Financial Globalisation, Financial Crisis and State Autonomy - the Asian Experience

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Introduction

Globalisation can affect the political economy of development in Third World countries in a variety of ways. In this article, I will focus on financial globalisation and state autonomy. The impact of financial globalisation on the room of manoeuvre of the state is highly complex. One aspect is the way international capital mobility -- in particular conjunctures and of particular types - constrain and discipline autonomous action of nation states in developing countries. Another aspect is the role of interventions by global actors, such as the IMF through its bailout packages with built-in conditionalities.

I will address these issues by looking at globalisation of finance or financial capital mobility with particular reference to the Far East and the present financial crisis there. After having presented some general points related to the broader process of economic globalisation in the first section, I deal more specifically with the content and dynamics of financial globalisation in the next. In the third section, the working of these dynamics is analysed in detail in the Thai case. Then follows a section on the role of IMF during the Asian financial crisis. The final section broadens the discussion out to by looking at the general relation between financial openness and capital mobility on the one hand and policy choices in developing countries on the other hand.

Economic Globalisation as a Plurality of Processes

During the last decade, we have observed an increasing intensification of economic flows and activities across societies so that economic events, decisions and activities in one part of the world have significant influence upon actors in another distant parts of the world.

The process of economic globalisation, however, refers to a number of different things. First, it refers to the intensification of international economic relations (especially globalisation of financial markets, globalisation of technology development and diffusion, globalisation of business activities and production chains and global patterns of consumption)[61]. Secondly, it refers to the horizons and practices of actors, who more and more scan the world for markets, labour, finance and partners as part of their daily work. Thirdly, it refers to simultaneity, the increasing extent to which similar goods and services are available in many places around the world at the same time. Fourth, globalisation also refers to the way in which decisions of international organisations such as WTO and Bretton Woods institutions constrain and discipline political and economic actors in the world, and in particularly in The Third World - globalisation of economic governance and regulation. (Junne 1996, Kanter and Pittinsky 1995-96, Scholte 1997).

The debate on economic globalisation centres around two crucial issues. First, the extent to which local and national economies are subsumed and re-articulated into a new set of essentially global processes and transactions (the end of geography). Second, the extent to which processes of globalisation erodes the capacity of the nation states as 'sovereign' economic regulators (the end of the nation state). Concerning the latter, it is often argued that the state's domestic power is "hollowed out" partly because of the intensified cross-border exchanges, partly due to the rise of a "globalised society", in which states co-exist with stronger sub-national and super-national actors (Holm & Sørensen 1994, Strange 1994).

In recent years liberal (and neo-marxist) scholars have pointed at the steady disintegration of national economies and the demise of the state's domestic power. According to this "hyper-globalisation" school we have moved from a prior process of internationalisation i.e. the geographic spread

[61] As suggested by Jan Aart Scholte, it might useful in relation to these relations to distinguish between: increase in cross-border relations (internationalisation), rise of open-border relations (liberalisation) and increase in trans-border relations (globalisation) (Scholte 1997)

of economic activities across national boundaries, towards a global capitalism with a substantial functional integration among these internationally dispersed activities (Ohmae 1991, Ohmae 1995, Gereffi 1995 and Gereffi 1996).

I am generally fairly critical towards this new "globalist orthodoxy" because it misses key aspects of the intensified internationalisation by considering it as a irreversible process and by looking at globalisation as having a single logic of development rather than competing logics of development which combine integration and disintegration as well as equalisation and unevenness (Jessop 1998).

There seems to be general agreements that cross-border internationalisation and trans-border globalisation have advanced most within the financial sphere. Therefore, it is particularly useful to look at globalisation processes in this field and analyse how they have impacted upon the room of manoeuvre of the state.

Globalisation of Financial Capital

Since the outbreak of the Asian financial crises in 1997 there has been much focus of on capital mobility. It has since long been documented that world trade has expanded more rapidly than global income growth and that financial transactions have expanded even more. It has become usual to talk about globalisation of finance. Global capital markets are in operation 24 hours a day and financial service providers operate on a continuous basis.

> "The "globalisation of finance" is the latest jargon used to connote a number of interrelated developments in the contemporary world economy. Among the most important changes are the reduction of direct controls and taxes on capital movements, the liberalisation of long-standing regulatory restrictions within national financial markets, the expansion of lightly regulated off-shore financial markets and the introduction of new technologies in the process of financial intermediation. These developments render capital more mobile, both within and across national borders." (Pauly 1995, 369)

The total size of the international capital market is estimated to around US$ 6 trillion in outstanding loans and the introduction of new financial technologies – derivatives, future and option contracts etc. – makes it possible to re-engineer long-term assets – reducing their immobility and minimising

exposure to market risks. Moreover, there is little doubt that international finance increasingly is in the process of becoming globalised, in the sense that interest rates (adjusted for exchange rate variations) are now determined globally and in the sense that even national financial markets are affected by global developments (Perraton et al 1997)

When considering the causes behind financial globalisation, it is important to underline both political and economic factors. Financial globalisation is on the one hand a market-driven phenomenon and on the other hand an intended result of political decisions – a strategy.

