the announcement of the NBJP, specifically to agree an implementation architecture for the plan.

This initiative itself arose from the Prime Minister’s concern that the stimulus (1) might be diluted in its impact by process delays at the state level and (2) might be in part offset by state cutbacks at the same time as the federal government was increasing spending. The Department of Prime Minister and Cabinet devised a management, reporting and monitoring structure to roll out the key stimulus initiatives, in particular the school building and social housing programmes. Coordinators-general were established for each state and territory and each of the major stimulus programmes. These in turn reported to a federal Coordinator-General. Timelines for delivery and even standard designs were explicitly stipulated, and progress was regularly monitored. Crucially, “maintenance of effort” clauses were inserted into the agreement with the states to prevent them from taking their own money out as the Commonwealth money was being paid in. This architecture was wrapped up in a comprehensive agreement signed by all the state leaders.
and released publicly. In this way, the Prime Minister ensured state leaders had politically “bought in” to the timely rollout of the stimulus.

Corporate memory

Two further factors worked to shorten fiscal lags across the board. The first was a strong corporate memory of the last Australian recession among policymakers. Focusing specifically on the Treasury, for example, the Department is well known in Canberra for being one that people serve for long periods of their career. The Executive Board, as its chief decision-making body, has an average tenure in excess of 20 years. For the purposes of management during the economic crisis, it had one distinct advantage: most of the senior people advising the Treasurer had been in Treasury (and in one case, the Reserve Bank of Australia (RBA)), at the time of the last recession, almost 20 years earlier. One Executive Director, Mike Callaghan, put it to me this way (in interview on 29 September 2010): “I was in Treasury during the last recession. Our forecasting group was following the economy down. We never had the right picture of the recession. We were always too late. It was a sobering experience for all involved.”

This was no small matter. It meant that the new government had a view through the windscreen of the impending global recession, not a view through the rearview mirror of what we had already hit.

Nor should we discount memories of the early 1990s recession among politicians themselves. This was a searing experience for Labor politicians (and many of their staff). We all remembered not only how slow fiscal stimulus was to arrive in the early 1990s (after the recession had passed) but also the very patchy record of labour market programmes introduced after to try and reduce unemployment. They were by most experts’ agreement expensive and slow to work, and left too many long-term unemployed, some of whom never worked again. There was a deep attraction in getting ahead of the deteriorating economy to prevent unemployment from soaring in the first place.

Policy responsiveness of new administrations

Many of these individual elements may not have been as decisive were it not for a final, and I think critical, factor: we were a new administration. A new government necessarily assembles facts and questions assumptions differently from an established one. I have no doubt it was much to the frustration of a number of our official advisors, but the Prime Minister and his ministers were obsessive about obtaining briefing and analysis on a
wide range of economic developments. This went to the critical question of how long the recognition lag was before decision makers realised something would need to be done. But it also had a powerful effect on the time it took to consider options and make a decision.

The consequence of so much concentrated senior attention to developments in the economy was that ministers’ views had aligned sufficiently by that October 2008 weekend for decisions to be made relatively quickly. It wasn’t the case that decisions were made without thinking, or that large differences of opinion were glossed over. Rather, long and intensive engagement with the subject matter had brought opinions close enough together for agreement to be reached.

The converse point needs to be made. New governments are not burdened by the rhetorical and policy positions of old ones. Let’s consider the counterfactual: in my view, the Howard government (in power between 1996 and 2007) was so politically invested in the strength of the economy and budget surpluses, it would have found it very difficult to accept that (1) the economy was seriously threatened and (2) the surpluses needed to be deployed to protect it. Based on their record, one might expect the Howard government to have provided something in the way of cash payments (though not as targeted) and offered a first homeowners’ boost. This would likely have been insufficient as a fiscal response.

**CONCLUSION**

Australia has been called the “miracle” economy since well before this most recent crisis (Krugman, 1998). While its performance has certainly been remarkable, the label is unhelpful: it suggests the country’s strong economic performance is the product of chance alone and excludes the important role good economic management has played in the past 20 years of Australian economic success. Former British Prime Minister Gordon Brown used to talk about banishing “boom and bust” economics in Britain. This was and remains the dearest goal of economic policymakers around the world. Brown’s emphasis was on monetary and fiscal rules to provide a stable policy framework. This wasn’t wrong, but it also wasn’t enough. Better regulation was an obvious blind spot, but so was a practical plan for intervening in times of crisis.

The general pre-crisis consensus in macroeconomics was that discretionary fiscal policy was ineffective for managing economic growth. It was thought better to leave aggregate demand management to monetary policy, which acted more speedily and was more able to operate with greater symmetry
through the economic cycle. I think we learn something different from Australia’s most recent experience, and the conclusion for discretionary fiscal policy more broadly is one of bounded optimism. On the one hand, we should remember the unusual circumstances of success in this instance of fiscal policymaking. It is rare to have a country with as propitious starting circumstances as Australia, some advance warning of a serious downturn and an ability to act quickly enough to make a difference.

But all of these propitious factors are themselves amenable to policy action. Countries can—and should—choose to build strong economic fundamentals such as sound financial regulation and a strong fiscal position. Countries can build the systems and linkages that give them better advance warning of looming crises. And countries can be prepared to act on the fiscal front when it is justified by the economic circumstances and when the odds of success are sufficiently high, accounting for the risks of intervention. In particular, governments must have fiscal stimulus packages fully formed in their top drawers. The Australian government had elements of such a package ready, but much of it still had to be purpose built at the time. Immediate cash payments are a simple enough thing to design but, in a sustained downturn, cash payments have to pass the baton to investment projects. These take time to scope and plan, and time is the one thing policymakers never have when crises hit. There must be a conscious effort to have viable and beneficial projects ready beforehand. In the good times, they can be part of a queue of projects to be steadily worked through as fiscal circumstances allow. But they must be constantly replenished to be ready in case of crisis. Even if they are never built, they sit there as an insurance policy against recession and mass unemployment. A blanket denial of the potential effectiveness of fiscal policy deprives policymakers of options at the precise times they are most in need of them.

It is important that the story of Australia’s fiscal policy success during this crisis is understood for what it can tell us about the conditions under which such interventions can be successful in future—and when they can’t—and that policy advisors and policymakers continuously seek to learn the lessons to be ready for future crises.
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IRELAND: FROM GOOD EXAMPLE TO MAJOR WARNING

Declan Dineen, Julie Kennedy and Donal Palcic
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INTRODUCTION

While it could not have been fully understood at the time, few countries entered the global recession as poorly positioned as Ireland. This was an economy where gross national product (GNP) grew at a rate in the range of 5–15 percent every year from 1991 to 2006 (Kelly, 2010), and this sustained growth achievement had been widely admired. Yet Ireland, once seen as a good example, now serves notice of a major warning. Kelly (2010) describes the Irish economic growth performance during the past two decades as a sequence of transitions “from basket case to superstar and back again – or almost”. The story is certainly compelling, and is characterised by what appears to have been a remarkable economic transformation, followed by a very pronounced and ongoing contraction. This paper explains Ireland’s economic rise and reversal.

The key to understanding what happened to Ireland lies in realising that the recorded surge in macroeconomic growth stemmed from two very different phases, and the transition between them attended a significant change in the structure of the Irish economy. Ireland is a textbook small open economy, where exports represent over 90 percent of gross domestic product (GDP), and the move from boom to bubble mirrored the dynamic in the country’s growth in exports. Ireland’s huge exports to GDP ratio and privileged position in global supply chains helped it grow rapidly in the 1990s. This export-led boom gave way to an unsustainable credit-led property price bubble, financed by net external borrowing, after 2000. In the period from 2001 to 2006, new homebuilding disguised problems in the export sector. Indeed, if the construction sector is subtracted from national output, Ireland was in recession from 2001.

The current Irish debt crisis has resided, to a great extent, in property-related bad loans as a result of Irish banks’ heavy loan losses on their development property portfolio acquired at the peak of the market. Easy access to consumer credit, funded by Irish banks’ increasing reliance on wholesale external borrowing, and a sharp rise in construction lending fuelled a growing property bubble. Irish residential property prices declined continuously after 2007. The weaknesses of Irish banks were exposed after

1 “Exports of goods and services” (€144,782 million) as a percentage of “GDP at current market prices” (€159,646 million) in 2009 (CSO National Income and Expenditure, 2009).
the downturn in the domestic property market and the near-collapse of global debt markets in late 2008.

However, the causes of Ireland’s current economic dislocation are wider than the solvency of its banking system. Domestic macroeconomic imbalances had built up during most of the second period of growth associated with the property bubble. The government’s procyclical fiscal policy stance, budgetary measures aimed at boosting the construction sector and a relaxed approach to the growing reliance on property-related and other insecure sources of tax revenue were significant factors contributing to the unsustainable structure of spending in the Irish economy at this time (Honohan, 2010). While most of the causes of Ireland’s economic malaise are home grown, additional important external influences included its membership of the eurozone in particular, and the added expansion of credit that attended the entry of foreign banks into the Irish market.

IRELAND’S ECONOMIC TRANSFORMATION AND GROWTH CONVERGENCE IN THE 1990s

Before the onset of the current worldwide economic downturn, the turnaround in the performance of the Irish economy, especially during the 1990s, received considerable international attention. The focus of this was generally on how an economy with severe fiscal imbalances and endemic unemployment in the 1980s was transformed in the 1990s to exhibit remarkable economic growth and employment gains. During the 1990s, Ireland emerged from a lengthy period of economic stagnation marked by high unemployment, emigration and crippling public debt, despite high tax levels (Deegan and Dineen, 2003; Honohan and Walsh, 2002; Ó Gráda and O’Rourke, 1996).

Ireland’s economic transformation during the 1990s constituted something of a macroeconomist’s “vision of utopia”, characterised as it was by high and sustained economic growth, low inflation, a current account balance of payments surplus, falling unemployment, net immigration and a growing budget surplus. Also, an expanded flow of European Union (EU) structural funds amounting to as much as 3 percent of GDP helped fund sufficient public infrastructure in those years (Honohan, 2009a).

IRELAND’S ECONOMIC GROWTH CONVERGENCE

Ireland’s upsurge in economic growth during the 1990s was outstanding not only in terms of its own historical experience but also in an international comparative context. However, Ireland had been a laggard in terms of its
performance during the European economy’s “Golden Age”, which spanned the period 1950–73. Hence, there are elements of delayed catch-up in its economic transformation (Barry and Crafts, 1999). Irish growth performance in the 1990s is a clear outlier, in terms of GDP per capita based on purchasing power parities, relative to the group of Organisation for Economic Co-operation and Development (OECD) countries considered in Figure 1, which presents initial income levels and subsequent growth. Ireland is located well above the trend line (not shown), illustrating the very robust annual average growth in income per head experienced between 1992 and 1999. It is clear that Ireland’s belated catching-up was a comparatively rapid phenomenon. At the beginning of the 1990s, Ireland was grouped with the other peripheral EU countries (Greece, Portugal and Spain) in having among the poorest living standards in the OECD.

EXTRACTIONS DURING THE 1990S BOOM

During Ireland’s first growth period, the exceptionally large contribution of exports to GDP increased, and the vertical integration of much of the country’s manufacturing sector into the global production chains of major...
multinational firms deepened. These characteristics, when combined with
the sustained growth in world trade, contributed to a sustained output
boom during the 1990s.

Irish exports of goods and services amounted to the equivalent of 102
percent of GNP in 1999, and the combined share of exports and imports
in GNP was almost 190 percent (CSO National Income and Expenditure,
1999).2 The volume of Irish goods exports grew at the phenomenal rate of
16.5 percent per annum from 1993 to 2000—a rate that would lead to a
doubling of exports every 4.5 years (Kennedy, 2001). Ireland experienced a
rapid increase in its share of export markets during the Celtic Tiger period,
but in accounting for the overall surge in Irish export performance, this
effect was secondary to the growth of the export markets themselves. There
were two important external dynamics that made for a resurgence in trade:

In the 1990s, the US returned to the rapid growth rates experienced during
the “Golden Age” before the first oil crisis in 1973. High US economic
growth translated into massive growth of US imports.

Despite continued low growth of European GDP, the import elasticity of
demand with respect to GDP in the EU was substantially higher in this
period than in the preceding 30 years.

The buoyancy of the US economy helped Ireland on both the supply and
the demand side. On the supply side, Ireland secured an increased share of
the flow of US foreign direct investment (FDI) to Europe; on the demand
side, the strong growth in US imports underpinned the buoyancy of world
trade, as well as providing a rapidly expanding market for Irish goods.

In 1992, the US was only the fourth most important market for Irish
exports, corresponding to about one-third of Irish exports to the UK
(Kennedy, 2001). By 2000, it was on the way to overtaking the UK as
Ireland’s most important export market. The growth in Irish exports to the
US was heavily concentrated in high-productivity, labour-intensive indus-
tries. For example, by the year 2000, organic chemicals (SITC Division No.
51) accounted for nearly half of all Irish exports to the US. Even without
any consideration of transfer pricing, this category has very high value-
added relative to its employment.

The Irish growth rate would have been constrained, though, without a
major acceleration in the growth of the volume of goods imports in the
EU—the area receiving two-thirds of its exports. A wider consideration is
why other EU countries, apart from Ireland, did not derive more benefit in

2 Exports and imports of goods and services exclude factor income flows.
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<td>1926–47</td>
<td>0.9</td>
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<td>1947–60</td>
<td>2.3</td>
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<td>1960–80</td>
<td>4.1</td>
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<td>-0.4</td>
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<td>1980–93</td>
<td>3.3</td>
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<td>1993–2000</td>
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Source: CSO National Income and Expenditure (various years); ESRI (2000).
terms of higher exports and GDP growth. US FDI was critical in enabling Ireland to realise the potential offered by the Single European Market.

Ireland during the 1990s was a case study of the effects on a small developing host economy of export-oriented FDI. The Single European Market provided the primary source of demand for these exports. Inflows of FDI to Ireland increased from an annual average of US$615 million during the period from 1987 to 1992 to US$838 million in 1994, US$2,618 million in 1996 and US$6,820 million in 1998 (O’Sullivan, 2000). Increased investment by US enterprises accounted for more than 80 percent of overall flows into Ireland from 1994 to 1997, and the Irish share of US FDI stocks in Europe increased from 1.19 to 2.94 percent. Increased levels of direct investment by US firms in Ireland were especially important in chemicals and allied products and electric and electronic equipment. The output and exports of US enterprises operating in Ireland grew by annual average rates of 20.3 and 20 percent, respectively, from 1992 to 1997. US companies alone contributed nearly 47 percent of manufacturing gross output and 61 percent of manufacturing exports in the Irish economy in 1997, and provided about 25 percent of manufacturing jobs by 1999.

ACCOUNTING FOR IRELAND’S GROWTH IN THE 1990S

The most remarkable feature of the first Irish economic boom during the 1990s was the economy’s previously undiscovered capacity for creating employment on a rapid and sustained basis. In a short period, the extraordinary growth in employment transformed the economy from a situation of chronic labour surplus to one with labour scarcity.

