FINANCIAL LIBERALIZATION AND THE ECONOMIC CRISIS IN ASIA

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After the Asian economic crisis of 1997-98 a vast literature on the analysis of various aspects of its causes and impact has emerged. This book is a welcome addition in two respects. First, the volume focuses on what several economists have contended is the crux of the underlying explanation, namely, the operation in double harness, of inadequate domestic financial systems and volatile international capital flows. Second, in addition to countries at the forefront when the crisis meandered through the region, namely (in alphabetical order), Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand, the process of financial liberalization of three Asian countries with the largest GDPs of the region (again, in alphabetical order, China, India and Japan) is also investigated. The latter group of economies were generally unaffected by the crisis.

An introduction by the editor reviews briefly the debate on the process of financial liberalization in the afflicted Asian economies, especially alternate views on why promised results were not delivered, as prior to the crisis these very economies were often glorified in superlatives for their high economic growth rates. One plausible set of explanations is in terms of a misunderstanding of how to establish a viable market-based financial system, and in these countries financial liberalization was interpreted as 'a simple mirror image' of financial repression, that is, deregulation of interest rates, privatization and promotion of competition in the financial sector, elimination of directed credit, and removal of foreign exchange controls. Another line of thought contemplates that factors such as the operation of various pressure groups, that is, 'crony capitalism' (practice of relying or political or personal relationships to advance and protect business interests), together with inadequate accounting standards and lax enforcement of regulations, prevented correct implementation and eventual failure of what were generally sound financial sector reforms. It is contended that for success, financial reforms must encompass, both the removal of Government intervention in the financial markets and the deliberate establishment of institutional preconditions (centring on the legal, supervisory, and regulatory systems) for the efficient functioning of a market-based system.

The book contains eight country chapters, each written by an expert in the subject. With some variation among countries, financial liberalization permitted local

citizens and foreign residents to open accounts with commercial banks either in national or local currencies; banks to extend credit in foreign currencies in the domestic markets; non-bank private sector corporations, as well as financial institutions, to borrow abroad; foreigners to own shares listed by national companies in the domestic stock exchanges; the sale of securities on international stock and bond markets by national companies; the sale of domestic monetary instruments, such as central bank bills and treasury bills to non-residents; greater freedom of entry into the domestic banking system of foreigners; and establishment of offshore banks, which were allowed in some cases, to borrow and lend domestically.

The chapter 'Premature liberalization and economic crisis in Thailand' by Bhanupong Nidhiprabha identifies a juxtaposition of several factors as leading to the financial crisis in that country. Chief among these were currency and maturity mismatches, as also large short-term foreign currency short-term debt. Relaxation of capital controls, a pegged exchange rate and domestic interest rates that were high in comparison to global levels induced large capital inflows, but these were not sterilized due to the lack of the necessary apparatus. As a result, much of the money raised abroad was channeled to borrowers in Thailand and was invested mostly in the non-traded goods sector. The consequent widening of the current account deficit imposed a pressure on the baht, which led to its devaluation in mid-1996 and is widely assigned as the starting point in the Asian financial crisis.

In 'Financial sector reform and Indonesia's economic crisis of 1997-98' Anwar Nasution traces the foundation of the crisis to banking sector reform in late 1988 in Indonesia which even permitted foreign banks to establish joint ventures with domestic banks, and removed ceilings on foreign commercial borrowings by banks. It was expected that a larger presence of foreign financial institutions would bring in more external savings along with advanced technologies. What happened instead was that increased competition veered financial institutions to take on projects, without adequately evaluating new sources of credit and market risks. The liberal entry policy for capital rapidly raised the country's external debt, of which almost one-half had become private sector short-term debt by mid-1997. The country had thus become highly vulnerable to a currency crisis, and that is exactly what happened when foreign lenders refused to roll over its huge short-term debt.

'The political economy of financial liberalization and the crisis in South Korea' by Yoon Je Cho asserts that from 1992 the foreign investment regime was relaxed, and capital account liberalization accelerated after 1995 with a focus on the deregulation of outflows. The aim of abolishing financial controls was to internationalize the economy, and by 1997, financial reform in the Republic of Korea removed completely direct intervention in credit allocation and Government management of commercial banks. These measures led to high indebtedness of corporate firms in the country, particularly of some of the large business houses [*chaebols*] which wielded a controlling influence on various sectors of the economy.

In essence, the crisis in the Republic of Korea is interpreted as being due mainly to inadequate corporate governance and the lack of a sound banking or credit culture.