Financial Globalisation as Strategy

The present working of the global capital markets is closely linked to the break up of the Bretton Woods system in the 1970s. The designers of the Bretton Woods compromise were convinced that "global finance" and "hot money" had destabilized the post-WWI gold exchange system. Consequently, they agreed on a system with convertible and stable exchange rates to ensure free multilateral trade and long-term foreign investments, and with capital control to ensure countries against currency speculation. Moreover, that consensus implied that defence of stable exchange rate should not take precedence over full employment and social welfare.

The so-called Article 6 of the Bretton Woods agreement allowed members to control capital movements, provided such controls were not intended to restrict trade.

It is important to notice that during the heyday of the Bretton Woods system, participants were willing to tolerate on capital mobility in order to achieve the two objectives exchange rate stability and autonomy in their macroeconomic policy-making. Furthermore, most industrial countries in fact adopted such controls on short-term capital movements during the 1960s and early 1970s.

Since the 1970s, the Bretton Woods agreement has disrupted. The pegged dollar based exchange rate system was replaced by a floating dollar exchange system, that is by a "getting prices right" mechanism that should ensure a balance between demand and supply of foreign exchange.

In the mid-1970s, first United States and later Britain started a process of capital market liberalisation. In 1979, Britain opened for "offshore" trading of British financial institutions and in 1981 United States allowed US. Banks to set up a regulation-free international banking facilities "on-shore". Then followed Germany, Japan and the smaller OECD countries. During this period capital mobility was privileged, and increasingly the

main policy focus has been on ensuring the freedom of financial capital to move globally.

However, as the volatile interest rates were not converging and as exchange rate volatility almost became the norm, the floating exchange rate system lost its credibility and there was a growing consensus on the need to dampen that volatility and concerted market intervention became more important. The 1985 "Plaza Agreement" aiming at more stable yen/dollar and mark/dollar rates initiated this process of concerted market intervention, but with modest success.

In spite of a range of financial disasters in developed as well as developing countries during the 1980s and 1990s, the new norm of cross-national capital mobility became even stronger and spread to a range of developing countries. Third World countries – among then the so-called "Group of Five" (South Korea, Thailand, Malaysia, Indonesia and the Philippines) in Asia - lifted their capital account control during the first half of the 1990s and were advised by the IMF to stabilise their foreign exchange rate in order to reduce foreign exchange risks of portfolio investors.

By the late 1990s, we then ended up with a new and strong norm of cross-national capital mobility and with increased emphasis on international co-operation on financial market supervision. While the Bretton Woods norm saw containment of international capital mobility as a necessary condition for stable exchange rates and relatively free trade, the new norm advocates a combination of free trade, stable exchange rates and free international capital mobility. The systemic risks, then, are left to the states to supervise. The IMF organised bail out system becomes the prevalent mechanism of crisis management while the capital control instrument is considered as old-fashioned and non-acceptable.

During the last five years, the IMF has pushed for a replacement of article 6 by new rules requiring member countries to make their currencies freely convertible for all capital account transactions, too. During the September 1997 Annual meeting in Hong Kong, IMF were given mandate to start the process of obtaining additional "jurisdiction" over the capital account as well as the current account of its member states (Jomo 1998,19).

The Economics of Globalisation of Financial Capital

The rapid diffusion of the new norm of cross-national capital mobility has given space to globalising forces in the economic sphere.

One important aspect is *surplus-capital in the OECD countries* searching for new investment fields in "emerging markets". In the 1980s, it took the form of syndicated bank loans to Latin America – in particular rolling over of short-term loans with a flexible interest-rate and with low risk for lenders because of the structure of the loans and because "sovereign states could not go bankruptcy". In 1982, a combination of high US interest rates and a related strong appreciation of the US $ and falling commodity prices started the Latin American debts crisis. More recently, surplus capital from the core countries rushed into (and later out of) a group of Asian countries leading to the present economic and social collapse of these and other economies – Russia, Venezuela and Brazil.

A second important economic change is the growth of *secondary capital markets and new financial instruments*. The secondary market deals with trading in existing financial instruments. In this market a 30-year US government bond (a long term investment) can be re-engineered into more than 60 coupon bonds with a maturity from six month to 30 years. Consequently a purchase of a long-term bond need not indicate a long-term investment (Kregel 1996,57). Generally, there exists today an "exit option" not just for bonds and equity portfolio but also for bank credits. Capital export to developing countries increasingly takes the form of short-term credits or highly mobile portfolio investments. It has been estimated that 60% of bank credit to Asia, 60% of the loans to Latin America and 100% of the lending to Eastern Europe in 1997 were of a short-term nature (Huffschmid 1998, 965) Consequently, it is hardly surprising that "instant exit" behaviour among investors has played such a big role during the last two decades.