Table 1 shows the growth rates of output volume, population and employment in Ireland over various periods since 1926. The period 1993–2000 is taken as the “first boom”, or so-called “Celtic Tiger” phase. The remarkable acceleration in the growth of output (measured here as the total volume of GDP at constant factor cost) and GDP per capita distinguishes the 1990s from all previous phases of Irish economic history. Of particular note, however, was the absence of any increase in the rate of growth of overall labour productivity, as measured by GDP per worker. All of the acceleration in the growth in output, therefore, is accounted for by the acceleration in the growth of employment to an average annual rate of 4.75 percent per annum.

3 Ireland’s share of FDI among OECD nations increased from an average of 0.06 percent for the 1986–90 to 0.66 percent for 1991–7.

4 For a wider discussion on Irish industrial development during the 1990s, see Bradley (2000) and O’Sullivan (2000).
THE SECOND GROWTH PERIOD: THE PROPERTY BUBBLE

Ireland recorded prolonged and rapid economic growth even after the 1990s witnessed a belated convergence in living standards towards the highest in Europe. This growth also endured beyond the cyclical downturn in Irish export performance after 2001 (see Figure 2). From 2001, the sources of growth shifted sharply (Honohan, 2009a; Honohan and Lane, 2009). An unsustainable property price and construction boom had taken over from exports as the main driver of Irish growth. Initially prompted by the increased household formation (related to unprecedented levels of net immigration—see Figure 3) and by the sharp fall in interest rates that accompanied the transition to Economic and Monetary Union (EMU) membership, the property bubble was increasingly financed after 2003 through foreign borrowing by the banks, which in turn lent to overleveraged households.

Figure 2: Year-on-year change in the volume of Irish GDP and goods exports (%)
At the same time, Ireland experienced a sharp loss of competitiveness as domestic demand-led growth drove up prices and wages in the economy (Figure 4). In addition, the consumer boom increased imports, resulting in a deteriorating trade balance (Figure 5). The effects were not yet felt in aggregate unemployment while the domestic boom continued.

The Irish economy continues to be afflicted by three problems: a retail banking solvency crisis that was initially (misre)presented by the banks themselves as a liquidity difficulty; a large budget deficit; and negative or very marginal economic growth. These issues are not independent of each other. The Irish government’s commitment to absorb the losses of its banking system—calcified by the EU/International Monetary Fund (IMF) agreement—has heightened concerns in relation to a spiralling debt ratio and the solvency of the sovereign. In this sense, private banking debt has become public debt.

Even aside from the huge banking loan losses, the severe economic downturn had given rise to a large budget deficit. Although the Irish government ran annual budget surpluses until 2006, an increasing share of the revenue that supported these surpluses came from taxes on the value and volume of property asset transactions (see below). The tax base had narrowed during the housing price bubble years, and Ireland’s overreliance on this source of revenue was sharply exposed by the collapse in the property market. In the Irish case, the combination of falling numbers of transactions and falling property prices has been acute. In addition, the deep recession in construction has had an indirect impact on the rest of the economy. Employment in service sectors linked to property and building has declined.
rapidly. The economy-wide unemployment rate currently stands at over 14 percent—very far from the full employment of the Celtic Tiger period (the unemployment rate hadshrunk from 15 percent, on the International Labour Organization (ILO) basis, in 1994 to 4 percent in 2000—CSO Labour Force Survey and Quarterly National Household Survey, various years). The automatic stabiliser effects for the exchequer are obvious. Also, lower employment leads to a decline in consumer spending with a multiplier effect on the rest of the economy. As a result, tax revenue from all sources has been falling.

**THE EMERGENCE OF A PROPERTY BUBBLE: WHAT WENT WRONG IN IRELAND?**

Even if the combination of lower interest rates from 1998 (see Figure 6) and higher income meant a sizeable increase in housing affordability, property prices overshot equilibrium levels. The threefold increase in average real new house prices from 1993 to 2007 was the highest in any advanced economy in recent times. Private house completions accelerated to a peak of over 88,000 in 2006 and the share of the (growing) workforce engaged in construction rose from 6–7 percent in the early 1990s to nearly 13 percent in 2006–7 (Figure 7).

**Figure 6: Real interest rates—Ireland and EU-15, 1992–2008 (%)**

![Figure 6: Real interest rates—Ireland and EU-15, 1992–2008 (%)](http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm).

Figure 7: Real house prices, private house completions and construction's share of total employment in Ireland, 1990–2008

Real new house prices, whole country
(2000 = 100)

Private house completions
000’s

Construction share of total employment
%

In 1995, the average first-time buyer took out a mortgage equal to three years’ average industrial earnings, and the average house cost four years’ earnings. By the bubble peak in late 2006, the average first-time buyer mortgage had risen to eight times average earnings, and the average new house now cost ten times average earnings. As the price of new houses rose faster than the cost of building them, investment in housing rose. By 2007, Ireland was building half as many houses as Britain, which has 14 times its population (Kelly, 2010).

The legacy of this second boom is that Ireland now has a large excess stock of housing, with the effect that this industry will not represent an area of significant economic activity in the medium term. In parallel with the property bubble, there was a sharp escalation in private debt. Overleveraged households are likely to spend quite some time repairing their balance sheets. Hence, it is clear that households are not in good shape to drive the economic recovery. Moreover, despite the fall in disposable incomes—owing to tax increases and public and private sector pay cuts—the savings rate has increased, as the drop in consumption has exceeded the decline in incomes.

The current difficulties of the Irish banks—whether in terms of liquidity or solvency—are directly attributable to their over-lending for land and property investment, much of it funded through heavy short-term wholesale foreign borrowing. Without the latter, the banks would not have been as vulnerable to the worldwide liquidity crisis which intensified throughout 2008 (Honohan, 2010).

Ireland in 2007 was relatively poorly positioned heading into the global crash, for “three distinct but related domestic reasons: a home-grown banking crisis, a trend loss in wage competitiveness that had been underway since 2000 and a tax structure whose yield was far too heavily dependent on a continuation of the boom” (Honohan, 2009a: 1). The global recession influenced the timing and severity of the Irish economic crisis from 2007, but Ireland was not just an aspect of international pressures. Certainly, the global credit crisis brought the wholesale funding, risk management and capitalisation of the Irish banks into sharp focus. However, the collapse of the construction and property bubble has brought in its wake rapidly unwinding property prices, a near failure of the banking system, a very large fall-off in tax revenues and uncompetitive wage structures.

FISCAL CRISIS

Although the Irish government ran annual budget surpluses until 2006, an increasing share of the revenue that supported these came from taxes whose
yield was sensitive to high and increasing asset prices and asset transactions, including housing (capital gains taxes, capital acquisition taxes and stamp duties). Once the asset markets turned, the volume of transactions dried up and the level of tax revenues plunged during 2008 exposing a structural deficit—exacerbated by a strong upturn in public expenditure in recent years.

The Irish government had entered the crisis period with a healthy balance sheet—the gross government debt stood at only 24.8 percent of GDP at the end of 2007 and Ireland had a sizeable sovereign wealth fund in the form of the National Pension Reserve Fund (Honohan and Lane, 2009). The period of sustained economic growth allowed the Irish government to cut income taxes, increase spending and still run a budget surplus. During the four years from 2003 to 2006, the surge in tax revenue directly related to property transactions was another manifestation of the credit boom. The Irish property tax system was highly geared to activity and property prices: stamp duty is a straight transaction tax; value-added tax (VAT) is charged on the gross purchase price of a new home; and capital gains tax (CGT) liability is triggered, where it is applied, through the realisation of gains. Revenue from property jumped from 8 percent of total tax receipts in 2002 to 18 percent by 2006. However, after the collapse of the construction and property bubble, total direct revenue from property dropped to €3.6 billion in 2008 from €8 billion in 2006 (McCarthy and White, 2008). Between 2007 and 2009, overall tax revenue fell by 20 percent, while expenditure rose by 9 percent, moving the state from a balanced budget to a deficit of 12 percent of GDP (Kelly, 2010). The dependence of the government on transitory property revenue is remarkable and should not have been seen as a platform for expenditure increases.

In combination with the collapse in tax revenues in 2008–9, the fiscal crisis was driven partly by an autonomous surge in total government expenditure (after 2004). Figure 8 presents data for total government expenditure (gross current expenditure plus exchequer capital expenditure) and gross current government revenue for the period 1996–2009, and reveals the sudden collapse in taxation. It also shows the strong upward momentum of government spending.

1 The sustained output, profit and asset price boom which extended for two decades from 1988—with only two brief hesitations in 1993 and 2001–2—lulled policymakers into a false sense of security as to the sustainability of the revenues from cyclically sensitive taxes, and induced them to take advantage of the extra revenues by narrowing the base of the personal income tax and lowering rates.

2 This excludes income tax from construction workers, VAT on furniture and electrical goods and corporation tax receipts from construction firms.
THE PROPERTY BUBBLE, THE BANKING CRISIS AND PUBLIC DEBT

Apart from the experience of Iceland, this has turned out to have been the poorest performance of any banking system during the current global downturn. Yet Irish banks had not indulged in the financing of US securitised mortgages, nor were they involved in aggressive international acquisitions—flaws that characterised weakened banks elsewhere (Honohan, 2010).

The economic fault-line in relation to the debt crisis in which Ireland finds itself runs from (delinquent) bank lending practices feeding an unsustainable property bubble, resulting in a banking crisis that required extraordinary intervention by the state with the manifestation that the enormous private debt of the Irish banking system has been loaded on the taxpayer.

At root cause, the property bubble was funded by the Irish banking system, which in turn relied heavily on the international inter-bank market and accumulated substantial net external liabilities. As credit growth began to exceed deposit growth, an increasing share of lending was funded mainly by borrowing from other financial institutions, with nearly half coming from UK banks. Figure 9 shows the growing reliance of the Irish banking system on wholesale external borrowing as opposed to the more traditional domestic deposit funding model. By early 2008, net foreign borrowing by Irish banks had jumped to over 60 percent of GDP, from 10 percent in 2003 (Honohan, 2009a).
Moreover, the collapse of the construction and housing bubble, and the concentration of Irish banking loans in these sectors, has been central to the deterioration in financial health of the Irish banking system. By 2007, property-related lending (residential mortgages, commercial property and lending to construction companies) accounted for more than half the stock of bank lending (Figure 10). To the lack of diversification in loan assets we can add spiralling loan–deposit ratios (see Figure 11) and a pronounced deterioration in shareholder equity to assets and to risk weighted assets ratios. In a wider context, while Basel II was designed to improve prudential risk management, this was at a time when the general international application of Basel II risk weighting would have released capital for most banks. At a minimum, the internal risk management of the main Irish banks left much to be desired. This was compounded by what could euphemistically be described as “light-touch” regulatory oversight.3,4

3 Prior to the onset of the current global credit crisis, a light-touch regulatory orthodoxy held sway in many countries. Over the previous decade, the financial system had expanded hugely. This was encouraged by a general belief in laissez-faire regulation based on the assumption that financial innovation was spreading risk, not concentrating it. Ultimately, financial regulators were not equipped to see the risk concentrations and were not able to contain the risks resulting from rapid innovation and increased leverage, which had been building for years.

4 Private sector imbalances, such as excessive credit growth and large current account imbalances, were not at the core of the scrutiny framework used under the euro area’s existing surveillance arrangement. Furthermore, the Stability and Growth Pact was created to ensure no country would pursue fiscal policy that would endanger the financial and economic stability of the other member states and the euro area as a whole. However, this mechanism was not broad enough in scope, as it left non-fiscal economic imbalances outside the scope of surveillance. Ireland is an unfortunate (though far from blameless) example of this.
Elements of eurozone membership, including low interest rates and the removal of exchange rate risk, certainly contributed to the property bubble and to the deteriorating drift in wage competitiveness. The exchange rate and interest rates were no longer sensitive to domestic developments—the “one size fits all” low interest rates prevailing in the eurozone were orthogonal to Ireland’s business cycle for virtually all of the period between the launch of the single currency and the onset of the global recession. During the period 1998–2007, real interest rates averaged minus 1 percent.
Furthermore, in sourcing loanable funds, the Irish banks borrowed heavily in eurozone inter-bank money markets from 2003. Unlike imbalances of the past, over-borrowing did not lead to interest rate increases because currency risk had been removed altogether.

In 1997, Irish banks’ lending to the non-financial private sector was 60 percent of GNP. By 2008, this had grown to 200 percent of national income. Irish banks were lending 40 percent more in real terms to property developers alone in 2008 than they had been lending to everyone in Ireland in 2000, and 75 percent more to house buyers (Kelly, 2010). By 2006, two-thirds of loans to first-time buyers had loan-to-value in excess of 90 percent; one-third were getting 100 percent loans (Honohan, 2009a).

At the end of September 2008, the Irish government announced a blanket guarantee of the liabilities of the main Irish-controlled banks, including senior bondholders. As well as guaranteeing the deposits and most bonds of Irish banks, the government announced in April 2009 that a National Asset Management Agency (NAMA) would be created to buy the non-performing development property loan portfolio of the banks at a written-down value. NAMA acquires these loans at a discount (“haircut”), paying the banks with government-backed bonds, issued by a special purpose vehicle. The banks can then use these bonds as collateral against which they can borrow (access liquidity) from the European Central Bank. NAMA, however, does nothing about the Irish banks’ losses for mortgages, personal lending and the small-to-medium enterprise sector. The government has also had to inject unprecedented funds into the Irish banking system in order to recapitalise domestic banks and has consequently assumed ownership of a number of major banks.

**REGULATORY FAILURES**

Following in the wake of the newly established Financial Services Authority (FSA) in the UK, the Irish government decided in October 1998 to consolidate the prudential and customer protection regulation of all financial institutions under the umbrella of one institution, called the Irish Financial Services Regulatory Authority (IFSRA). In 2003, IFSRA initiated a move to a principles-led and risk-based approach to regulation with the aim of improving the quality and minimise the quantity, where possible, of regulation (Government of Ireland, 2004). This involved moving away from reliance

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5 The NAMA process has left the banks with insufficient capital. As loan losses crystallise and get taken into account in a bank’s balance sheet, its cushion of capital (essentially the difference between its assets and its non-risk-bearing liabilities) shrinks. Government injections of capital are more about protecting the depositors and other creditors against future risks than they are about making loanable funds available.
on detailed rules and to depend instead on high-level broadly stated rules or principles (Black et al., 2007). In this new “principles-led” environment, the board of directors of each supervised financial institution was responsible for setting its own standards in relation to tolerance of risk, etc. This approach relied on entities to act with their own integrity and placed a much greater emphasis on internal supervisory systems within banks.

The Irish retail banks’ management took full advantage of the discretion that principles-based regulation allowed and began to expand their business models at an unprecedented pace. In the period from 2000 to 2005 alone, Irish domestic banks’ lending doubled. The international credit boom saw an increase in bank lending across most eurozone economies and the UK, with loans increasing to 100 percent of GDP on average in 2008. In Ireland, Spain and Portugal (in descending order), bank lending to households and non-financial firms as a percentage of GDP exceeded 150 percent. In Ireland’s case, this indicator had accelerated to almost 200 percent by 2008.

Since joining the EMU, Irish banks had been operating in a setting of greatly increased wholesale funding opportunities, and banks from abroad began to compete strongly in the Irish retail mortgage lending market. Competition intensified and “uncritical enthusiasm” (Regling and Watson, 2010: 35) within the Irish banking system resulted in an environment where prudent risk management was ignored. Financial sector compensation became based on short-term profits, as the Irish retail banks sought to generate returns via rapid expansion of their loan books. Short-term (wholesale) borrowing to fund long-term loans held sway. Against this backdrop, strongly risk-averse reactions from the Irish regulator would have been needed. However, in reality, there were serious failures regarding the supervision of credit institutions in Ireland, and bank governance and risk management were flawed.