In 'From financial liberalization to crisis in Malaysia' Kok-Fay Chien and K S Jomo note that in the early 1990s, to attract foreign capital and promote Malaysia as an international financial centre, a financial market liberalization programme was launched under which foreign institutional investors were allowed to buy shares in Malaysian corporations up to 30 per cent. Large portfolio investments flowed into the country, and the stock market experienced a boom. When the bull run reversed in early 1997, the portfolio investors scrambled to get out of the Malaysian stock market and, as by then the currency had become overvalued in relation to the United States dollar, the crisis came to Malaysia. However, part of the explanation for the equity crash was also because much of the funds raised in the equity market did not go to new productive investments, but instead into the acquisition of existing public sector assets being privatized.

'Financial liberalization and economic reform: the Philippine experience' by Maria Socorro Gochoco-Bautista explains that by early 1990s restrictions on current account transactions were virtually dismantled, and limitations on inward and outward capital flows were sharply reduced. Since 1994, entry of foreigners into the banking sector had been greatly eased, and they could purchase equity in an existing bank or establish new joint-venture banks with residents. However, the commercial banks were still mainly owned or controlled by large family-owned corporations. Financial liberalization thus strengthened the stranglehold of the corporations that the elite controlled, with access to bank financing for both short-term loans and longer-term investments. There followed periodic balance of payments crises that eroded the value of the peso relative to the United States dollar, but the Philippines was less affected than its neighbours by the Asian financial crisis, as its economy was relatively less dynamic due to other structural weaknesses.

In 'Japan, the Asian crisis, and financial liberalization', Thomas F Cargill argues that stresses in the Japanese financial system were unrelated to the Asian financial crisis and resulted mainly from the failure of its regulatory authorities to resolve the problem of non-performing loans. Although Japan commenced financial liberalization in the mid-1970s the reforms remained incomplete, and pre-liberalization elements such as non-transparent regulation, the 'convoy system' for dealing with troubled financial institutions and Government deposit guarantees persisted. These limitations were compounded by close links between politicians, financial institutions and regulatory authorities, which led to a poor financial disclosure system and the subsequent bankruptcy of several financial institutions in rapid succession in 1998.

'The case of China' authored by Nicholas R. Larry mentions that China was insulated from the Asian financial crisis as it did not have free capital account convertibility, and was assisted by modest external debt and a strong balance-of-payments position for several years prior to the crisis. China also depended

primarily on foreign direct investment, rather than the potentially more volatile sources of foreign capital such as debt and bonds. The financial reform process in China, however, has a long way to go as the central bank controls both deposit and lending interest rates, and credit allocation is by the Government. Accordingly, banks and other financial institutions are in a very weak position as most of their loans are to state-owned enterprises at extremely low interest rates. Of serious concern to the viability of financial institutions in China, is that a large part of borrowings by state-owned enterprises was utilized for paying wages and financing inventory of unsold stock.

The case of India, which too was saved from the contagion effect of the Asian financial crisis, is discussed in 'Financial liberalization in India: issues and prospects' by Rajendra Vaidya. In spite of post-1991 reforms that deregulated interest rates and freed price restrictions on new stock market issues, financial liberalization in India is still incomplete as there are restrictions on banks' use of credit and several major commercial banks are controlled by the Government. As a result of Government directed credit in the pre-1991 years, the public sector banks have significant non-performing loans. To add to the incomplete process, financial liberalization has been hampered by the Government's dependence on banks for low interest borrowings to finance the fiscal deficit, and labour unions that dislike privatization of banks. The author highlights non-performing bank loans as the most serious threat to the financial system of India, and asserts that the operational and regulatory aspects of both the foreign exchange and capital markets have to be strengthened if the benefits of a liberalized capital account are to be availed.

The message of the book is that although premature liberalization increases a country's vulnerability to currency crisis, postponing financial liberalization is not a desirable policy to pursue, especially in the era of globalization. Instead, taking a lesson learnt from the Asian financial crisis, the book rightly supports that strengthening the domestic financial system by building necessary national institutions, in a proper sequence, is essential for a developing country to benefit from participating in global capital markets. However, it is also clear that a more robust domestic financial system may not be enough to reduce the likelihood of a future crisis, because participating in global capital markets creates greater exposure to financial instability originating abroad. Hence, the view emerges that developing countries may consider a gradual approach to capital account liberalization, in which the state establishes appropriate procedural and legal infrastructure for prudential regulation and supervision over the financial institutions. As mentioned in the book, but not elaborated, the development of local expertise in tasks such as credit analysis, risk management, foreign exchange and securities trading, and international banking is also an important prerequisite for the success of financial liberalization.

Overall, the book is mostly written in non-technical language and in a style that makes for easy understanding. Each chapter is fairly well referenced. It should

therefore be a valuable addition to the literature on the subject for graduate students, policy makers, and even the more dedicated researcher. But the price is too high to make it affordable as a text book for a university course on development policy, or even as a volume to adorn the private collection of an interested individual. A last point is that the reviewer hopes that the inadequate binding of the book, in spite of its high price, is peculiar only to the copy that he had perused.

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* The views expressed in this review are these of the reviewer and do not necessarily reflect those of the International Labour Organization.