Even what is statistically registered as FDI might not be as immobile. It is not unusual for direct investors to borrow locally in order to export capital, and re-invested earnings need not be invested in productive enterprises but can be invested by the foreign-owned subsidiary in highly liquid financial assets. So even here the opportunity for "instant exit" is higher than before (Kregel 1996).

A third and related feature, is rise of *new institutional patterns* in the international financial markets. The traditional players such as banks have been supplemented by institutional investors such a insurance companies,

pensions funds and mutual funds, and the banks have in turn met this challenge by concentrating more investment banking business.

A particular institutional invention is the famous hedge funds. Hedge funds are a particular group of financial institutions that concentrate on speculative investments in "expected changes" in interest rates and foreign exchange rates. They operate through a range of derivatives, are often off-shore based and therefore unregulated. They are only open to rich people, they charge a large fee, normally 20%, and promise making absolute returns rather than relative ones. The first hedge fund was established in 1949. It is estimated that hedge funds in 1992 managed about 30 billion US$ of investors money. Today, around 3000 hedge funds managing 200-250 billion US$ and it is further estimated that they by means of borrowing can run future contract having a total value of 4.000-8.000 billion US$.

George Soros' Quantum group and Julian Robertsons Tiger-group are the biggest and most well-known hedgefund, but John Meriwether's Long-Term Management Fund (LTCM) became well-known when it lost almost 2 billion $, partly because they believed that yields on Danish mortgage-backed securities would converge with those of American Treasuries. LTCM was rescued through the "cronyist" involvement (the former Vice-chairman of the Federal Reserve and a friend of Alain Greenspan, David Mullins, was sitting in the LCTM board). It was revealed that LTCM had a debt-equity ratio of 50:1. It had an equity capital of US$ 4.8 billion but had borrowed a total of 200 US$ bn. The money came from the Worlds largest banks (including the second largest – UBS) and from some central banks (including the Italian and Chinese Central Banks) (The Economist October 17th 1998, Financial Times October 3-4 1998).

A fourth and final important element is the still more autonomous *foreign exchange trading*. The daily turnover in the foreign exchange market is now US$ 1300 billion compared with US$ 190 billion in 1986. That trade is now over 50 times the level of world trade. Moreover, inter-dealer trade constitutes around three-fourth of forex trading leaving just one-quarter to dealer-final customer transactions. Forex trading therefore, is only to a limited extent servicing financial requirements of the "real" economy. The central banks that used to be the main actors of forex trading are today probably involved in less than one-tenth of the total global transactions (Felix 1996, 73ff).

Accelerating Number of Financial Crises in "Emerging Market Economies"

During the 1980s and 1990s, we have seen a range of financial crises which have required a co-ordinated international crisis management – a form of management that have usually followed a "too big to fail" rule aiming at saving large banks or subsections of the globalised financial system. The Mexican crisis in 1982; Chile, Uruguay and Argentina in the early 1980s, ERM (European Exchange Rate Mechanism) collapse in 1992, Mexico (tequilla crises), Turkey and Venezuela in 1994, Argentina in early 1995, and the group of five in Asia, Russia and Brazil in 1997-99 all belong to that category.

Moreover, there appears to be a still more tight interdependence between banking and asset inflation deflation crisis on the one hand and currency crises on the other hand. Kamisky and Reinhart examined 71 balance-of-payment crises and 25 banking crises and found that while during the period 1970-79 only 3 banking crises were associated with the 25 balance-of-payment crises, 22 banking crises coincided with 46 balance-of-payment crises during the 1980-95 period (here from Montes 1998,7). Other analysts emphasise that the link between on the one hand banking and asset deflation crises and on the other hand currency crises are much more significant for developing countries in comparison with developed countries (Akyüz 1998,36).

The accelerating number of financial-cum-currency crises in developing countries seem to follow in the wake of the spread of the new norm in the international financial sphere mentioned above. Many developing countries have introduced the "twin liberalisations" – the liberalisation of the domestic financial system and the opening of the capital account (Montes 1998).

One major problem is the intrinsic instability in international lending is excessive capital inflows followed by excessive capital outflows ("instant exit") later on.

In the Asian case, these short-term capital inflows led to a domestic liquidity expansion, which in turn spilled over into investments into short-termist and speculative assets. Rather than investing in more risky sectors such as agriculture and industry, international investors preferred loans with collateral (e.g.. property). Mass lending to these sectors led to increases in the value of the collateral which in turn led investors to believe in the value of these assets until the investment bubble finally burst. Moreover, due to financial liberalisation in these countries during the early 1990s, domestic credit expansion was difficult to prevent. If the government raised interest rates to cool the economy this served to attract further investments and

expand liquidity even more. Moreover, if it introduced a more flexible foreign exhange regime, the local currency would appreciate to the detriment of the chosen export model.