By 2007, it had become evident that the Irish regulator had placed an unfounded reliance on principles-based regulation “based on a mistaken view of governance within banks” (Cowen, 2010) and had not backed this up with adequate supervision. As Honohan (2009b: 7) notes, the financial regulator “largely ignored the need for conventional prudential regulation of the main banks” and was inadequate in addressing the overexposure of the Irish banks to the accumulation of excess risk through their lending activities. However, the Irish regulator throughout the boom period was operating within an environment where excessive weight was placed on fears of upsetting the competitive position of domestic banks, even at the expense of prudential considerations (Honohan, 2010). Ultimately, IFSRA
had failed in its primary job of protecting and ensuring the credibility and solvency of the Irish banking system.

**COST OF THE IRISH BANKING CRISIS**

Estimating the net fiscal costs related to banking crises can be problematic. Even when assessing the fiscal costs of historical crises, where one would imagine that the passage of time would allow for a complete analysis, it is often difficult to source reliable data on the amounts paid out by the exchequer and the rate of recovery. It is even more difficult to examine the fiscal costs associated with ongoing crises, where the costs related to guarantees, recapitalisations, nationalisations and liquidity schemes will not become apparent for a number of years. Notwithstanding these difficulties, from the information available it is clear that the Irish banking crisis currently ranks as one of the costliest in history. The total gross cost of bank recapitalisations to the State as of March 2012 stood at €62.8 billion (equivalent to almost 40 per cent of 2011 GDP). This figure does not include the cost of acquiring troubled loans from the covered domestic banks by the National Asset Management Agency (NAMA) between 2010 and 2011. NAMA was established at the end of 2009 as an asset management agency that would acquire troubled loans from five domestic banks (see Palcic and Reeves, 2011 for further detail on NAMA and the Irish banking crisis). By the end of 2011 NAMA had paid €31.7 billion to acquire loans with a book value of €74.2 billion at a discount.

A number of studies have attempted to estimate the direct fiscal outlays associated with systemic banking crises over the past number of decades. Caprio et al. (2005) provide estimates of the direct fiscal costs associated with 56 crises over a 50-year period. For systemic crises, they find that the median fiscal cost was 13.1 percent of GDP (mean 16.8). Laeven and Valenica (2008) find that the mean fiscal cost of 42 systemic crises in their database is 13.3 percent. Honohan (2008) extended the sample of Caprio et al. (2005) and found that the median fiscal cost for the 78 systemic crises in his sample was 15.5 percent (mean 19.1). Although the final fiscal cost of the Irish banking crisis will not become apparent for some time, the direct costs incurred by the Irish government to date would appear to be far in excess of those experienced historically.

While the Irish banking crisis has obviously resulted in significant direct fiscal costs, it is also important to note the considerable indirect cost of the crisis in terms of its impact on key variables such as output, unemployment.

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and government debt. The peak-to-trough decline in real GDP, increase in unemployment, fiscal deterioration and explosion in national debt all rank among the worst experienced in the aftermath of a banking crisis on record (see Palcic and Reeves, 2011). The sheer scale of the crisis is put in stark perspective by Reinhart and Rogoff (2011), who show how the increase in public debt experienced in Ireland (and Iceland) between 2007 and 2010 already ranks as the worst in history. The authors state that the debt build-ups in both countries (which are projected to increase further) are “associated with not only the sheer magnitude of the recessions/depressions in those countries but also with the scale of the bank debt buildup prior to the crisis—which is, as far as these authors are aware—without parallel in the long history of financial crises” (11).

CONCLUSION

It is clear that Ireland’s economy faces severe challenges. The twin crises in the banking sector and in public finances have fed back negatively into credit availability and rising tax rates, deepening the output loss. It follows from the above that the broad domestic policy response to the economic crisis has four key elements, with significant crossover effects between them:

• Correcting the fiscal imbalance;
• Addressing bad banking loans and capitalisation issues, and facilitating credit flow to enterprise;
• Reform of financial regulatory/supervisory instruments, resources and enforcement; and
• Providing for a stimulus to nudge the economy towards a stable natural growth path, as well as decisive labour market policy measures.

The rationale for a stimulus is obvious, especially in light of the recent, and necessary, budgetary adjustments. These “consolidations” have had a dampening effect on growth potential, and a jobs and growth package needs to be given effect in parallel with the ongoing process of fiscal correction. Ireland was one of the first countries to introduce tough budgetary austerity in this recessionary cycle. Despite the cuts, Ireland currently has one of the highest budget deficits in the EU. The problem is clear: when you cut spending you also lose tax revenues from people who earned an income from that money. Further, the newly unemployed seek benefits, so Ireland’s spending cuts in one category are partly offset by more spending in another. Without growth, the budget deficit still looms large. Also, the growth rate is a key issue for the international investor community, which is trying to work out
whether the Irish economy will grow sufficiently quickly to make its public and private debt levels sustainable.

However, at an average interest rate of 5.8 percent, the EU/IMF loans are unlikely to improve Ireland’s long-term debt situation. The interest rate is very likely to be higher than Ireland’s nominal annual growth during the period of the loan, and that means the real value of the debt will increase.

Recent Irish industrial production data show promising signs in relation to export performance. Moreover, the balance of payments current account position displays continued improvement, and the fall in nominal wages has reduced unit labour costs. The downward adjustment of this competitiveness indicator could be given further effect through increased productivity fostered by policies that promote new products and innovation.

The Irish banking crisis has essential implications for how the design of regulatory and supervisory responsibilities will evolve. Robust regulatory leadership must set the trend for effective risk management and governance practices within the Irish banking system. Ireland has already embarked on the road to a much better resourced and independent financial regulatory enforcement with principle-based supervision only in conjunction with clear rules. If the financial regulator is to become a strategic agent for transparent and effective regulation in the post-crisis it must ensure that banks can no longer conceal or ignore risk. A reliance on banks’ discretion in the management of risk has proven hugely costly in the Irish case. Reform of Ireland’s financial regulatory architecture has included a new formal risk assessment framework, known as the Probability Risk and Impact System (PRISM) which should be given effect by the end of 2011. More prescribed and clear regulatory rules and instruments must be accompanied by sufficient powers—including manpower—to discharge the regulatory function effectively.

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INDIA’S EXPERIENCE OF THE CRISIS AND KEY LESSONS

Indira Rajaraman
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GLOBALIZATION

Over the past three decades, the international policy establishment has urged developing countries to lift all borders with respect to flows of goods (real borders) and flows of financial capital (financial borders). It was promised that unilateral adoption would bring advantages, even without reciprocity. The intellectual structure of globalisation was projected as fully thought through.

This paper focuses in particular on the message to developing countries to open their financial borders to international capital. India followed this prescription, starting with the reform of the economy in 1991. It first deals with the monotonicity corollary that went with this injunction: the only permissible direction for the capital account regime was towards liberalisation, without reversals of even a temporary kind along the way to cope with inward or outward surges. The impossible trinity—whereby it is deemed impossible to have a stable exchange rate; free capital movement (absence of capital controls); and an independent monetary policy all at the same time—was recognised, but developing countries were denied the option of resolving this through temporary cessations of free capital flows, once that freedom had been put in place. The year 2010 was a watershed, marking a major change in the international stance on the temporary imposition of capital controls, but until then, any country mindful of its international reputation could not flout the rules. India abided by them, although there were countries that did not.

The paper next looks at policy instructions to developing countries in the aftermath of the East Asia crisis of 1997. Transparency in macroeconomic policy was identified as a necessary preventive to such crises. Fiscal transparency is atheoretic, and therefore encountered no definitional obstacles, finding widespread support among both market-friendly reformers and supporters of the role of the state. Monetary policy, on the other hand, relies on the control of levers affecting private market players. What should be revealed therefore became subject to theorising on the reactions of market players to information. As such, the very definition of monetary policy transparency reflected the modelling of the macroeconomic system. This paper covers the manner in which monetary policy transparency was defined, and the constraints this posed to the sanctioned role of central banks.

The next section deals with the manner in which the Reserve Bank of India
(RBI) coped with a capital inflow surge into India during the pre-crisis period 2004–8. India did not flout the ban on the temporary imposition of capital controls, but instead engaged in the sterilised purchase of dollars to hold down the appreciation pressure on the Indian rupee, so flouting the received definition of monetary policy transparency dictated by stylised models. Thanks to this, India met the crisis of 2008 with a buoyant export sector and a sizeable reserve at end-August 2008 of US$295 billion (23.5 % of gross domestic product—GDP).

Next, the paper discusses the manner in which the RBI, in its role as banking regulator, handled the housing bubble which was a concomitant of the capital inflow surge. This section also looks at a corollary of the transparency requirement, that public ownership of commercial banks was in itself a violation of transparency. India and China are the two major countries with a sizeable state-owned banking sector.

The paper then goes on to conclude with lessons from the narrative of the preceding sections.

THE MONOTONICITY CONSTRAINT

The imposition of (renewed) controls in countries which had previously liberalised their capital account regimes should perhaps more correctly be termed “capital regulation” or “capital management”, but the term “capital controls” is still used, and much of the opposition to it happened when it had that name. So this latter term is used here in relation to going into reverse gear on capital account liberalisation.

The change in the international stance on capital controls in 2010 was marked by the G20 communiqué after the Seoul Summit in November 2010, and the statement by the managing director of the International Monetary Fund (IMF) at the Shanghai meeting in October of that year, both of which endorsed capital account management among permissible “carefully designed macro-prudential measures”. These are big signals, even if they merely mark recognition of what countries facing the newest round of capital surge that started in mid-2009 had been doing anyway, starting with the temporary tax on short-term capital inflows imposed by Brazil.1

Prior to 2010, for a period of 12 long years, capital controls met with outright hostility and condemnation, dating back to 1 September 1998, when Malaysia imposed capital controls in what had been the most famously

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1 Ocampo 2010 speaks of the “pronounced swing of opinion against unfettered capital account liberalization which has occurred among a majority of academic economists.”
free capital account regime in the developing world. A fuller description of this episode can be found in Rajaraman (2003). Malaysia had gained current account convertibility status under Article 8 of the IMF’s Articles of Agreement in November 1968. Subsequently, the Malaysian ringgit went into a full float, along with the dollar, pound and yen, right from 1973.

That record of early commitment to borderless capital flows was reversed abruptly in 1998. It was not as though the temporary imposition of capital controls was previously unknown: Colombia had imposed unremunerated reserve requirements (URRs) on capital inflows between 1993 and 2000, and even Malaysia temporarily restricted an inflow surge in 1994. The difference was that those were controls on entry, whereas the 1998 Malaysian move controlled exit. This was immediately condemned as an egregious abuse of sovereign power and a violation of international trust. But what Malaysia did was not extreme. It was a carefully calibrated move designed to give Malaysia the space to lower interest rates without precipitating an outward stampede of capital. For non-resident capital, there was no ban on taking out profits and interest; it was only the principal that was incarcerated within the country. After six months, the ban was converted to an exit levy, and after another six months the levy was reduced to 10 percent on capital gains alone, later further reduced to a levy on capital gains only on capital that had been in the country less than a year. By May 2001, all controls had been fully lifted (although controls on exit of resident capital were retained for a longer period).²

This was not a story of irresponsible monetary policy: it enabled Malaysia to recover from the East Asian crisis with far less macroeconomic pain than other countries in the region. And it was clear that Bank Negara was continually calibrating controls to the need of the hour, and removing them when they were no longer required.

The international reaction was swift and broadbanded, condemning all controls of any kind on foreign capital, at the point of entry or exit. To the basic lesson for developing countries that capital account liberalisation gave access to capital at a lower cost and was therefore good for them was added a corollary, that such liberalisation must be monotonic at all times. There was no formal justification for this requirement, and also no empirical support. And meanwhile, Malaysia offered a clear case of a country that had worked its way out of the East Asian crisis by disregarding monotonicity.

Any country worried about its international reputation was compelled

² Bank Negara, the Malaysian central bank, also introduced a number of institutional measures to insulate the country on a long-term basis from recurrences of external volatility (Rajaraman, 2003).
to abide by these rules. Thus it was that, when capital inflows into India quadrupled over the period 2004–8, regulating the inflow of capital was not seen as an option. The RBI had to use such instruments as were available to stop the exchange rate from appreciating wildly as it would have done if the dollars surging in had not been added to official reserves, and to sterilise the rupee inflow from the continued dollar purchase. This task was managed well, albeit at a huge fiscal cost. What also helped was the RBI using its role as a banking regulator to prick a potential asset bubble in its infancy.

Two countries did dare to flout the rules, even after the post-East Asian crisis ban. Colombia re-imposed URRs on inflows in 2007, and Thailand imposed a URR along with a number of other measures in 2006. A recent paper (Gallagher and Coelho, 2010) assesses these actions for their effectiveness, set against the background of a panel of neighbouring countries in each case. Generalisable empirical results are intrinsically difficult to establish, since the kinds of capital control used, their timing and their duration all matter critically for the success of the initiative. An earlier review (Magud and Reinhart, 2006) provided a useful survey of findings on capital controls in the 1990s, and a few cases in the 1980s. Temporary restrictions have been found, with variations in success by country and episode, to enable monetary policy autonomy, control the composition of inflows in desired directions, help stabilise the exchange rate and regulate the pace of inflows.

**STYLISTED MONETARY POLICY MODELS**

This section deals with received models of monetary policy transparency, and why they do such a disservice in guiding central banks facing a capital inflow surge.

Based on standard stylised models, monetary policy transparency has been equated to credible prior disclosure of an inflation target in the market for goods and services (Geraats, 2002). There is a Geraats transparency index which rates central banks on a scale of 0–15, using which Dincer and

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3 See Nachane (2010) for an excellent account of the Indian failure to use capital controls. One study (Balin, 2008) sees some of the instruments adopted, such as intervention to prevent the appreciation of the rupee, altering permissible maturities in debt inflows and tightening some institutional regulations governing portfolio inflows as tantamount to capital controls. None of them directly obstructed the volume of inflow, except for the last, which had a regulatory rather than an obstructive intent.

4 Gallagher and Coelho (2010) found somewhat more modest gains from the URRs imposed in Colombia and Thailand during the 2006–7 period.

5 This section reproduces portions of Rajaraman (2010).
Eichengreen (2009) assign transparency scores to 100 central banks, for each year of the eight-year period 1998–2006. The average score rose from 3.4 in 1998 to 5.4 in 2006. The RBI scored 2 in 1998 and stayed there—one of the lowest scores in the whole set and the lowest in South Asia. From the previous section, it is clear that the very reason for the low rating of the RBI on the Geraats index is what saw the country through the years leading up to and after the crisis.

In the model outlined below, when inflationary expectations are set by a credible central bank inflation target commitment, the policy rate of interest is free to target adjustments to supply and demand shocks to the system, and therefore reduce output volatility. Transparency so defined was therefore justified as an enabler of macroeconomic stability.

