Systemic Instability or Global Growing Pains?
Implications of the Asian Financial Crisis

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Small, open economies are like rowboats on a wild and open sea. Although we may not be able to predict when the boat will be capsized, the chances of eventually being broadsided by a large wave are significant no matter how well the boat is steered.

Joseph Stiglitz, Chief Economist, The World Bank

Introduction and Summary

The financial crisis that erupted in Thailand in mid-1997 has spread to Korea and Indonesia, other parts of East and Southeast Asia, and even to Brazil and the Czech Republic. This is the third such crisis this decade: the previous two were centred in Europe in 1992 and in Mexico in 1994-95. Much of the 1980s, known in Latin America as "the lost decade," was consumed sorting out the enormous developing-country debt problem.

In each crisis, no part of the globe has been immune. During the Mexican peso crisis in 1995, for example, Canadian and US dollars came under speculative attack. In Canada, just the threat of a crisis likely prompted the federal government to accelerate plans to eliminate fiscal deficits and reduce accumulated debts. Similar pressures throughout the industrialized countries have led to the decimation of social welfare, education, and health programs. Even Hong Kong, a bastion of conservative economic policies, was under a state of financial siege as the Asian crisis spread in late 1997. Although there have been serious setbacks to social welfare in the industrialized countries, in the poorer developing countries such crises have left a trail of much greater human misery through higher unemployment, greatly reduced incomes, or even deeper poverty.

Governments throughout the world have typically been unable or unwilling to cope with these human consequences. As with Canada in 1995 and the Asian governments in 1997-98, they have concentrated primarily on restoring the confidence of the financial markets. Their hope has been that "sound economic policies" will protect them from future crisis and help address their social and human problems. At the same time, however, such "sound" policies intensify the depressing effect on employment and income in the crisis countries. Moreover, with devalued currencies, their capacity to import falls and their ability to export competitively undercuts producers elsewhere. The crisis countries could, therefore, spread depression to the rest of the world.

The hope that financial crisis could be avoided through "sound economic policies" alone has been gravely undermined by the Asian crisis. On the contrary, sound policies and good performance, along with premature capital-account liberalization, may actually have helped precipitate the crisis. Thus, countries recently hailed as "the Asian tigers," paradoxically, have first attracted and then been destabilized by a surfeit of footloose capital. External capital was in excess supply when the Asian...
countries (with already high domestic savings rates) did not need it. But, when the crisis broke and it was acutely needed, it suddenly took flight and became deficient.

What is even more disturbing is that there is growing disagreement about both the underlying causes of such crises and the appropriate policy response. Many critics argue that current policies, whether to prevent or remedy crises when they do break out, are heading in exactly the wrong direction. The International Monetary Fund (IMF) is at the centre of the debate on how to prevent or to resolve financial crisis, and it has come under considerable attack from both the left and the right for its diagnosis and its policy prescriptions. But it would be wrong to heap blame solely upon the IMF, which enforces rules devised primarily by rich country members of the Organisation for Economic Co-operation and Development (OECD). These rules govern the nature, scope, and pace of economic globalization.

This *Briefing* explores the reasons underlying the recurrence of ever more serious and pervasive financial crisis. It assesses the most recent episode of crisis in Asia, and critically examines the policy responses to date. It also advances possible policy alternatives to prevent crises and reduce their damaging impact on people.

**Some Key Conclusions**

- Financial crises are not solely caused by the actions of a small number of rogue speculators, although these can help trigger crisis;
- Crises result from the workings of the current international financial system and particularly from large movements of short-term capital;
- International investors are prone to several weaknesses and often behave irrationally, making international capital market failure-and financial crisis-more likely;
- Weak or misguided economic policies (for example, inflation-causing deficits or poor domestic supervision or governance) play a role, but rectifying or avoiding these problems is not sufficient to prevent crisis;
- Policies promoting financial-sector deregulation and liberalization (i.e., the globalization of deregulated financial markets) increase the risks of financial crisis;
- Under current policies, the costs of financial crises are borne by taxpayers and ordinary people, whereas the benefits of financial deregulation and liberalization accrue to banks and those with large financial assets;
- The globalization of financial markets starkly illustrates the phenomenon of "global economic integration causing local social disintegration." The Asian crisis, in particular, demonstrates that private financial markets can fail massively, with negative, world-wide repercussions.

**Some policy implications for preventing crises**

*For the international rules of the game*

- Measures to promote universal financial liberalization and integration, as with proposals to move to capital-account convertibility in the IMF, to liberalize trade in financial services in the World Trade Organization (WTO),
and to establish a multilateral agreement on investment in the OECD are certainly premature, if not misguided;

- Internationally, there is as yet little prospect for the so-called Tobin Tax (see Box 7), but there is scope for much greater supervision, regulation, and monitoring of the international investment activities of banks and financial firms housed in the leading industrial countries. However, none of the existing international financial institutions is well-equipped to play this role.

For developing-country policies

- Policies that encourage long-term capital (as with most foreign direct investment) and discourage short-term capital movement across borders are more conducive to economic growth, development, and stability;
- Domestically, preventive measures include a cautious approach to external capital-account liberalization and instruments such as the Chilean policy of reserve requirements (in effect, a tax) on short-term inflows;
- Institutionally, there is a need to strengthen domestic financial systems, prudential supervision, and monitoring of external debt (especially short-term debt).

For developed-country policies

- Mergers and acquisitions within the banking sector, and between banks and non-bank financial institutions (e.g., insurance and investment brokerage), should be viewed critically and constrained to limit the scope for greater speculative activity and reduce problems of moral hazard of potential claims of "too big to fail;"
- Financial-sector supervisors should more closely monitor the financial exposure of their banks and fund managers in developing countries. They should also offer more assistance to and cooperation with their developing-country counterparts, as they do already to combat money-laundering.

Policy responses when financial crises do erupt

- More of the costs of adjustment need to be shifted from domestic debtors and borrowers to international creditors and lenders;
- Considerably more care is needed to contain the social impact of the crisis so that costs are not borne by the poor and vulnerable.

The role of the international financial institutions:

- IMF support should be more unconditional. Crises should not excuse the intrusive advocacy of orthodox agendas upon sovereign governments. The IMF's first priority should be to achieve creditor rollover and restructuring.
- There must be better coordination between the IMF and the World Bank and other multilateral and bilateral agencies to enhance longer-term development prospects.
- International financial institutions (IFIs) should avoid the potential moral hazard of private lenders by rewriting loan agreements for clients to ensure that, in crisis circumstances, there would be constraints to using the proceeds
to service private obligations (in effect, forcing part of the costs of adjustment onto external, private creditors).

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2From the Keynote address to the Asia Development Forum, Manila, March 12, 1998.