> "Successful economies offer high returns by way of yields as well as capital gains. If international investors can find ways to enter these economies, or if their entrance is facilitated by capital account liberalisation, they tend to rush in, generating a surge of capital inflows that effect key economic variables. Exchange rates become overvalued; the prices of key assets – like shares or real estate – rise quickly and sharply. There is an increase both in real income and in perceived wealth. Banks tend to relax lending standards, lifting liquidity on business, as they assume that current trends will continue. The balance of payment deteriorates, often quite rapidly, as both consumption and investment rise. Initially, this is not seen as a problem, as foreign lenders and investors are willing to continue lending or investing. Economic authorities delay the necessary adjustment, confident that their previous success will be continued, and crises happen elsewhere." (Griffith-Jones et al 1998,9)

The high level of and dramatic reversal of capital inflows were obvious in the Asian crisis countries. The combined net inflows to Indonesia, Korea, Malaysia, the Philippines and Thailand went up from US$ 41 billion in 1994 to US$ 93 billion in 1996. In 1997 the estimated net outflow was US$ 12 billion, so that these five countries experienced a turnaround of US$ 105 billion (from US$ 93 billion inflow to US$ 12 billion outflow), which represents around 11% of their combined GDP - somewhat higher than the 8% turnaround during the debts crisis in Latin America in the 1980s. On a disaggregated level, the figures shows that FDI remained stable, while the most shifts were found in commercial bank lending, followed by short-term portfolio flows (Radelet and Sachs 1998,3; Griffith-Jones et al 1998,7).

While other factors and problems were in play during the financial meltdown in Asia, it is extremely difficult to explain the scale, severity, timing and simultaneity of the crisis, if the sentiments and herd behaviour of the international financial markets are not taken into account. The Asian experience shows how a change in one country – Thailand – triggered a massive shift in confidence among international mobile investors. The lack of in-depth going information about their investments and cases of "cronyism" - both downplayed by investors during the period of "euphoria" - contributed to this quick and excessive shift in perceptions. Suddenly all Asia looks

fragile and risky, and a self-fulfilling and panicky process started. The World Bank presents the logic of this process and the interaction between the foreign exchange market and the financial market in the following manner:

> "The increase in vulnerabilities does not fully account for the spread and depth of the crisis, however. The severity of currency and stock market declines and the few warnings from the market participants indicate that a self-fulfilling loss of market confidence played an important role. With the loss of confidence and substantial uncovered foreign exchange exposure, currency depreciation became self-perpetuating: the rise in the local currency value of liabilities impaired balance sheets, lowered stock prices, and increased demand for foreign exchange to cover open positions. Increased demand for foreign exchange led to further currency depreciation, and so on. Both healthy and insolvent firms suffered because of the lack of transparency (investors, unable to distinguish among firms, withdrew from all of them), the effect of currency depreciation on dollar-denominated debt, the increase in interest rates to defend the currency, the contraction on credit resulting from the rapid drop in equity of highly leveraged financial institutions (due both to their own losses and to the insolvency of their borrowers), and increased uncertainty and the economic downturn." (World Bank 1998, 30)

Thailand – The Epicentre of the Financial Crisis

Thailand became the epicentre of the financial meltdown in Asia[62]. The roots of Thailand's financial crises date as far back as the early 1990s. Boosted by financial liberalisation, *a second wave of foreign capital* entered into Thailand. The first wave was the East Asian direct investment pushed by currency appreciation in Japan, South Korea and Taiwan after the Plaza-agreement (1985), and pulled by the cheap labour and land costs in Southeast Asia. The second wave of investments came predominantly from Europe and Japan (and United States), pushed by the declining returns in the stock market and the low real interest rates in depressed Europe and recession-bound Japan, and pulled by high profit margins, high interest rates and low risk due to dollar-pegged currencies in Southeast Asia.

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[62] More details about the financial crisis in Thailand can be found in Lauridsen 1998.

Due to high interest rates in Thailand and a fixed exchange rate policy linking the baht to the US$, foreign investors were eager to place their money in Thailand, preferring to lend on a short-term basis (typically for 3 or 6 months), for which they could obtain 10-11 per cent interest rates. Domestic borrowers were also eager to borrow offshore because such money was cheaper (lower interest rates) and the "virtually pegged" exchange rate encouraged borrowers to think that there was no currency risk. Corporate borrowers discovered they could thus borrow at an interest rate of 5-8 per cent, instead of paying more than 13 per cent when borrowing domestically. They could even earn money simply by borrowing from abroad and depositing baht in Thailand.

In 1992, as part of a broader *financial liberalisation package,* the Anand government deregulated foreign exchange. The Bangkok International Banking Facility (BIBF) was established to attract more foreign funds to cover the increasing current account deficits, to turn Thailand into a regional financial centre, and to ensure a greater degree of competition in the banking sector. The BIBF made it possible for local and foreign commercial banks to take deposits or to borrow in foreign currencies from abroad, and to lend the money, both in Thailand and abroad (Chaiyasoot 1995).