The central bank maximises the objective function:

$$ W = -\frac{1}{2} \alpha (\pi - \tau)^2 - \frac{1}{2}(1 - \alpha)(y - \kappa)^2 $$

Inflation target : \( \tau \) (actual inflation is \( \pi \))

Output gap target : \( \kappa \) (actual output gap is \( y \))

The actual output gap \( y \) is impacted by the rate of interest, \( r \), and unanticipated demand shocks, \( d \), thus:

$$ y = -r + d $$

The economy is defined by the following expectations-augmented Phillips equation, which accommodates unanticipated supply shocks, \( s \), thus:

$$ \pi = \pi^e + y + s $$

Credible inflation target: \( \pi^e \)

The optimal (policy) rate of interest in such a system will be given by the first order condition for maximisation of the objective function \( W \) of the central bank with respect to \( r \), thus (given \( \pi^e \)):

$$ r = \alpha (\pi^e - \tau) - (1 - \alpha) \kappa + \alpha s + d $$

If there is a credible inflation target to which inflationary expectations in the economy are equated, so that the first term in the above equation disappears, this leaves (for unchanged output targets) a rate of interest that needs to be changed only for adjustment to unanticipated supply and demand shocks.

The model has severe limitations. The exogenous shocks are all real shocks, and inflation stability refers uniquely to prices of real goods and services. Exogenous financial shocks do not have any play. A capital inflow surge is
an example of the kind of exogenous financial shock that could destabilise the real system in a world of free capital flows. In the face of such a surge, a single-minded focus on stable (inflation in) prices of goods and services could lead to disastrous volatility in another price, the exchange rate of the domestic currency.

The model assumes friction-free market correction. An exchange appreciation spike would lead to a follow-on negative real (external) demand shock, which will be endogenous to policy pursuit of the inflation target. In a friction-free world, the directionality of correction would be perfectly aligned with what it should be to restore the system to the pre-surge equilibrium. The interest rate will be lowered to correct the negative external demand shock, and will reinforce the exchange rate appreciation to choke off the capital inflow surge which caused the problem in the first place.

But the world as we know it is not free of friction. This process of adjustment will not be instantaneous. Ruptured links between exporters and buyers are not easily restored, and could lead to a long-term demand shock which will not be corrected with lower interest rates. The risk is a function of the concentration of products and destinations in the export basket; the importance of exports in aggregate demand; and whether the export production vector is aligned with the domestic demand vector. Developing countries are in general far more vulnerable than developed countries on all three counts.

Single-minded pursuit of price stability would thus result in disastrous instability, both real and financial. Large-scale defaults by exporters, following from exchange rate appreciation, could seriously destabilise the banking system. The comparative statics of stylised models do not factor in the time intervals between equilibria and the economic (and follow-on political) turbulence during such intervals.

This is an example of a rating index gone astray. The index rewards:

- Prior commitment to a preferably single objective like price stability, when what is needed is macroeconomic stability, whereby the components of that objective are not possible to prioritise independently of context;
- Rigidity in adherence to objectives, when flexibility is needed to respond to unforeseen eventualities as developing countries open up; and
- Predictability in central bank actions, and full exposure of the basis for those actions, which denies discretionary actions towards ensuring real and financial stability.
Indian capital inflows quadrupled over the period 2004–8. In 2007–8 alone, net capital inflows amounted to US$108 billion (9.2% of GDP), at a time when the current account deficit amounted to only US$17 billion (1.5% of GDP). Given the international policy establishment ban on any re-imposition of barriers to the free movement of capital once these had been lifted, India was compelled to cope with the flow with such policy instruments as it had in hand. There was heavy appreciation pressure on the Indian currency, which the RBI resisted through the sterilised purchase of dollars. Figure 1 illustrates the policy followed.

Figure 1: Net capital inflows, external reserves and exchange rates to the US dollar in India, 2004–2009

The need for sterilisation outpaced the RBI’s holdings of government securities, and a new scheme had to be invented, named the Market Stabilisation Scheme (MSS), whereby borrowing instruments in a range of maturities were issued and the proceeds sequestered in a separate cash account. These receipts were not available to fund any government expenditure, other than repayment of the securities issued. However, interest payable on these MSS bonds did add to the fiscal expenditure of the government. Table 1 shows the magnitude of issuance of these bonds. At its peak, at the end of the fiscal year 2007–8 (end-March), the stock of MSS bonds amounted to 3.42 percent of GDP. The corresponding interest bill is not directly reported, since total interest paid by the government on its liabilities is not broken down by its constituents. But inferred from the share of MSS bonds of total
domestic market debt, at the 2007–8 peak, 9.43 percent of the interest bill on domestic market debt went towards interest on these sterilisation bonds. The cost of stabilisation went beyond the interest payable on MSS bonds, since the selling pressure raised the interest rate on government securities across the board. Against this, there was the interest earned by the RBI on foreign exchange reserves, which was close to negligible on the form in which they were held, typically US Treasury Bills.

### Table 1: Market stabilisation bonds to sterilise a capital inflow surge in India, 2004–09

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<tbody>
<tr>
<td>MSS bonds/domestic market debt (%)</td>
<td>5.03</td>
<td>2.09</td>
<td>4.08</td>
<td>9.43</td>
<td>4.38</td>
</tr>
<tr>
<td>MSS bonds/GDP (%)</td>
<td>1.98</td>
<td>0.79</td>
<td>1.47</td>
<td>3.42</td>
<td>1.59</td>
</tr>
</tbody>
</table>

Note: All figures of MSS bonds and domestic debt are stocks at the end of the fiscal year shown. Interest like GDP is a flow figure for the fiscal year. Domestic market debt is called internal debt in Indian documents.

Source: GOI (various years).

The report of a committee constituted to chart the path to financial sector reform in India says: “[…] this Committee believes it is neither possible nor advisable to manage the external value of the rupee”, but goes on to say that, in the face of substantial capital inflows, monetary policy did “strike a balance between managing inflation and stabilising the nominal exchange rate” (GOI, 2009: 28–9).

The test of the success of sterilised intervention in coping with the surge was in the macroeconomic outcomes achieved. Some indicators are shown in Table 2, spanning the two years before and after the global crisis year 2008–9. It can be seen that, after a dip in growth and external reserves in 2008–9, the economy rapidly approached its pre-crisis momentum the very next year.
Table 2: Macroeconomic outcomes in India, 2006–12

<table>
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<tbody>
<tr>
<td>GDP growth (%)</td>
<td>9.6</td>
<td>9.3</td>
<td>6.8</td>
<td>8.0</td>
<td>8.6</td>
</tr>
<tr>
<td>Industrial growth (%)</td>
<td>12.7</td>
<td>10.3</td>
<td>4.7</td>
<td>8.1</td>
<td>8.3</td>
</tr>
<tr>
<td>Export US$ (vol.) growth (%)</td>
<td>22.6</td>
<td>28.9</td>
<td>13.7</td>
<td>(-)3.6</td>
<td>29.4</td>
</tr>
</tbody>
</table>

Note: All GDP figures are by the new series with base 2004–5; industrial growth is from a grouping of manufacturing, utilities and construction but excludes mining; export growth in 2010–11 covers the period April 2010–January 2011.


Table 3: Stimulus measures in India, 2008–11

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Fiscal stimulus (% GDP)</td>
<td>Actual – target</td>
<td>3.04</td>
<td>3.39</td>
</tr>
<tr>
<td>Cash reserve ratio (% demand and time liabilities)</td>
<td>Change</td>
<td>(-) 4.0</td>
<td>(+) 0.75</td>
</tr>
<tr>
<td>Repo rate (%)</td>
<td>Change</td>
<td>(-) 4.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Reverse repo rate (%)</td>
<td>Change</td>
<td>(-) 2.5</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Note: The fiscal stimulus is calculated as the difference between the actual fiscal deficit and the target of 3 percent of GDP for the final year of the Fiscal Responsibility and Budget Management Act of 2003, as amended in July 2004, extending up to 2008–9. The fiscal deficit target is presumed to have held in the medium term, extending beyond the period of the Act, applicable to 2009–10 and 2010–11.


The outcome data in Table 2 owed not just to the pre-crisis management of the capital inflow surge, but also to the fiscal and monetary stimuli that were introduced starting from September 2008, the midpoint of fiscal year 2008–9. The stimulus measures are shown in Table 3. It can be seen that the monetary stimulus was decisively unwound in fiscal year 2010–11, as capital inflows began to surge again in the middle of calendar year 2010.
The unwinding of the fiscal stimulus is also visible. The figures in the table pertain to national government. In addition, states’ borrowing entitlements, which are controlled at national level, were raised by 0.5% of gross state domestic product (GSDP) in 2008–9, and by +1.0% of GSDP in 2009–10.

**Bubbles and Regulation**

A housing bubble built up over the period 2005–8 in India, concomitant with the capital inflow surge. There was huge pressure on the RBI, as the banking regulator, to permit the unfettered growth of securitisation of housing loans, along the lines of the infamous pre-crisis US model. The RBI did not ban the practice, but subjected it to regulations laid down in a document that could serve well as a model for central banks in the rest of the world, for the clarity of its definitions and its prescriptions for the nature of the relationship between the parties to a securitisation transaction.

The document (RBI, 2006) defines a “true sale”, under which no lingering relationship remains between the buyer and the seller. For all transactions where there is a continuing relationship between the two parties to the transaction offering varying degrees of comfort to the buyer, in the form of first and second loss credit enhancement facilities, the originating bank was required to maintain capital against the value of the underlying asset. These were to be deducted from Tier I and Tier II capital of the originating bank, at the amounts the bank would have been required to hold for the full value of the assets, had they not been securitised. Liquidity and underwriting facilities were to be given 100 percent credit conversion and risk weights.

Among other prudential measures, the RBI raised risk weights on commercial real estate loans starting July 2005 in stages, to a peak of 150 percent by May 2006, and provisioning requirements starting May 2006, also in stages. The structuring of these is sufficiently important that Table 4 below displays the distinction made between loans to individual borrowers and to commercial real estate, and how, even as risk weights were high for commercial real estate loans, they were actually dropped for small individual loans and further differentiated by the loan to value (LTV) ratio for them. Both risk weights and provisioning were lowered back to pre-existing levels in November 2008. Commercial banks were further advised to build an Investment Fluctuation Reserve over 2002–7.

The impact of this and of the larger macroeconomic prudential action to fend off exchange rate volatility and secure financial stability taken by the
RBI is evident in the non-performing assets of Indian banks, shown in Figure 2 below.  

### Table 4: Risk weights on real estate lending and mortgage-backed securities

<table>
<thead>
<tr>
<th>Date</th>
<th>Risk weights</th>
<th>Loan loss provisioning</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Individuals</td>
<td>Commercial real estate</td>
</tr>
<tr>
<td>Before December 2004</td>
<td>50%</td>
<td>100%</td>
</tr>
<tr>
<td>December 2004</td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>July 2005</td>
<td>125%</td>
<td></td>
</tr>
<tr>
<td>March 2006</td>
<td>[a]</td>
<td></td>
</tr>
<tr>
<td>May 2006</td>
<td>150%</td>
<td></td>
</tr>
<tr>
<td>January 2007</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May 2007</td>
<td>50% (b)</td>
<td></td>
</tr>
<tr>
<td>July 2008</td>
<td>50–100% by LTV (c)</td>
<td></td>
</tr>
<tr>
<td>November 2008</td>
<td>100%</td>
<td>Reduced to 0.4%</td>
</tr>
</tbody>
</table>

Note: Prior to May 2002, housing loans to individuals and commercial real estate were assigned risk weights at 100 percent. In May 2002, the risk weight on loans to individuals was dropped to 50 percent, in order to encourage housing finance by banks.

^a Disbursements of approved loans were subject to clearances from all relevant government authorities and statutory agencies for start of construction.

^b These applied to loans with a value of <2 million rupees.

^c Risk weights varied according to whether the LTV ratio was > or <75 percent and whether the value of the loan was < or >30 million rupees.

Source: RBI Bulletin (assorted issues), circulars relating to the housing sector.

India and China are the two major countries where commercial banks are largely state owned, a longstanding ownership pattern which is under attack by the international policy establishment for its supposed lack of transparency. A passage in the report of a major official committee to design the liberalisation of the Indian financial sector reads as follows: “Out of 138 countries only nine had a predominantly state owned banking sector. India and China are in this group […] No high income country has a state dominated banking sector” (GOI, 2009: 81). The report sees

6 See also Kohli (2010) for an endorsement of these actions.
public sector inefficiency as an inevitable consequence of promotion based on seniority and the inability to fire employees for non-performance. It states: “A majority of this Committee does not see a compelling reason for government ownership” (91). The ineffectiveness of public sector ownership is specifically pinned on the inability to price risk: “Public sector entities do exactly what private sector entities do, though less well because they have more constraints, a poorer skill pool, and poorer incentives […] the skill deficit will make public sector firms less effective at pricing risk. And the costs will partially have to be borne by the government when the under-priced risk eventually hits public sector balance sheets” (78).

After the crisis of 2008, precipitated by ineffective pricing of risk by privately owned banks in the US, in turn because of the distortion in the incentive structure when employee remuneration is tied to short-term enhancement in shareholder value, this statement has a comical ring. In fairness, the report does commend the performance of the Indian banking sector: “Steady growth has come without significant instability, in contrast to the experience of some other emerging markets. Historically, (Indian) banks have attracted some of the best talent available” (80). A McKinsey survey in 2007 is also cited in the report: “Indian banks have done exceedingly well in providing high returns to shareholders, registering the highest regional growth rate in assets, deposits, and return on equity as well as one of the highest total returns globally” (82).

Although public sector banks in India account for 74 percent of gross assets of commercial banks (at end-March 2010), there are as many as 27 public sector banks, out of a total of 81. The variation within the set of
public sector banks in terms of efficiency is very wide, which in and of itself questions the overwhelming importance given to ownership as an explanator of efficiency. Furthermore, some, though by no means all, public sector banks in India outperform private sector banks, whether domestic or foreign owned (Rajaraman and Vasishtha, 2002). More recently, in a data envelopment analysis, public sector banks were on the efficiency frontier and privately owned banks inside it (RBI, 2006–8). However, a recent paper (Gupta et al., 2011) using bank-level data from 1991–2007 finds that public banks even after liberalisation allocated a larger share of their assets to government securities than did private banks—larger than the statutory minimum—thus establishing that ownership does influence banking behaviour to some degree.

The limited purpose of this section is to sound a cautionary note about predicing financial sector reform on dogma rather than on a considered examination of the empirical evidence. The committee report mentioned above also delineates the directions for reform if a change of ownership is not feasible. Among these, the recommendation that the compensation structure be changed for top executives clearly has a pre-crisis ring.

CONCLUSIONS

The year 2010 has fortunately seen a radical alteration in the international policy establishment stance on temporary impositions of capital controls in countries facing an inward or outward surge. This is a long overdue recognition that granting countries autonomy in dealing with surges can go a long way towards reconciling the impossible trinity. Clearly, the success of capital management interventions will be a function of their timing, nature and duration. But equally clearly, the central bank of a country, which is ultimately accountable for its actions, is best positioned to take a call on when and how much to intervene, in place of an externally imposed condemnation of such actions.