As a consequence, Thailand undertook *too much offshore borrowing*. The external debt increased from almost US$ 40 billion in 1992 to US$ 80 billion in March 1997. Therefore, total outstanding debt as a share of GDP increased from 34 per cent in 1990 to 51 per cent in 1996, an increase generated almost exclusively by the private sector. Of the total debt stock, 80 per cent was private debt and almost 36 per cent was short term, i.e. maturing in 12 months or less. In August 1997, the Bank of Thailand (BoT) revealed that the foreign debt was about US$ 90 billion, of which US$ 73 billion was by private companies with US$ 20 billion falling due by the end of 1997. In January 1998, the Thailand Development Research Institute (TDRI) showed that total short term borrowings accounted for 46 per cent of all borrowings in 1996 compared to 36 per cent in 1990, and that the ratio of short-term debt to foreign reserves increased from 0.6 in 1990 to 1.0 in 1995. Through its access to foreign credit via the BIBF and the Eurobond market, the private sector had obtained large amounts of foreign credit. By late 1996, almost half of the private sector foreign loans had been channelled through BIBF. The figures show that the Thai financial crisis is primarily a "private sector" crisis.

This access to foreign funding was fuelling a domestic credit expansion in Thailand. Financial sector lending to the private sector went up from 72% of GDP in 1990 to 142% of GDP in 1995 (Montes 1998,13). However in contrast with 1994-95 crisis in Mexico, the funds was not mainly utilised for

consumption but for investments. The financial crisis in Thailand arose after a period of *excessive investments — many of which turned out to be too optimistic and too unproductive*. During the 1990-96 period, the investment ratio (gross domestic investment as a percentage of GDP) was between 40 per cent and 44 per cent, compared to average investment ratios of 25 per cent and 30 per cent during the 1980-84 and 1985-89 periods, respectively.

The massive inflow of money tripled the amount of loans in the financial system, and, causing a *misallocation of investment resources*. An investment bubble was thus created by careless lending. A substantial part of the money was channelled into already inflated assets in the *real estate sector*. Between 1992 and 1996, a total of 755,000 housing units were built in Bangkok, double the national plan estimate. Loans from financial institutions to property developers also increased. In 1993, loans totalled 264 billion baht, but by March 1996, they had gone up to 767 billion baht, of which 45 per cent stemmed from finance companies and 54 per cent from commercial banks. By 1996, it became apparent that the supply of housing was outstripping effective demand, and in the following year, Thailand had residential vacancy rates of 25 to 30 per cent and vacancy rates for offices in Bangkok of 14 per cent.[63] Moreover, many property owners artificially inflated the value of their assets and kept borrowing against them, while most real estate companies had poor cash flows.

When the economic recession started in 1996 and the buying power of the middle and upper classes began declining, the property bubble burst and left substantial bad debts on the balance sheets of the finance companies, which had financed their investments by borrowing abroad. In February 1997, Somprasong Land missed payment on a euro-convertible debenture worth US$ 80 million. In March 1997, the BoT had classified Bt 100 billion of the loans owned by real estate developers as non-performing (i.e. not having been serviced for 12 months), but the amount of bad property loans was estimated by financial agencies at Bt 300 billion (about US$7.5 billion) (Parnsoonthorn 1997, Terdudomtham 1998). Part of the borrowed money went into large industrial complexes in steel, pulp and paper, cement and petrochemicals.

Misallocation of loan funds was one problem. A second problem was *vulnerability*. First, most of the loans — even those going to the industrial sector — were not hedged against currency fluctuations. Second, a *currency mismatch* arose as much of the foreign money went into non-tradable sectors of

[63] During the economic recession in 1998 oversupply became much more serious. For offices the average vacancy rate reached the level of 40%. For those banks loans given to the property sector the non-performing ratio (NPL) was a high as 80% (Parnsoonthorn 1999)

the economy, i.e. with no foreign exchange receipts. Third, there was a *term mismatch* as short-term borrowing was utilised to finance long term projects with longer term returns. Finally, financing of equity purchases by loans without taking the foreign exchange risk into account was not unusual. The Thai experience therefore involved a boom-bust cycle of property and stock markets. The public sector was able to control its own debt creation but after liberalisation of the capital account in 1993, it was unable to control a private sector that lacked a similar discipline in its debts creations.

As the real economy weakened in 1996 with sluggish export growth and an increase in the current account deficit, even more "hot money" flowed in to cover the deficit, but also encouraging more careless investments and further asset price inflation. The gradual loss of competitiveness during the 1990s was aggravated by the *foreign exchange regime* that tied the baht to a strengthening US dollar. The current account deficit widened and reached a level that worried currency traders in the post "tequila crisis" period.

When the creditors realised that "the party was over" they overreacted as did local firms desperately trying to hedge their foreign exchange liabilities. As a consequence, the booming inflow of short-term funds turned into a panicky outflow of capital.

IMF Intervention and Constraints on National Policy

The Thai currency collapse then spread to Indonesia, Malaysia and the Philippines, just as Korea became involved in November 1997. In Thailand, Indonesia and South Korea, the IMF entered with bailout packages to a total value of US $ 115 billion, almost half of it going to the strategic South Korea.