The purpose of the focus on the policy response to a particular episode of capital inflow surge in India in the years leading up to 2008 is not to defend the particular choices made, but to highlight the practical policy imperative to factor in costs of adjustment between comparative static equilibria in stylised models. A narrow-focus watch by a developing country central bank on prices in the market for goods and services alone, and not in any other markets, can be devastating where the exchange rate of the domestic currency in international markets is an all-important price. The exchange rate in such countries, especially those with a small domestic
market, underpins domestic inflation, growth and financial stability. In particular situations, the central bank may choose to limit itself to a watch on prices in the market for goods and services, but this limitation should be a choice rather than a compulsion. Most of all, the compulsion should not be dictated by the desire to do well on a misguided international monetary policy transparency rating.

The lessons from the Indian episode detailed in the paper are essentially three.

First, macroeconomic policy transparency remains paramount, but it cannot be equated to rigidity in central bank targets and instruments. Outcomes are what determine the credibility of a central bank, not prior straitjackets adopted. The reputation of a central bank for delivering financial stability is what the international policy establishment should ultimately be interested in. Transparent functioning of a central bank should be redefined to permit flexible responses to unforeseen eventualities and the use of any discretionary actions needed to ensure real and financial stability. It should permit the full range of supervisory discretion under Pillar 2 of Basel II and at the same time require full disclosure of sales and purchases by the central bank in securities and exchange markets and full disclosure of policy decisions, with effective dates, and pre-announced finite, or indefinite, durations.

Second, macro-prudential regulation is as important for financial stability as narrow-focus micro-prudential regulation.

Third, the episode highlights the need to recognise that allowing policy competition will bring to the fore the best and most prudent ideas on financial sector regulation. It is best if the regulator in each country which is vested with the task of ensuring the soundness of banks is left free to permit or obstruct the introduction in developing country markets of financial innovations originating in developed country markets. The independent path charted by the RBI in India, which is also the banking regulator, on regulation of the market for securitised housing loans, and on sector-specific risk weights and provisioning, affords an admirable example of fruitful resistance to international fashions in risk taking and innovation. As a corollary, it is important not to enforcing international conformity to a single regulatory template, for example separation of banking regulation from the role of the central bank as lender of last resort. Here again, each country should be free to chart its own path. What matters ultimately is effective regulation of the banking sector, not where regulation is vested.
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How Malaysia Weathered the Financial Crisis: Policies and Possible Lessons

Mah-Hui Lim and Soo-Khoon Goh
HOW MALAYSIA WEATHERED THE FINANCIAL CRISIS: POLICIES AND POSSIBLE LESSONS

Mah-Hui Lim and Soo-Khoon Goh

INTRODUCTION

Financial crises have occurred with increasing frequency since the advent of financial liberalisation and deregulation in the 1970s. Between 1970 and 2007, there were 124 banking and financial crises worldwide; between the 1940s and the 1970s, when banking was regulated and capital flows were controlled such crises were much less frequent (see Figure 1).

Figure 1: Weighted two-period moving sum of banking crisis frequency

![Graph showing weighted two-period moving sum of banking crisis frequency](image)

Source: Bordo and Landon-Lane (2010).

Malaysia and other Southeast Asian countries have experienced two major financial crises in the past two decades: the first from 1997 to 1999, known as the Asian financial crisis, as this is where it originated; and the second an offshoot of the recent global financial crisis which originated in the US. Strictly speaking, the second crisis to hit Asia was more a trade and gross domestic product (GDP) growth crisis rather than a financial crisis, because most Asian countries, including Malaysia, rebuilt their banking and financial sector after the Asian financial crisis to be more resilient and hence were able to avoid a financial meltdown.

Our analysis of the impact of the recent global financial crisis on Malaysia therefore begins with an understanding of the Asian financial crisis of 1997–9 and how it shaped this crisis. Malaysia, like most Southeast Asian countries, suffered this, its worst financial crisis, from 1997 to 1999 as a
result of the wholesale and uncritical adoption of financial deregulation, in both capital accounts and the banking sector, pushed by the International Monetary Fund (IMF) and the US. Unregulated capital flows coupled with pegged exchange rates brought a surge of capital flows into Southeast Asian economies which were taking advantage of arbitrage opportunities. Figure 2 shows the net flow of private capital into and out of Southeast Asia before and after the Asian financial crisis, causing havoc to the financial and economic stability of these countries.

Figure 2: Net capital flows—Indonesia, Philippines and Thailand, 1985–2006 (US$ billions)


Malaysia was not spared this calamity, even though its external debt burden was not onerous. In 1997, the ringgit plunged from RM2.4 to a low of RM4.9 to US$1. Net portfolio investment shrunk RM22 billion, from positive RM10.3 billion in 1996 to negative RM12.9 billion in 1997. This led to a collapse of the stock market, the ballooning of foreign debt, massive corporate defaults and non-performing loans, resulting in a banking crisis.

INTRODUCING IMF POLICIES

Because of its relatively low level of foreign indebtedness, Malaysia did not apply for any IMF assistance. Nevertheless, it followed the standard IMF prescription in facing the crisis. On the macroeconomic policy front, it raised interest rates with the view to stemming capital outflows, the currency was floated to allow for free capital flows and public expenditure was reduced by 18 percent. On the financial sector side, Malaysia changed
the definition for non-performing loans from six-month arrears to three-month arrears, following international standards. Unfortunately, with the implementation of these policies, what started as a financial and currency crisis soon became a full-blown economic crisis.

Aggregate domestic demand declined in 1998 for the first time since 1986, owing to a significant negative contraction in private investments (by 55 percent) and private consumption (by 10 percent). The real economy contracted 14 percent, with GDP growth plunging from positive 7.7 percent in 1997 to negative 6.7 percent in 1998. The stock market plummeted by over 70 percent and the ringgit fell to its lowest of RM4.9 to US$1 in January of 1998.

MAHATHIR’S COUNTER-STRATEGY

By early 1998, it was clear that the pro-cyclical IMF macroeconomic policies were not working. Dr. Mahathir, then Prime Minister of Malaysia, changed direction, set up the National Economic Action Council and centralised decision making and policies. In July 1998, he launched the National Economic Recovery Plan, seen as an alternative to orthodox IMF policies. The objectives of this were to stabilise the local currency, restore market confidence, maintain financial market stability, restructure corporate debt, recapitalise and restructure the banking sector and revitalise the economy. These policies were implemented in stages.

To counter the recession, on the monetary and financial sector front Bank Negara loosened monetary policy by reducing interest rates gradually from 11 percent in July 1998 to 6 percent in May 1999 and 3 percent in December 1999. The statutory reserve requirement was also lowered, from 13.5 percent in July 1998 to 4 percent by October 1998. The non-performing loan definition was changed back to six-month arrears instead of three months. Bank Negara also set targets for banks to increase their loans by 8 percent in 1999.

FOREIGN EXCHANGE RATE POLICIES

Malaysia is a highly open economy, with external trade (exports and imports) constituting over 200 percent of its GDP. Hence the stability of its currency is crucial for its external trade. Prior to and during the crisis, the ringgit was traded offshore, and the higher interest rates paid to offshore ringgit deposits encouraged an outflow of the currency. At the height of the crisis in 1997 and 1998, speculation drove the offshore ringgit interest rate in Singapore to between 20 and 40 percent a year compared with an
11 percent onshore ringgit interest rate (Fane, 2000). Mahathir banned offshore market trading of the ringgit in September 1998 and gave depositors a grace period to repatriate their offshore ringgit deposits back to Malaysia. At the same time (September 1998), he fixed the ringgit exchange rate to US$1 to RM3.8.

SELECTIVE CAPITAL CONTROLS

Mahathir further introduced selective capital control measures that were strongly opposed by the IMF at that time. For foreign institutions and persons, a one-year moratorium from the purchase date of shares was imposed on repatriation of proceeds from the sale of those shares. The aim was to discourage speculative short-term trading in local shares. Ringgit loans to non-resident banks and stock-broking firms were stopped. Restrictions were imposed on transfers of ringgit funds in external accounts held by non-residents. Measures were also introduced to control conversion of the ringgit to other currencies. Except for trade payment purposes, Malaysian residents were allowed to make payments to non-residents or make investments of up to the equivalent of RM10,000, above which they had to obtain prior approval from Bank Negara. Residents were not allowed to obtain ringgit credit facilities from non-residents. Resident companies were prohibited from foreign loans unless their revenue was also in foreign currency, to prevent currency mismatch—a major factor in the Asian financial crisis.

The ringgit was still freely or easily convertible for the purposes of trade, inward foreign direct investment (FDI) and the repatriation of dividends and profit from FDI. What the government wanted to discourage was speculative short-term portfolio and other investments by foreign residents and the flight of capital by local residents, although the effectiveness of the latter objective is debatable.

EXPANSIONARY FISCAL POLICIES

To resuscitate the economy, the government embarked on an expansionary fiscal policy. In July 1998, it unveiled a fiscal stimulus package of RM2 billion which turned the budget from a surplus of 2.5 percent of GDP in 1997 to a deficit of 1.8 percent in 1998 and 3.2 percent in 1999.
SETTING UP DEBT RESTRUCTURING AGENCIES

Finally, on the corporate front, the government established a number of agencies to help restructure both financial and non-financial institutions. It provided guarantee of banking deposits and decided not to close down troubled financial institutions that would have aggravated the financial crisis, but rather to consolidate, restructure and recapitalise them. To this end, Danaharta (the debt restructuring agency) was set up in June 1998 to take over non-performing loans from banks, and to restructure and manage them. Danamodal was set up in August of 1998 to recapitalise and restructure troubled financial institutions. In addition, the Corporate Debt Restructuring Committee was established to assist corporations in negotiating and restructuring debt with their creditors.

THE EVOLUTION OF MONETARY AND CAPITAL FLOW POLICIES

According to conventional economic theory, it is not possible for a country to control both its interest rates (through its monetary policies) and foreign exchange rates under a regime of free capital flow. This is because, with free and unimpeded capital flows, a lower interest rate would encourage outward capital flows and hence a lower exchange rate, and vice versa. This is termed the “impossible trinity” (see Figure 3).

The primary objectives of the Malaysian government’s monetary and capital control policies are to ensure stability in the ringgit foreign exchange rate so as not to disrupt trade flows, and at the same time to maintain a steady and relatively low interest rate to sustain economic growth.

Figure 3: The impossible trinity
In choosing the appropriate monetary and other less conventional instruments to achieve the above objectives, the government is guided by pragmatism and flexibility. Hence monetary and foreign exchange rate policies have undergone several transitions.

1997–2000

During the Asian financial crisis, Malaysia faced a large depreciation of the ringgit and massive capital flight, even though it raised domestic interest rates. To stem this outflow and depreciation, the government fixed the value of the ringgit at RM3.8 to US$1 to manage the impossible trinity problem. This allowed it to lower interest rates to stimulate the economy without worrying about capital flight or currency volatility. When the economy started to recover in 1999, capital and currency controls were gradually relaxed and finally removed. In February of 1999, the one-year moratorium on repatriation of profits from share sale was replaced by a 10 percent exit levy on the sale proceeds on a graduated scale.

2001–5

From 2001 to 2005, the government relaxed capital controls but still maintained the pegged ringgit. But at the same time, it also resorted to monetary instruments, via sterilisation and its reverse, to smoothen out the effects of capital flows. In 2001, the exit levy was abolished altogether. Residents were gradually allowed to operate foreign currency accounts and to invest abroad. As the economy recovered, capital began to flow back into the country. In 2003, net portfolio investment was positive RM4.2 billion up from negative RM6.5 billion a year earlier; it surged to RM33 billion in 2004.

2005 ONWARD

From 2005 onward, the exchange rate and capital flow policies became almost fully liberalised. Capital controls were removed and the pegged ringgit was lifted in July 2005 and changed to a managed-float system, but the ringgit remained non-internationalised, that is, there were limits to non-residents borrowing in the local currency.
POST-ASIAN FINANCIAL CRISIS

The country now faces a different set of conditions. Current account surpluses have been rising steadily every year since 1999, averaging over 10 percent of its GDP. This has not been matched by an equivalent financial and capital account deficit; consequently, the country’s reserves rose from RM117 billion (US$31 billion) in 1999 to RM336 billion (US$100 billion) in 2007. Besides using monetary instruments, namely sterilisation, to mop up the excess liquidity, the government has also reversed its policy of not allowing residents to invest abroad. Allowing outward investments by residents is another way of mopping up excess dollar liquidity. Malaysia therefore witnessed a significant outflow of direct investments by residents from 2005 onwards. In fact, outward direct investments became greater than the inflow of FDI such that net direct investments were negative from 2007 onwards (see Figures 4 and 5).

Figure 4: Outward investments and FDI in Malaysia, 1999–2010 (RM millions)

Source: Bank Negara Monthly Statistical Bulletin (various years).

The largest category of net outflow of capital comes from “other investments”, which represent mostly deposits or placement of assets abroad by domestic financial institutions. The net outflow of other investments averaged over RM20 billion annually between 2003 and 2005 and more than doubled to RM56 billion in 2006.
Malaysia entered the latest global financial crisis in a position of relative strength in terms of both its national and its corporate balance sheet. What could be of some concern down the road is the strength of its households’ balance sheet. Helped by a positive external environment, the country instituted the right mix of macroeconomic, monetary and financial sector policies to facilitate its recovery from the Asian financial crisis, with exports leading the way. Figure 6 compares the performance of the export sector in the three recent crises (including the dot.com crisis). In both the Asian financial crisis and the recent global financial crisis, government monetary and fiscal stimulus programmes plus export demand led the way to recovery.

Source: Authors’ own calculations.
STRONG CURRENT ACCOUNT BALANCE AND FOREIGN RESERVES

Malaysia’s current account balance rose from a deficit of RM17 billion in 1997 to a positive of RM37 billion in 1998. From 2003 onwards, this surplus has exceeded RM50 billion yearly. Even when the global financial crisis hit Malaysia in 2008, the country’s current account surplus was over RM130 billion, dipping to RM112 billion and RM90 billion in 2009 and 2010, respectively. Its foreign exchange reserves have been rising steadily, from RM59 billion in 1997 to RM328 billion in 2010 (see Figure 7). Reserves peaked at RM410 billion in June 2008 and plunged to RM320 billion at the height of the crisis in December 2008, but soon stabilised at soon stabilised RM 316 billion in 2009, adequate to finance 7.6 months of import and 3.9 times its short-term external debt (Bank Negara, 2009).

Figure 7: Foreign reserves and current account balance in Malaysia, 1997–2010

Source: Bank Negara Monthly Statistical Bulletin (various years).

HEALTHY BANKING SYSTEM

The Malaysian banking and corporate sectors emerged healthier after the Asian financial crisis (see Figure 8). Its risk-weighted capital ratio was above 13 percent from 2001 to 2010, its core capital ratio above 10 percent. Non-performing loans based on the three-month arrears classification dropped from 11.5 percent in 2003 to 2.6 percent in 2008. The impact of the crisis on the Malaysian banking system was modest, as domestic banks had negligible exposure to US subprime loans and derivatives. The corporate sector was also healthy, with little currency mismatch. Loan growth was relatively in line with GDP growth. Between 2005 and 2010, total bank loans grew at an annual rate of 8.7 percent, slightly faster than the country’s GDP growth of 8.0 percent.
What could be of concern, although we are still at an early stage, is the resilience of Malaysia’s household sector. Growth in household loans grew at an annualised rate of 9.8 percent during the same period, about 2 percent higher than GDP growth (see Figure 9). Household debt to GDP in Malaysia stood at 76 percent in 2010, but household debt to disposable income was at a high of 140 percent, higher than in the US. Meanwhile growth in per capita income was only 4.3 percent annually. Hence most of the annual growth in personal consumption of 9.8 percent is driven by debt rather than income growth. Much of the growth in household debt is driven by an increase in house prices which outpaced income growth, followed by passenger car loans which consume a substantial portion of household

Source: Bank Negara Monthly Statistical Bulletin (various years).