Southeast and East Asian countries have generally been used to World Bank structural adjustment programmes, but they have been able to seek alternative financial support from Japans in cases where they preferred not to follow the World Bank prescription. Both Thailand and South Korea tried in 1997 to address Japan to find a bilateral solution but in both cases Japan refused a bilateral solution and pointed at IMF as the right place to go.

In the case of Asia financial crisis, the IMF started a very ambitious programme, in which it combined on the one hand the traditional stabilisation package with a mix of fiscal policies (higher taxes and cut down on government spending) and credit tightening (higher interest rates), and on the other hand a programme for fundamental changes in the economic and institutional structures. The latter part of the programme seems to be inspired

by the policies introduced by IMF in Eastern Europe and the former Soviet Union.

By early 1998, it was clear that the original IMF program had failed and that IMF had to accept significant changes in its standard package. In the case of Thailand, for instance, the first agreement with IMF stated the goal of a 1% surplus in the public budgets. In the third agreement IMF accepted a more relaxed approach and in the sixth agreement the goal was set at 5% public deficit.

The failure of the IMF package to bring about a modest economic growth, to stabilise the foreign exchange rates and to ensure roll over of short-term debt, was probably due to more factors.

First and foremost, the IMF by ordering a standard package, normally utilised for traditional balance of payment crises (demand contraction in order to bring imports into balance with exports), failed to understand that the Asian financial crisis was a capital-account-led crisis (private overborrowing), which probably needed a different response. IMF chose to insist upon its standard macro-economic stabilisation policies in countries with balance in their public budgets, with low inflation, with high savings and generally with sustainable current account deficits.

Secondly, the high interest policy in combination with falling currency values led to a further weakening of the already seriously wounded domestic financial sector. IMF conditionality in this manner tended to undermine rather than restore markets' confidence.

Thirdly, by stressing the fundamental weaknesses of the "East Asian Capitalism" and by taking an "everything is wrong and must be changed" position, IMF contributed to the confidence crisis and postponed debt restructuring talks between private lenders and private borrowers.

Fourth, the IMF thought it could restore confidence of private actors in the financial sector by introducing far reaching financial sector reforms at an early stage, but "there is no reason to believe that closing banks and finance companies and tightening supervisionary standards would in fact restore market confidence in the middle of a panic, in the sense of stemming demands for the repayment of short-term debts." (Radelet and Sachs 1998,62). As later acknowledged by the IMF itself, the closing down of 16 Indonesian banks in November 1998 contributed to panic rather than restoring confidence there.

Fifth, the actual disbursement of funds from the loan packages was slow when compared to the short-term debts falling due. The disbursement was organised in trances related to specific conditionalities. By late 1997, Thailand had received only two-fifth of its loan package. The strategy of IMF appears not to have been that of helping these countries in re-

establishing international credit worthiness. In contrast, the IMF entered a comprehensive and reform programme which aimed at "dismantling an economic system based on conglomerates, the collusion between the state, banks and business, and the restrictive markets" (IMF Director Michel Camdessus). Thailand, Indonesia and South Korea were suddenly caught in an IMF socio-economic experiment. IMF had extended its domain to include such issues as: financial system, tax and tariff structures, labour markets, central banking procedures, corporate governance. By introducing such wide ranging reforms that the United States (and partly Japan) has pushed for long time, the IMF went beyond and distracted attention from what was needed for restoring financial market confidence in the short term (Feldstein 1998).

Sixth, the IMF-driven reform packages were organised in such a way that they ensured "bailing out" of private creditors rather than "bailing them in" by forcing them to enter debt restructuring agreements including fair burden sharing between debtors and creditors (Griffith-Jones et al 1998)

Finally, the IMF has insisted upon financial opening and upon foreign access to domestic financial markets, although foreign lenders and financial liberalisation were part of the problems leading to overexposure to short-term foreign borrowing in private sector in these countries.

Capital Account Crises and "Sand in the Gears"

During the second half of 1998, it became more generally acknowledged that the current crisis in Asia was not a crisis in a particular "Asian model of development". What appeared to be an Asian crisis turned out to be a global crisis in Asia. What somebody thought was a crisis of overregulation turned out to be a crisis of underregulation. What IMF and others thought was a traditional current account crisis revealed itself as a capital account crisis (Radelet and Sachs 1998, Stiglitz 1998, Griffith Jones et al. 1998)

This has inceasingly also become the World Banks semi-official position, driven by economists such as its Chief Economist and Vice-president Joseph Stiglitz. The World Bank now advocates a slowdown in financial market deregulation in developing countries.

Refering to a new World Bank Report "Global Economic Prospects and Developing Countries 1998/99" Joseph Stiglitz came forward with the following opinion in a personal comment in Financial Times December 3, 1998:

"There is no single culprit for the problems that have beset the region. The economic situation in each country differed. But *Global Economic Prospects* concludes that the origins of the crisis lay fundamentally in the interaction between two things: the difficulties of domestic financial liberalisation and the problems associated with volatile international capital markets.