HOUSEHOLD LOANS AND HOUSING ASSET BUBBLE?

income. Household loans, consisting principally of housing loans, passenger car loans, credit card and personal loans, make up 55 percent of the total banking loans. Furthermore, half of Malaysia’s household disposable income is used to service household debt.

House prices in Malaysia have been rising steadily, except for a slight pause in 2008; they resumed their upward climb vigorously in 2009 and 2010 when interest rates were relaxed (see Figure 10). The average house price for the country as a whole is still quite affordable, at RM203,000 (US$65,000), with an affordability index (average house price/average household income) of 4.1 times. But the affordability index is not sustainable in the major urban areas like Kuala Lumpur (5.9 times) and especially Penang (about 9 times). In Penang, the linked house price index rose from 100 in 2000 to 214 in 2010.

While the central bank raised interest rates gradually in 2010 to control inflation, it is constrained by the fear of derailing economic growth. With half of household disposable income servicing household debt, a further rise in interest rates could result in default and a rise in non-performing loans. The central bank, however, thinks the problem is still manageable. So far, it has only lowered the loan to value (LTV) ratio to 70 percent for buyers of third residential property, leaving the market to determine the LTV ratio for other purchases. In 2008, to counteract the slowdown in housing demand, property developers raised the LTV ratio to 95 percent and introduced marketing gimmicks such as 1 percent booking fees, providing “interest-free” financing during the construction period and paying for buyers’ sales transaction charges, to boost the market. In 2010 the government reintroduced modest short-term capital gains tax to tame house prices. But the tepid measures of the central bank have not had much effect in slowing down rising house prices.
Despite the relative strength of Malaysia’s macroeconomic conditions and banking sector, the country was not spared the worst of the crisis. Being a highly trade-dependent economy, and having almost fully liberalised its exchange rate and capital account after 2005, the country was hit hard in the trade and investment sectors. Exports plunged 45 percent, from RM64 billion in July 2008 to RM38 billion in January 2009. Imports plummeted by the same percentage over this period so that the trade surplus remained positive and declined marginally (see Figure 11).
Unlike in the Asian financial crisis, the ringgit this time depreciated only about 10 percent, gradually recovering and appreciating in the post-crisis period (see Figure 12).

**Figure 12: Ringgit–US$ exchange rate, 2008–2010**

With almost full liberalisation of its financial and capital accounts, Malaysia is now subject to highly volatile capital flows, the most erratic being those of portfolio investments. Figure 13 shows that net portfolio investments plunged RM100 billion from positive RM18.3 billion in 2007 to negative RM84.4 billion in 2008; the Malaysian stock market likewise lost 40 percent of its value in the year 2008. Net portfolio investments then recovered in 2009 and surged to RM44.2 billion in 2010.

**Figure 13: Net financial flows in Malaysia, 2007–10 (RM millions)**

Source: Bank Negara Monthly Statistical Bulletin (various years).
Significantly, the banking and financial sector in Malaysia remained stable. It did not suffer a liquidity or solvency crisis. Non-performing loan ratios remained stable around 2 percent and the banks are well capitalised. Loan growth slowed in the second half of 2008, but picked up again by the first half of 2009.

**IMPACT ON THE REAL ECONOMY**

With the drastic decline in exports and spike in capital outflows, the Malaysian economy entered into a recession, with GDP contracting 1.7 percent in 2009. Growth turned negative the first three quarters, with the economy contracting 6.2 percent in Q1 of 2009. Unlike the IMF prescription during the Asian financial crisis, this time around, all governments, including Malaysia’s, went into high gear to implement counter-cyclical monetary and fiscal policies. The government took up the slack where private demand slumped.

**FISCAL STIMULUS AND MONETARY LOOSENING**

In late 2008 and early 2009, the government introduced two vigorous fiscal stimulus programmes totalling RM67 billion, equivalent to 10 percent of GDP. The central bank cut interest rates aggressively three times, totalling 150 basis points, to a low of 2.0 percent. It also reduced the statutory reserve requirements by 200 basis points to 1.0 percent. All these measures worked to stabilise the domestic economy. Private consumption, which fell 2.9 percent in Q1 2009, gradually improved in the second half of the year. But for the full year 2009, private sector expenditure contracted 3.4 percent while public sector expenditure rose 7.7 percent (Bank Negara, 2010).

On the supply side, growth in the first part of 2009 was affected severely by the collapse of manufacturing exports in the second half of 2008. The services sector recorded a marginal decline while the construction sector remained positive throughout the year owing to public investments and the fiscal stimulus. Fortunately for Malaysia, exports rebounded quickly in the second half of 2009 and the first half of 2010. Significant to note is the shift in the direction of trade. Exports to the US declined while those to China and other countries, particularly intra-regional trade, rose (see Figure 14).
The worldwide massive monetary and fiscal loosening brought about uneven recovery. Growth in Europe, Japan and the US remains weak, whereas that in emerging countries is stronger. Malaysia’s real GDP growth was negative for three quarters but rebounded strongly in the latter part of 2009 and first half of 2010 (see Figure 15).

**NEW CHALLENGES FOR ASIA**

In fact, emerging countries now face a different set of challenges. They are not decoupled from advanced countries; they remain firmly integrated into the world financial and trade system. Financialisation of the global system and speculation are the order of the day. Capital flows instantly and
incessantly in search of higher yields; the most visible are the carry trades where investors borrow in low-yielding currencies such as the yen or the US dollar to invest in higher-yielding currencies and assets like the Australian dollar. The massive liquidity injection by the Federal Reserve Bank in the form of quantitative easing did not calm the liquidity and lending conditions in the US. Rather, much of the funds flowed to emerging countries experiencing higher growth, resulting in both appreciation of their currencies and asset inflation in stock and property markets.

The stock market index in Malaysia, as in many other emerging countries, has now exceeded its pre-crisis peak, and the property market has been registering double-digit gains since 2009. As was stated earlier, policymakers are using both monetary and other physical instruments to rein in property prices. Meanwhile, inflation risks increase with sharp rises in food, fuel and other commodity prices. The governor of Bank Negara warned in May 2009 that inflation risks could outweigh the downside growth risks in the Malaysian economy (Star, 2010). The central bank remains vigilant and will adopt measures to meet these challenges.

CONCLUSIONS AND POLICY LESSONS

Malaysia, like many other Asian countries, faced two major crises in the space of 10 years. How did it weather these and what lessons can be drawn from this experience?

1. Increasing integration into the world trade and financial system brings with it benefits and dangers. Malaysia’s economy, like most other emerging economies, is becoming more integrated, rather than decoupled, from the world economy, through both trade and capital flows. Financial openness exposes the domestic economy to sudden and large movements of capital and volatility in exchange rates. Exchange rates today are influenced more by capital flows than by trade flows. If a country, particularly a small economy, maintains full liberalisation of capital flows, such massive and volatile capital flows can undermine its monetary policies, as in the case of the Asian financial crisis.

2. Policymakers should not be tied to IMF orthodoxy. Rather, they should be pragmatic and flexible in their policies, and guided by overall national objectives. Fiscal, monetary and banking policies should be countercyclical. They should be willing to use instruments other than the normal monetary one to attain these objectives. Malaysia adopted selective capital controls to stabilise trade, capital flows and exchange rates and adapted or removed these as conditions changed.
that time, such a policy was considered heretical; yet today even the IMF is advocating selective controls as a legitimate tool to manage economic and financial stability. Today, as many emerging countries face asset inflationary pressure resulting from excess liquidity created by quantitative easing and carry trades, policymakers should be willing to use additional tools to manage their currencies and capital flows.

3. There is no substitute for building strong macroeconomic fundamentals and healthy national, corporate and household balance sheets. Malaysia’s external debt at the outset was low, and there was little currency mismatch in its external debt. Another reason many Asian countries, including Malaysia, were able to weather the global financial crisis relates to their ample foreign exchange reserves, which provided them with the liquidity and ability to absorb external shocks. In 2008–9, Malaysia suffered a net capital outflow of about US$30 billion, but the country still had US$90 billion in foreign reserves, equivalent to eight months imports and over three times its short-term foreign debt. Countries like South Korea and Indonesia, which had high exposure to foreign debt, currency mismatches and low levels of foreign reserves, were in a more precarious position.

4. Malaysia is highly dependent on trade, and manufacturing forms the largest component of its exports. A total of 60 percent of its manufacturing exports come from the electrical and electronics industry. To lessen volatility, it should diversify both its export composition and its export destination. The crisis witnessed a discernible shift in Malaysian export destinations toward intra-regional trade, and in particular towards China.

5. The world financial system is becoming increasingly fragile and unstable, and financial crises are at the heart of major economic crises. Asset inflation, rather than wage or consumer price inflation, has been the driver of economic boom and bust, and was the main cause of the global financial crisis. Malaysia should learn from this lesson, and central banks should pay more attention to asset inflation and be willing to adopt lean-against-the-wind measures to avoid or minimise similar crises in the future.

6. Maintaining a prudent and sound banking system with a low level of exposure to fancy financial instruments stood Malaysia in good stead. Malaysian banks had minimal exposure to collateralised debt obligations and other derivatives, were well capitalised and had stable non-performing loan ratios. The government should resist pressures to indiscriminately liberalise its financial systems or adopt the latest fad in financial innovations.
REFERENCES


SOUTH KOREA’S EXPERIENCE WITH GLOBAL FINANCIAL CRISIS

Hyekyung Cho

INTRODUCTION

The belief that deregulated financial markets will benefit everybody, the rich and the poor as well as the developed and the developing world, has reshaped the global economy, starting in the early 1980s. However, un fettered capital flows do not work as advertised. Over the past three decades, the world has endured recurrent financial crises, which have incurred long-lasting damage. More disturbingly, market failures caused by the un fettered nature of finance have almost always led to state rescues which have had to use taxpayers’ money. Indeed, free financial markets would have disappeared long ago if not for the state’s helping hands.

In South Korea (henceforth Korea), as in many other emerging market economies, currency crisis in 1997 helped facilitate un fettered finance. Given the country’s heavy dependence on exports, its overarching financial priority had been to maintain currency stability; accordingly, free capital mobility had never been a vital part of its financial policy. Rather, a system of state-led “financial repression”, in which the banking sector was a servant to the “real economy”, was the main force behind Korea’s economic miracle, decades of which had resulted in underdeveloped capital markets.

Since the start of financial liberalisation experiments in the early 1980s, Korea has faced many challenges, most notably in harmonising financial liberalisation with currency stability. Eventually, the first experiment ended in twin financial crises—in currency and banking—in 1997–8. The crises and the International Monetary Fund (IMF) intervention that followed marked a watershed in terms of Korea’s shift to financial liberalisation and openness. Bold structural and regulatory reforms towards full-fledged liberalisation were undertaken. However, the Korean economy then suffered a series of financial shocks, which led to another currency crisis in late 2008.

This paper assesses the impact of the recent global financial crisis in Korea. Although the country was not involved directly in the US subprime market debacle, the global credit crunch after the collapse of Lehman’s hit its financial markets severely, provoking a foreign and domestic liquidity crisis and a collapse of the won. This paper examines factors behind the financial turmoil that Korea has experienced since late 2008 and its policy response to the crisis. The case illustrates the dangers posed by un fettered global
finance, with sound macroeconomic fundamentals, including huge foreign currency reserves, offering little protection against currency instability and financial crisis.

KOREA’S FINANCIAL SECTOR DEVELOPMENT AFTER THE 1997 CRISIS

Korea’s impressive economic performance, politically adorned when it entered the Organisation for Economic Co-operation and Development (OECD) in 1996, came to an abrupt end in late 1997 when the devastating tsunami of financial crises that began in Thailand reached the country. The overseas borrowing spree of domestic banks and firms became fatal, resulting in twin crises in currency and banking. After the 1997 financial crisis, the Korean government took radical steps towards further financial liberalisation and implemented IMF-imposed structural adjustment programmes. This was believed to be the best way to prevent another crisis as well as to increase the efficiency and competitiveness of Korea’s underdeveloped banking industry. Financial development corresponding to the size and development level of Korea’s real economy became a key policy objective in the post-crisis period. Full full-fledged financial liberalisation was considered the only effective way to reach this goal (see Cho and Kalinowski, 2009; 2010).

Financial restructuring changed the landscape of the Korean banking system dramatically, resulting in a massive concentration in the banking sector. The number of commercial banks halved, from 26 in late 1997 to 13 in 2007—7 nationwide and 6 regional banks. The market share of the three largest banks by assets has more than doubled, from 27 percent in 1997 to 58.6 percent in 2007. This concentration resulted from the government’s belief that economies of scale were the first step towards increasing the international competitiveness of the domestic banking sector.1

1 The Korean government has long held the goal of establishing a megabank ranking in the world’s top 50 banks and being able to compete with global financial giants like Goldman Sachs and Citigroup.
Table 1: Assets and foreign equity share in the commercial banking sector in Korea

<table>
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<tr>
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<th>Foreign equity share (%)</th>
<th>Assets (W trillions)</th>
<th>Asset share (%)</th>
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<tr>
<td></td>
<td>2001</td>
<td>2004</td>
<td>2007</td>
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<tr>
<td>KB Finance Holdings</td>
<td>71.11</td>
<td>76.1</td>
<td>81.32</td>
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<td>Kookmin Bank</td>
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<td>Woori Finance Holdings</td>
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<td>11.58</td>
<td>13.69</td>
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<td>Woori</td>
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<td></td>
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<td>Kyungnam</td>
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<td>Gwangju</td>
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<td>15.3</td>
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<td>Shinhan Finance Holdings</td>
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<td>KEB*</td>
<td>33.53</td>
<td>68.3</td>
<td>80.51</td>
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<tr>
<td>SC First*</td>
<td>50.99</td>
<td>48.6</td>
<td>100</td>
</tr>
<tr>
<td>Citi*</td>
<td>53.22</td>
<td>99.9</td>
<td>99.95</td>
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<td>Daegu**</td>
<td>3.77</td>
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<td>69.67</td>
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<tr>
<td>Busan**</td>
<td>10.64</td>
<td>59.2</td>
<td>64.21</td>
</tr>
<tr>
<td>Jeonbuk**</td>
<td>0.05</td>
<td>12.1</td>
<td>21.63</td>
</tr>
<tr>
<td>Total</td>
<td>32.78</td>
<td>56.27</td>
<td>66.42</td>
</tr>
</tbody>
</table>

Note: *Foreign controlled banks;**Independent regional banks.
Source: Financial Supervisory Services (FSS) data.

Another conspicuous change was a sharp increase in foreign participation in the Korean banking industry. Of seven nationwide commercial banks, three medium-sized ones were sold to foreign investors. In terms of equity ownership, three other banks are foreign owned. Foreign holdings in stocks of the commercial banking sector jumped from 16.4 percent in 1997 to 66.4 percent in 2007 (see Table 1). The government welcomed and fostered foreign participation as a necessary vehicle for efficiency and competitiveness of the Korean financial industry.