Unlike the Latin American debt crisis of the 1980s, the east Asian crises was not characterised by excessive sovereign borrowing or severe macroeconomic imbalances. Although the current crises has proven to be much harder to remedy, it has taught us that the primary role for fiscal and monetary policy in future financial crises should be to shore up demand, expand the social safety net, recapitalise banks and restructure corporate debt. Social safety nets in particular must be a central component of policy response. Excessively contractionary policies in economies beleaguered by highly indebted firms, lead to high rates of bankruptcy, making the task of corporate and financial sector restructuring and the restoration of business confidence more difficult.

The crises in east Asia revealed how difficult it is for developing countries to manage enormous private flows without adequate experience.

To deal with the risks posed by large capital flows, especially significant when financial systems are weak, the report suggests that reforms must be comprehensive, and include a combination of more flexible macroeconomic policies, tighter financial regulation, and where necessary, restrictions on financial capital inflows. Financial sector liberalisation, which can greatly increase the risk of a crisis, must be accompanied by stringent regulatory oversight" (Stiglitz 1998b).

Stiglitz even opened for "sand in the gears" - some form of restrictions on short-term capital flows – where necessary.

The Asian financial crisis clearly demonstrates how international capital mobility in combination with the twin liberalisations impacted upon state autonomy. During the pre-crisis period it turned out to be impossible for the state in Thailand to control private sector debt creation. Moreover, sterilisation operations of the central banks tended to be self-defeating because they exerted an upward pressure on domestic interest rates provoking further inflows. Later on, when the financial crisis broke out and IMF was

called in, sentiments on the financial markets as well as IMF conditionalities left little space for autonomous action. That is particularly the case for Thailand and South Korea. In contrast Malaysia with less exposure to short term foreign debt opted for a more nationalist strategy. During late 1998 Malaysia followed "IMF-like" package of austerity measures but in September Mahathir made tough restrictions on share dealings, fixed the currency at 3.80 ringgit to a dollar and introduced capital controls in order to be able to lower interest rates and follow a more expansionist finance policy.

Financial Opening, Capital Mobility and Constraints on State Autonomy

The present international financial crisis in Asia and elsewhere has demonstrated how a massive inflow of short-term bank loans and mobile portfolio flows followed by a massive outflow of financial funds directly have impacted upon the real economy as well as vast direct effect intermediated through the IMF austerity and structural reform programmes.

A more general question is how international financial openness and increasing capital mobility impact upon state autonomy and policy choices in developing countries. To answer that question one need to know more about the determinants of capital flows. To what extent are investment fund mangers behaving in a rational manner and driven by fundamental conditions, and to what extent are they more "irrationally" driven by sentiments or by "herd" behaviour? If they are determined by fundamental conditions, do they then respond mostly to domestic fundamental conditions or more to international conditions. If the flows respond to domestic conditions the effect of economic policy choices of the countries' leaders are important but if capital flows correspond to fundamental international conditions states are rather constrained by event on the global financial markets.

According to Perraton et al., developing countries are integrated into the global financial market as interest rates increasingly are determined globally. Consequently the influence of the national financial markets on national economic performance has declined as has the scope for government for influencing economic priorities through monetary policies. However, the authors emphasise that financial markets do not dictate specific policies but rather limit the room of manoeuvre of the state in an unpredictable manner.

> "Markets' response to government policies depends on their assessment of the economic credibility of the government; as such, there is no set

> market response to particular policies. However, the short-term and speculative nature of these markets can lead to sudden and sharp re-evaluations of the sustainability of policies.... Rather than global financial markets imposing specific policies on national governments; they have significantly changed the costs associated with particular policies and instruments through their effects on interest rate risk premia and exchange rate movements, at times these costs may be so high as to make the policy prohibitively expensive" (Perraton et al. 1997,270).

Sylvia Maxfield from Yale University puts less emphasis on uncertainty and unpredictability in her review and analysis of the political implications of financial internationalisation, but are also critically to the view that global financial markets dictate government policy according to simple criteria. She is particularly critical to the literature which argues that international capital mobility imposes a strong discipline on autonomous state action, because it becomes increasingly more difficult to tax mobile assets, because the market becomes a kind of "prison", where market forces "punishes governments" that follow policies that threaten the investment environment, and because the volatility of international capital in itself gives all types of governments an incentive to please global and related local investors in order to avoid being punished by ruthless capitalism (Maxfield 1998,1202-03).

Sylvia Maxfield has instead tried to summarise our knowledge in this area so far. She claims that we know much less on the consequences of capital openness than on trade openness. Sylvia Maxfield follows a range of possible causal links between international financial integration and the political economy of development with focus on democracy and development (inequality).