*The government has failed to re-privatise Wooribank, the second largest bank in terms of assets, which was formed through a merger of several nationalised banks after the 1997 crisis. On the banking restructuring process and its outcome, see Cho (2011); Cho and Kalinowski (2010).*
EXTERNAL FINANCIAL LIBERALISATION

In pursuit of financial development, priority was given to capital account and foreign exchange (FX) market liberalisation. In May 1998, the ceiling on foreign investment in Korean stock markets was abolished and the local bond and money market were opened fully to foreign investors. Furthermore, the experience with the 1997 crisis underscored the need to develop the shallow FX market in Korea. With the introduction of a free floating FX system in December 1997 and the country’s substantial financial opening immediately after the crisis, it was feared that market volatility would increase. Thus, FX market development was seen as critical to absorbing external shocks better. In 2002, liberalisation of FX transactions gained a new impetus as the Korean government, under newly elected President Roh Moo-Hyun, announced a national agenda to promote Korea as a financial hub of northeast Asia by 2010 (MOSF, 2007).

The financial hub project was a deliberate policy to designate the financial industry the key strategic sector and future growth engine of the Korean economy. As part of the project, the government presented a plan for full liberalisation of FX markets by 2011, virtually removing all regulatory controls on FX markets and pursuing internationalisation of the Korean won. In 2005, the Roh Moo-Hyun administration advanced the deadline from 2011 to 2009. In January 2006, the capital account transaction permission system was abolished, and replaced by an _ex post_ reporting system. With only a few exceptions, the Korean FX market was fully liberalised.3

THE IMPACT OF GLOBAL FINANCIAL CRISIS ON KOREAN FINANCIAL MARKETS

CURRENCY MARKET TURMOIL IN 2008

One immediate effect of the global financial crisis in Korea was a freefall of the won (Figure 1), which depreciated 60 percent against the US dollar through the second half of November 2008 to become the second worst performing currency in the OECD after the Icelandic krona (The Economist, 2010).

3 Only three specific types of transactions were not liberalised: (1) non-residents are not permitted to buy won-denominated funds, including forward currency contracts, which can potentially be used to attack the local currency; (2) foreign currency borrowing by non-viable domestic firms is not permitted; and (3) the Korean government ensures that Koreans firms that have extended credit to foreign borrowers collect their debts. In addition, despite full FX market liberalisation, the Korean government has retained the right to re-impose restrictions on capital outflows in the case of severe economic or financial emergency.
Figure 1: Nominal won-dollar exchange rate, monthly average and FX reserve, 2008–10 (US$ billions)

Source: Bank of Korea (BOK) data.

The sharp depreciation of the won in late 2008 was a by-product of global deleveraging which began with the US subprime crisis in mid-2007 and accelerated after the collapse of Lehman’s in September 2008. This sparked the massive withdrawal of foreign capital from Korean financial markets. Within the four months between September and December 2008, capital outflows amounted to US$69.5 billion, about 30 percent of the US$221.9 billion 10-year gross capital inflow since 1998. The largest portion of capital outflows in 2008 comprised a rapid withdrawal of short-term foreign loans which had surged in previous years. Gross short-term foreign debt rose to US$160.2 billion in 2007 from US$65.9 billion in 2005, an increase of US$94.3 billion. This was attributable to the banking sector: in 2006 and 2007, its short-term foreign borrowing totalled US$74.4 billion, accounting for over 80 percent of the country’s total short-term foreign debt. Foreign bank branches were the major driver: their net short-term foreign borrowing in the same two years amounted to US$56 billion compared with US$26.7 billion of all domestic banks (see Figure 2).
In the second half of 2008 and the first quarter of 2009, amid the unfolding global financial crisis, Korea’s short-term foreign debt emerged as a major concern, following the same pattern as in the 1997 crisis. The short-term foreign debt to FX reserves ratio rose to 79.1 percent in the third quarter of 2008 from around 30 percent in 2005—approaching levels prevailing at the time of the 1997 crisis. However, the more recent rapid increase in foreign debt differed considerably from excessive foreign borrowing before the 1997 crisis: a substantial part of it was linked to FX hedge-related financing, which saw a rapid increase from 2004 alongside the appreciation of the Korean won. Despite stepped-up accumulation of FX reserves, the won continued to rise, as both capital and current account inflows increased sharply. From 2000 to 2003, the value of the won was maintained roughly constant on a real effective exchange rate (REER) basis. However, from 2004 to 2005, it appreciated by about 25 percent on a REER basis, largely because of massive inflows of foreign direct investment (FDI) and portfolio investment (Dwor-Frécaut, 2008). This prompted the Korean government to refocus FX policy on the liberalisation of capital outflows in order to alleviate upward pressure on the won and reduce the cost of large-scale sterilised intervention. Yet this attempt had little effect, as domestic exporting firms started to use FX forward transactions not only for hedging purposes but also for speculative bets against the won appreciation. As a result, net forward sales expanded dramatically (see Table 2). Along with the increase in FX derivative transactions, foreign borrowing by the banking sector continued to surge.
Table 2: FX forward transactions of domestic companies in Korea, 2003–10 (U$ billions)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales [A]</td>
<td>38.7</td>
<td>62.1</td>
<td>71.7</td>
<td>99.7</td>
<td>126</td>
<td>136.6</td>
<td>70.9</td>
<td>103.4</td>
</tr>
<tr>
<td>Purchases [B]</td>
<td>23.1</td>
<td>30.3</td>
<td>42.5</td>
<td>50.4</td>
<td>54.2</td>
<td>74.6</td>
<td>49.8</td>
<td>70.3</td>
</tr>
<tr>
<td>Net sales [A-B]</td>
<td>15.6</td>
<td>31.8</td>
<td>29.2</td>
<td>49.3</td>
<td>71.8</td>
<td>62</td>
<td>21.1</td>
<td>33.1</td>
</tr>
</tbody>
</table>

Source: BOK Foreign Exchange Market Trends (various years).

**FX Hedging and Foreign Debt**

In 2005, Korea’s major exporters, such as ship builders, with anticipated foreign currency export revenue rushed into selling dollars forward to banks in order to hedge against FX risks and expected losses from the ongoing won appreciation. Asset management companies involved in overseas investment did the same. Net currency forward selling by Korean firms soared to US$71.8 billion in 2007, from US$29.2 billion in 2005. As currency forward purchasers, banks proceeded with FX and currency swap contracts with foreign bank branches to adjust their FX positions.

The increase in FX risk hedging from 2005 had three effects. First, it contributed to further appreciation of the won, as the strategy involved foreign borrowing and selling dollars on the spot market (IMF, 2011b). Like a chain reaction, FX risk hedging activities added upward pressure on the won leading to a further need for FX hedging.

Second, it offered lucrative riskless arbitrage opportunities for foreign bank branches. As domestic firms’ need for FX risk hedging increased, foreign bank branches entered the FX swap market in Korea by selling dollars to domestic banks to buy Korean won on the spot market, simultaneously buying dollars on forward markets. Before the FX swap matured, they used the local currency bought through FX swaps to buy won-denominated assets such as certificates of deposit (CDs) and sovereign bonds. In FX swap transactions, foreign bank branches engaged in carry trade by borrowing at a lower dollar or yen interest rate to lend at a higher Korean interest rate. As the dollar demand for hedging purposes increased, the swap rates foreign banks paid for buying the Korean currency fell, which gave rise to profitable arbitrage opportunities. A surge in foreign bank branches’ FX swap transactions rendered the central bank’s monetary policy increasingly

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4 As the interest rate on 91-day CDs is used as the benchmark for floating-rate mortgage loans, the CD rate is the most important money market interest rate in Korea.
ineffective. Although BOK successively raised bench interest rates after 2006 to quell the housing bubble, market interest rates were not affected and remained low as a result of increased arbitrage investments by foreigners. This enabled banks to continue the mortgage lending spree.

Third, FX hedging resulted in a massive increase in the banking sector’s foreign borrowing. By the end of June 2008, the total external debt of Korea stood at US$420 billion, of which 41 percent, US$176 billion, was short term. According to the Financial Supervisory Commission (FSC), US$94 billion of Korea’s total external debt was incurred as a result of FX forwards’ hedging of pre-contracted future cash flows. Another US$51 billion was Korean shipbuilders’ FX hedge-related foreign borrowing.5

The global credit crunch that followed the collapse of Lehman’s led to an unwinding of arbitrage investments. The resulting massive withdrawal of foreign loans amounted to US$22 billion in the second half of 2008, of which $11 billion was channelled through foreign bank branches (see Figure 3). This deleveraging continued until the first half of 2009. In addition to rapid deleveraging of the banking sector, currency forward selling by Korean firms also declined, affected by the ensuing global recession. Korean shipbuilders’ forward selling dropped from US$53.5 billion in 2007 to US$16.7 billion in 2009. Consequently, the banking sector’s short-term debt fell sharply from a peak of US$106.4 billion in the third quarter of 2008 to US$56.5 billion in the first quarter of 2009. Withdrawal of foreign debts combined with foreign investors’ rush to exit the Korean stock market led to acute dollar shortage and a plunge in the Korean currency.

GOVERNMENT RESPONSE TO THE GLOBAL FINANCIAL CRISIS

FISCAL AND MONETARY RESPONSE

The export-dependent Korean economy took a hard hit from the global recession in late 2008. The government responded to the global economic downturn with proactive fiscal and monetary policy. Given the sound fiscal position and low sovereign debt level,6 there was sufficient budgetary capacity to deal effectively with the economic downturn, so the government

5 The government tried to downplay Korea’s foreign debt problem by arguing that FX hedge-related foreign borrowing by the banking sector should not be regarded as foreign debt because it was repayment free. Excluding these debts, the “genuine” foreign debts of the Korean economy would be only about US$268 billion, and far below the US$420 billion level (see FSC, 2008). However, these efforts to calm concerns had no effect. Whatever the reason behind the recent surge in its external debt, Korea fell into a severe foreign liquidity crisis in late 2008.

6 In 2007, Korea had a fiscal surplus of 4.7 percent of GDP and its sovereign debt was 27.9 percent of GDP (OECD, 2011b).
launched a fiscal stimulus package equivalent to 4 percent of gross domestic product (GDP), the largest among the OECD countries (OECD, 2011). There were successive interest rate cuts from October 2008, and the benchmark interest rate was cut from 5.25 percent to a record low of 2 percent in February 2009, which remained in place until early 2011. The Korean economy saw rapid recovery, driven by strong export growth resulting from the depreciation of the won and Chinese demand (see Table 3) as well as the huge stimulus packages. After having slowed to 0.2 percent in 2009, GDP growth rose to 6.1 percent in 2010.

**FINANCIAL MARKET STABILISATION POLICY**

In the year to September 2008, the Korean government seemed unconcerned about capital outflows, given its huge FX reserves, and even supported the accompanying depreciation of the won, expecting positive effects on exports. In addition, Korea’s exposure to US subprime mortgage markets was very limited. Therefore, it was believed that the subprime crisis would have little impact on the Korean banking sector. It was not until the full-fledged global credit crunch followed by the Lehman bankruptcy that the Korean government became of the serious collateral damage to the Korean

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7 According to the Ministry of Strategy and Finance (MOSF), investment in US subprime mortgages by Korean financial institutions totals US$850 million, which includes US$600 million by five local banks and US$250 million by nine insurers. Their appraisal loss is estimated at US$85 million (Korea Times, 2007).
### Table 3: Korea’s exports to key countries and regions, 2006–10 (US$ billion)

<table>
<thead>
<tr>
<th></th>
<th>2006 (Volume)</th>
<th>2007 (Volume)</th>
<th>2008 (Volume)</th>
<th>2009 (Volume)</th>
<th>2010 (Volume)</th>
<th>Total (Volume)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>69.5</td>
<td>91.8</td>
<td>86.7</td>
<td>91.7</td>
<td>116.8</td>
<td>325.5</td>
</tr>
<tr>
<td>ASEAN</td>
<td>11.4</td>
<td>11.3</td>
<td>10.4</td>
<td>12.3</td>
<td>12.6</td>
<td>32.1</td>
</tr>
<tr>
<td>EU</td>
<td>15.1</td>
<td>16.4</td>
<td>17.3</td>
<td>18.2</td>
<td>18.3</td>
<td>32.5</td>
</tr>
<tr>
<td>Japan</td>
<td>21.4</td>
<td>21.4</td>
<td>21.7</td>
<td>22.1</td>
<td>22.0</td>
<td>32.5</td>
</tr>
<tr>
<td>US</td>
<td>10.7</td>
<td>11.5</td>
<td>12.3</td>
<td>13.3</td>
<td>14.3</td>
<td>35.2</td>
</tr>
</tbody>
</table>

Notes: ASEAN = Association of Southeast Asian Nations; EU = European Union.

Source: Ministry of Foreign Affairs and Trade (MOFA) data.
banking sector. Faced with erratic FX markets and a skyrocketing sovereign credit default swap (CDS) premium, the government took emergency measures. In late October 2008, it announced that it would guarantee US$100 billion in foreign debt and forged a bilateral currency swap arrangement of up to US$30 billion with the Federal Reserve to secure additional FX sources. In December, currency swap deals took place Japan and China. Such aggressive emergency measures temporarily stabilised the won but did not help stop the massive capital outflow. Withdrawal of foreign short-term loans accelerated in the last quarter of 2008 and continued until the first quarter of 2009. In early 2009, the Korean won plunged again, this time at an even faster rate than experienced in previous months. By March 2009, it fell to a 10-year low.

RESPONSE TO DOMESTIC LIQUIDITY CRISIS

Given Korea’s increased linkages to global financial markets, the global credit crunch directly affected the country’s financial sector, resulting in a full-blown meltdown. The banking sector faced double risks. Rapid withdrawal of foreign loans and a surge in domestic and global market interest rates led to an acute liquidity crisis. This was because the commercial banking sector increasingly used short-term wholesale funding sources and short-term foreign borrowing related to FX hedging to finance longer-term mortgage loans. The rollover ratio of domestic banks’ short-term foreign currency debt fell to 33.9 percent in the fourth quarter of 2008, and the credit squeeze in FX markets and domestic capital markets in late 2008 pushed up market interest rates. Consequently, wholesale funding costs soared. CDS premiums on Korean bank-issued foreign currency bonds (five year) spiked to over 700 basis points in October 2008 from below 20 basis points in mid-2007 (BOK, 2010). This left global credit markets out of reach for domestic banks, and the banking sector faced serious difficulties refinancing its domestic and foreign debt.