First she argue that North-South capital flows are determined mainly by international conditions and history (reserves, debt levels and inflation history) rather than by present policy choices. The global liquidity situation - *OECD interest rates* - seem to be the most important determinant. When global liquidity is high and OECD investment rates are low, investors become less risk averse and the policy constraint on recipient governments are low. In the opposite situation, recipient governments have less autonomy as they have raise interest rates and insure exchange rate stability to attract foreign capital, which in turn limit other government policies. Furthermore, country risk premia appear to reflect the country's inflation history and accumulated debt rather than present policy choices. Finally, investors are concerned with

borrower's international resource stream (earnings from export) and thus constrain balance of payment policies rather than public finance policies (Ibid. 1204 ff).

A second major argument, concerns how to disaggregate capital flows. Instead of disaggregating according to volatility and time horizons, Maxfield suggest that it might be more fruitful to distinguish between different *investor strategies*.

One group of investors are the so-called "bottom fishers". They are price oriented (buying low and selling high) and their behaviour tend to be countercyclical. A second group of investors are relative yield investors – they focus on yields on bonds and dividends on stocks and compare alternative investments in other countries. They are concerned with policies that effect interest rates rather than country-policies as such. Mutual fund managers belong mainly to this group. Relative yield investors tend to have a shorter time horizon in their investment decisions and thus should be considered as the most threathening type of investor. A third group of investors - absolute value investors - which often focus on total return over the life of a bond. Pension funds and insurance companies are typical of this group. Generally, such investors have a longer time horizon in investments and will constrain national policies in ways which favour policies that protect the fundamental worth of national stocks and bonds. The last and fourth group are investors concerned with diversification which try to invest in different financial product areas and different countries. There seem to be no serious constrain on national policy from this group. The main point concerning investor strategies and policy constrain is then that in particular yield-oriented investors will tend to force governments in developing and transition countries to adopt policies which raise yields on their stocks and bonds compared to yields on substitute assets in other countries.

A final argument relates to how financial flows are structured. Here Maxfield emphasise that foreign purchasing of equity and corporate bonds involve more private risk sharing between investor and borrower and thus less state involvement in both distribution of resources and less risk of government involvement in case of a debt crisis. Generally, Maxfield's assay shows how important it is disaggregate financial globalisation if we want to come up with some general patterns on their effect on state autonomy in developing countries.

Concluding Remarks

In order to come closer to a "ranking of volatility" the events during the Asian financial crises certainly suggests that much need to be known about investor strategies, including how different kind of institutional investors (e.g.. mutual funds and hedge funds) allocate their fund globally. Moreover we need to investigate more into how various kinds of bank lending fits into such ranking (Griffith-Jones 1998 28). Finally, the crises challenges the assumption that investors make their allocation decisions on the basis of rationality and full information. The boom-bust nature of lending, overshooting in initial reactions, contagion, and the self-fulfilling behaviour before and during the Asian financial crisis can hardly be understood alone by reference to the categories referred to above.[64]

One aspect here is *"informational inefficiencies"* leading to sudden shifts in confidence which in turn leads to panicky investor behaviour. Any possible weakness in the economic fundamentals is suddenly discovered and magnified in the market-place. In relation to this and in contrast to Maxfields view, investors that follow a diversification strategy and invest in many countries might be particular sensitive due to their superficially knowledge. Moreover, as suggested by Griffith-Jones,improved information is not sufficient because "often the key problem is not lack of information (important as that may be), but how available information is analysed" (Griffith-Jones 1998, 19)..During the boom period investors showed little interest in the projects their funds were allocated to. They tended to bundle the country's (or even the region's) projects and were driven by expectations of rapid growth and high profitability. During that period there was few incentives to obtain and or utilise detailed information, the gathering of which was costly. Information on the behaviour of other investors were probably more important than information on the private projects to which most money was channelled (Montes 1998, xx-xxi and 26-28).

This leads to the other major aspect - *herd behaviour-* on part of fund managers. The rapid changes in perceptions of international investors and lenders are common in most currency and bank crises in developing countries, Herd behaviour undoubtedly reveals the working of irrational (emotional) forces but partly it can be explained with reference to the working of the incentive system of investment funds. Investment mangers get bonuses based on their performance in comparison with other funds which gives them an

[64] Please notice that Sylvia Maxfield also deals with incomplete information and herd behavior as possible and relevant determinants of capital flows (Maxfield 1998, 1208-1210 and 1216-1217.

incentive to follow the crowd in their decision making. However, so far little is known about the actual behaviour of different types of investment managers in the Asian case - local versus foreign investment funds, large versus small local banks, Japanese versus European banks etc..

To the extent that "sentimentals" rather than fundamentals are the driving forces in financial globalisation it is difficult to determine how exactly capital mobility constrains the state's room of manoeuvre. In this case the state is hostage of an unpredictable market with uncertain reactions to particular governments and policies. In this case Maxfield is right in stressing that ways of discouraging excessive inflows of potentially volatile short-term capital should become the focus of local policy makers and of researchers as well.

> "To the extent that investors are irrational we should not waste time trying to identify their rational response to particular policy measures. In this case emerging market policy makers are better off exploring ways to curtail exposure to financial market irrationality and insure against it" (Maxfield 1998, 1211).

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