Both a currency and a maturity mismatch in banks’ balance sheets made them vulnerable to capital outflows resulting from the unwinding of FX derivative transactions. In addition, credit risks heightened, with mounting non-performing loans (NPLs) incurred as a result of the downturn in the overall economy and in the housing market, which saw rapid expansion owing to excessive mortgage lending in previous years. In late 2008, banks’ balance

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8 Along with a sharp increase in mortgage lending since 2004, the loan to deposit ratio began to rise, reaching 138 percent in 2008. The funding gap was filled with wholesale market sources. In August 2008, the banking sector’s wholesale funding, like CDs, bank bonds and repurchase agreements, accounted for 32.8 percent of total funding, up from 15 percent in 2003 (BOK, 2009).
sheets deteriorated rapidly. This prompted the government to intervene by introducing a wide range of countermeasures. In early 2009, it announced plans for an additional foreign liquidity provision of US$55 billion for interbank transactions, a NPL Restructuring Fund of W10 trillion (US$7.8 billion at the 2009 average exchange rate of W1,276 to US$1) and a Bank Recapitalisation Fund of W20 trillion (US$15.6 billion) to prop up banks’ balance sheets (FSC, 2009). Other financial stabilisation measures introduced included a Bond Market Stabilisation Fund of W10 trillion (US$7.8 billion), a Stock Market Stabilisation Fund of W500 billion and a Corporate Restructuring Fund of W40 trillion (US$31.3 billion) (FSC, 2009b).

MUDDLING THROUGH THE SHOCKS OF THE GLOBAL FINANCIAL CRISIS

Pre-emptive measures to restore overall financial stability combined with aggressive interest rate cuts by BOK helped the banking sector weather the shocks of the global financial crisis. More importantly, the end of the global credit squeeze halted the withdrawal of foreign loans in the second quarter of 2009 and resolved the liquidity crisis. However, the sector faces a difficult time ahead: its greatest challenges are a sluggish housing market and snowballing household debt given that the lion’s share of banks’ assets are household and small and medium enterprise (SME) loans.9 This was the result of the debt-driven housing boom starting in 2005. Korea’s household debt to personal disposable income ratio went up from 143 percent in 2009 to more than 150 percent in 2010, among the highest in the world. Furthermore, variable interest rates accounted for more than 90 percent of all bank loans, so borrowers are exposed directly to interest rate risks. Korea’s overvalued housing market and high household debt have become more and more of a headache for BOK. Rapid economic recovery and massive capital inflows hinted at a build-up in inflation pressures during 2010, although BOK retained the record low interest rate. The government attempted to avert inflationary risks by asserting price controls,10 a strategy which had only limited success.

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9 At the peak of the housing bubble in 2007, outstanding household loans by the commercial banking sector accounted for 50.9 percent of the total, of which about 50 percent was mortgage loans; lending to the construction and real estate-related sector accounted for 27.3 percent of total corporate loans (Cho, 2011).

10 Since mid-2008, the Korean government has put a series of price controls on public services, selected basic foodstuffs and consumer products (Bloomberg, 2008). In January 2011, declaring a war on inflation, it announced additional price control measures by freezing power and gas charges and pressing companies to cut gasoline prices, mobile phone charges and college tuition fees (Bloomberg, 2011).
POLICY SHIFT TOWARDS CAPITAL CONTROL

A faster-than-expected rebound of the Korean economy in 2009 led to a sudden reversal in capital flows, and the won began to appreciate rapidly. The government feared that the rising won would hurt Korea’s exports and a sudden shift in global market sentiment would trigger a reversal in capital flows, leading to disastrous results like those of late 2008 and early 2009. Indeed, FX hedging started rising again along with the won. Accordingly, the Korean sovereign bond market saw a surge in foreign capital inflows lured by increased opportunities for arbitrage trading. Perplexed by extreme volatility in the FX market, the government scrapped its original plan to fully liberalise the capital market by 2009. In January 2010, it introduced a series of measures to control destabilising capital inflows. In response to warnings of exporters’ over-hedging, which exacerbated upward pressure on the won, a cap was introduced on FX forward trading by domestic exporters at 125 percent of underlying transactions. As for domestic banks, the long-term foreign currency borrowing ratio to foreign currency loans with maturity over one year was raised from over 80 to over 90 percent. Domestic banks were also required to hold a certain level of safe foreign assets, such as foreign treasury bonds rated “A” or higher (2 percent of total foreign assets) as a buffer against foreign liquidity shocks. Furthermore, the central bank continued to intervene in the FX market to stem the won rise. However, such efforts did not work amid excessive capital influx, which amounted to US$81.6 billion from January 2009 to April 2010, equivalent to about 10 percent of Korea’s GDP of US$820 billion in 2009.

In June 2010, the Korean government tightened the regulatory rules introduced in January 2010 and implemented additional measures targeting foreign banks. Foreign currency liquidity rules for domestic banks were tightened. The ratio of long-term foreign borrowing to long-term foreign lending was raised further to over 100 percent. The cap on FX forward trading by domestic exporters was tightened to 100 percent of their export revenues. More importantly, the government moved to impose capital controls, which marked a fundamental shift in the regulation of FX risks. New measures on capital controls had three components. First, foreign-currency loans of both domestic and foreign banks were limited to overseas use only. Second, foreign bank branches were recommended to establish liquidity risk management mechanisms, although these were not obligatory. Third, a cap on the build-up of FX derivatives was set, as this was considered the main cause of the won fluctuation and to be hampering monetary policy. The FX forward trading position by domestic banks was limited to
50 percent of their equity capital. Foreign bank branches were required to lower their FX forward positions to 250 percent of their equity capital.\(^{11}\)

### CHANGE IN REGULATIONS ON CAPITAL INFLOWS

Prudential regulations on FX risks introduced in 1999 stipulated that both domestic banks and foreign bank branches meet ceilings on overall FX positions, but these referred to only a net amount of forward and spot positions. Parallel with FX market liberalisation, the ceilings on the overall overbought and oversold position of FX were loosened from 20 percent of banks’ equity capital in 1999 to 30 percent in 2006 and 50 percent in 2007. Such ceilings were to be abolished by 2009. Amid the global financial crisis, the Korean government tightened the ceilings on overall FX positions to 20 percent in 2008 and raised them again to 50 percent in 2009 to relieve the dollar shortage. Yet the government saw that the regulations on overall FX positions had no effect in terms of discouraging volatile capital flows, as banks could expand both spot and forward positions without any changes in their overall FX position.

#### Table 4: Foreign exchange positions of domestic and foreign banks in Korea

<table>
<thead>
<tr>
<th></th>
<th>FX position (US$100 millions)</th>
<th>Equity capital (D)</th>
<th>FX positions as of equity capital (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Spot (A)</td>
<td>Forward (B)</td>
<td>Overall (C=A+B)</td>
</tr>
<tr>
<td>Domestic banks</td>
<td>-123.5</td>
<td>157.6</td>
<td>34.1</td>
</tr>
<tr>
<td>Foreign bank branches</td>
<td>-446.5</td>
<td>461.2</td>
<td>14.7</td>
</tr>
</tbody>
</table>

Note: FX positions as of end-April 2010, equity capital as of end-March 2010.

Source: Financial Supervisory Commission (FSC) data.

The Korean government was compelled to impose a separate control on FX forward trading, which has in recent years served as a major channel for excessive short-term capital inflows to the country. These new rules are implemented with a three-month grace period to avoid jolting the banking

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\(^{11}\) Korea’s financial authorities use local branch capital rather than parent banks’ capital as a benchmark for foreign bank branches’ operations in the country. Given regulatory norms based on separated branch level, the capital of each local branch, not that of head office, is regarded as the bank’s capital. After the 1997 crisis, the government eased some restrictions on foreign banks’ capital base. Foreign bank branches’ net borrowing from the parent bank is classified as bank capital.
system; in exceptional cases, existing positions can be held for up to two years. These rules will affect only some foreign banks, including SC First and Citibank. Foreign bank branches’ FX forward positions, which averaged over 300 percent of their capital (see Table 4), varied widely. For example, the FX forward position of BNP Paribas was 900 percent, whereas that of Deutsch Bank was only 236.2 percent. In the cases of Citi and SC First, which are considered domestic banks because of their legal status, their FX forward positions were 69.3 percent and 58.5 percent, respectively.

POLICY DILEMMA

Both the Korean financial authorities and mainstream economists who have advocated rigorously for full-fledged financial liberalisation in the past decade seem to have lost their faith in its benefits and the self-regulating efficiency of markets. The sudden implosion of US financial markets, which Korea had been emulating since the 1997 crisis, was a great shock to policymakers and proponents of neoliberal reforms in Korea. Nevertheless, the Korean government reiterated that it would go ahead with financial liberalisation to develop its financial markets. Even after imposing controls on capital flows, it tried to play down the implications of its policy move, arguing that the new regulatory measures were only an inevitable “surgical response” to enhance the overall soundness of the financial market, not an attempt to regulate or control it. This illustrates the regulatory dilemmas facing the country.

INCONSISTENCY IN FINANCIAL POLICIES

The Korean FX market has grown by 24 percent over the past three years, faster than the global FX market growth rate of 20 percent. With US$43.8 billion being traded on an average day, the market has become larger than that of Russia, Italy, India and China and is much larger than the stock and bond market. KOSPI, Korea’s main stock market index, has a daily turnover of about one-tenth of the FX trading volume. Theoretically, the daily FX trading volume of US$54.1 billion during the second quarter of 2010 can soak up Korea’s current FX reserve of US$289.7 billion in less than six days. Nevertheless, the government and advocates of financial liberalisation argue that the FX market in Korea is relatively small—accounting for only 5.4 percent of GDP as of 2007; Japan’s accounts for 10.6 percent, the US’s 11.5 percent and Singapore’s 256.8 percent. This position, represented by MOSF as well as the domestic financial industry, has dominated financial policymaking in the past decade and remains mainstream today.
Pointing out the low level of foreign investment in the Korean bond market, MOSF proceeded in 2007 with tax incentives for foreign investors. Until 2006, a 25 percent withholding tax had been charged on foreigners’ income and capital gains from sovereign bond transactions. In 2007, this was reduced to 14 percent, the same level of tax charged to domestic bond investors. In June 2009, a 14 percent withholding tax on foreign bond investors was abolished. It is not surprising that foreign investment in the Korean sovereign bond market has since surged (see Figure 4).

Tax exemptions for foreign bond investors stand at odds with ongoing desperate attempts to reduce destabilising capital inflows. While growth in net FDI and foreign equity investment has slowed considerably, net foreign bond investment has continued to rise, unaffected by the new regulatory measures taking effect in October 2010. Net foreign bond investment amounted to W63.1 trillion in 2010 (US$54.4 billion at the 2010 average exchange rate of W1,159 to US$1) compared with the previous year’s W53.5 trillion (US$46.1 billion). The won is destined to keep rising in the near future, as a further easing of monetary policy in developed countries is imminent. This will fuel more foreign capital inflows to Korea, posing a dilemma for officials, who have been willing neither to take a more aggressive approach to capital controls nor to allow the won to appreciate.

Figure 4: Foreigners’ net investment in securities market in Korea, 2000–10 (W billions)
CONSERTATIVE CRITICS OF FINANCIAL MARKET VOLATILITY

Until the recent global financial crisis, Korea’s banking sector development, with its huge profits and sound performance, was seen as a success story. Skyrocketing share prices of banks in which foreign investors had been the major driving force seemed to be evidence of this. The traumatic memory of the 1997 system failure had faded away with time. Not until the crisis of 2008 were underlying vulnerabilities revealed. Interestingly, criticism of the banking sector’s reckless practices came from expert groups as well as private and public research institutes that had long advocated financial deregulation and openness. These successfully pressured the financial authorities to reregulate the banking sector, particularly foreign banks. Alarmed by the strong upward trend of the Korean currency,12 the government stepped up capital controls in late 2010 by restoring a tax on foreign bond purchases and imposing a levy on non-deposit foreign currency debt held by domestic and foreign bank branches. Furthermore, the ceiling on the FX forward position was lowered from 250 percent to 200 percent of capital for foreign bank branches and from 50 percent to 40 percent for domestic banks (BOK, 2011).

The current conservative government is seemingly prepared to put an end, at least temporarily, to onerous experiments with unfettered finance since the 1997 crisis, opting instead for currency sovereignty. The government’s plan for financial reregulation is supported widely by the conservative ruling party and expert groups; progressive circles remain silent. It is ironic that the very financial authorities that stood at the forefront of unfettered finance in the past decade are now determined to go against free capital flows. The Korean government’s move towards financial reregulation is basically conditioned by the recent crisis situation, but also reflects disillusionment with past attempts to imitate US-style free financial markets.

CONCLUSION

In the past decade, Korea’s financial markets have seen rapid expansion in line with the financial liberalisation rigorously pursued by the government. The outcomes of the radical approach to financial liberalisation after the 1997 crisis were household debt-driven asset bubbles and heightened FX market volatility, which became major threats to the overall economy, with the banking sector suffering repeatedly from ill-fated overstretches in household debt and housing markets. Contrary to expectations, FX market volatility...
liberalisation made the domestic banking sector more vulnerable to global financial vagaries, as evidenced in the currency and liquidity crisis in late 2008. Furthermore, economic policies have increasingly been held captive to the dynamics of financial expansion, presenting the government with the daunting task of managing the “impossible trinity” of free capital flows, FX stability and independent monetary policy.

The government’s ambition to make Korea a financial hub in northeast Asia pushed financial expansion far beyond the ability of the country’s economy to deal with the risks and dangers inherent in financial development. The financial hub project runs increasingly counter to the overriding objective of Korea’s economic policies to maintain export competitiveness. Amid the escalating “currency war”, in which Korea has been one of the most active participants, the government is now compelled to choose one of both strategies and is more likely to opt for export competitiveness and currency stability alongside tighter capital controls. This is because there is no room for reviving domestic demand, given the prolonged crisis in the housing market. Such measures violate agreements such as the World Trade Organization (WTO) General Agreement on Trade in Services (GATS) and Free Trade Agreements (FTAs) with the US and the EU, as already signed by the Korean government.13

However, capital controls, although conflicting with GATS and FTA rules, have regained their legitimacy, reflecting a general global trend of financial reregulation in response to the recent global financial crisis. The Korean government’s determined action for capital controls was encouraged by the G20 Seoul Summit agreement in November 2010, which gave emerging markets the green light to use capital controls to deal with currency volatility. In addition, both the IMF and the Bank for International Settlements (BIS) have acknowledged the need for emerging market economies to curb destabilising capital flows by endorsing capital controls as a last line of defence against volatile and excessive financial flows in extraordinary circumstances (BIS, 2011; IMF, 2011a; 2011b).

Korea’s relentless efforts in the past decade to emulate a US-style financial system following neoliberal orthodoxy failed to achieve the desired results. Instead, it brought about a different kind of crisis-prone financial system exposed to a combination of market and regulatory failure. The case of

13 The GATS as well as FTAs with the EU and US do not allow countries to roll back their commitments to financial liberalisation. For more details on Korea’s obligations under the GATS, see Cho (2011). Korea’s FTAs with the US and EU contain provisions that prohibit the contracting parties from introducing any new restrictions on the movement of capital and making the existing arrangements more restrictive.
Korea shows that the more progress is made on financial liberalisation, the more government intervention is required to alleviate market deficiencies and correct market failure in crisis situations. However, government capacity and resources for coping with the negative effects of free finance have limitations. Sound macroeconomic fundamentals and huge FX reserves provide little protection against volatile capital movements. The vulnerability of emerging market economies with open capital accounts is not to be overcome at individual state level, but rather requires a global solution. Coordinated capital controls at the global level are needed to tame destructive volatile capital flows. In parallel, after having suffered unmanageable financial liberalisation in the past decade, Korea needs to turn away from the obsession with financial expansion and refocus its financial policy on strengthening the banking sector’s basic role of stable financial intermediation and promoting financial inclusion of marginalised groups and SMEs.

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