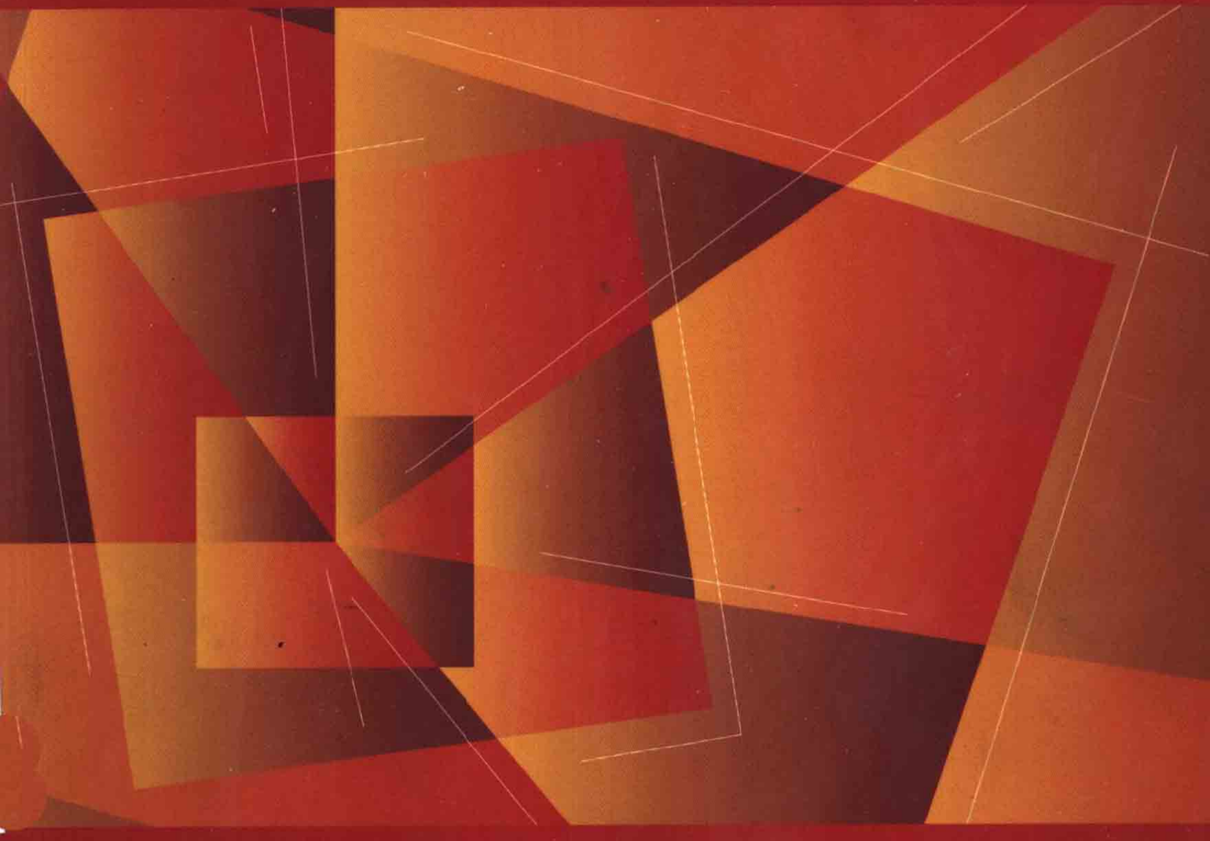
FINANCIAL CRISES IN "SUCCESSFUL" EMERGING ECONOMIES



Ricardo Ffrench-Davis, Editor

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editor

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Preface

This book is the result of a project developed by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), with support from the Ford Foundation. The text encompasses five articles analyzing emerging economies that were generally rated as successful by international financial institutions and the financial press during episodes characterized by a broad supply of external funds. We include the cases of Chile, Korea, and Mexico in the critical years of the 1990s and Chile in the deep crisis of the 1970s. All of these economies were praised for their efficient public policies. They all experienced episodes of an abundant supply of financial capital, and they all suffered macroeconomic disequilibria as a result. We contrast these cases with the positive experiences of Chile during the Tequila crisis and of Taiwan during the Asian crisis.

Three of the articles are country studies, undertaken from a comparative perspective. The paper by Manuel Agosin, professor at the University of Chile, draws parallels between Korea and Taiwan. These two countries achieved a similar performance from the mid-1960s through the early 1990s, but their paths then diverged. The study analyzes the national policies adopted in each case and the underlying motives.

The article by Ricardo Ffrench-Davis and Heriberto Tapia, both economists at ECLAC, compares three positive financial shocks experienced in Chile: the liberalization of the capital account in the 1970s, which exploded in a massive crisis in 1982; a substantial policy shift in 1991–94 in the direction of a *prudential* macroeconomic management of the capital account, which kept Chile immune to the tequila crisis in 1995; and the capital surge of 1995–97, which culminated in a rather severe adjustment in 1999.

The third study is by Dr. Jaime Ros, Mexican economist and professor at Notre Dame University, who addresses the contrasting experiences of Mexico in 1991–94 and 1996–97. The paper examines the different domestic and external variables that explain the marked differences in the two episodes, and it evaluates the depth of the economic and social effects.

The fourth article, by Dr. Stephany Griffith-Jones of the University of Sussex, analyzes the current architecture of the international financial system and its incapacity for preventing crises or moderating the disequilibria that generally lead to crises. The article analyzes several recent proposals, including those of the author herself.

Finally, the paper by José Antonio Ocampo, Executive Secretary of ECLAC, and Ricardo Ffrench-Davis, which opens the book, examines why countries that were considered successful before the explosion of a crisis incurred a level of macroeconomic disequilibria that made them vulnerable to a financial run. We start by considering the nature of supply, focusing on investors who specialize in short-term, highly liquid operations. We then trace the evolution of the prices of financial assets, foreign exchange, and stock markets in the receiving countries, and we identify links with paths that culminate in unsustainable macroeconomic disequilibria. On the basis of this analysis, we expose five misconceptions that are commonly held among proponents of full liberalization of the capital account.

Heriberto Tapia provided highly professional support in preparing the final manuscript, verifying the technical content, and ensuring agreement between the Spanish and English versions. Lenka Arriagada was exceptionally efficient in assisting with the presentation of the final manuscript.

We thank ECLAC for providing a stimulating environment for policy-oriented research and the opportunity for independent analysis on a most relevant issue today. Our deepest thanks also go to the Ford Foundation for its support. Naturally, all the opinions presented here are the responsibility of the respective authors.

Financial Crises in "Successful" Emerging Economies

Contents

RICARDO FFRENCH-DAVIS
JOSÉ ANTONIO OCAMPO*

1 The Globalization of Financial Volatility: Challenges for Emerging Economies

One of the outstanding features of modern financial crises is that they occurred in emerging economies that were generally viewed as very successful until the crises exploded. Moreover, recent crises have been radically different from those typical from the 1940s to the 1970s, which, in Latin America, displayed three major features that have been absent or relatively less important in recent experiences. First, past crises involved large fiscal deficits that were financed with external loans or, in the absence of such financing, by central banks. Second, domestic financial systems were repressed, a fact that was generally accompanied by private sector access to rediscount or bank loans at negative real interest rates. Finally, balance of payments crises were frequently associated with a sharp worsening in the terms of trade or explicit domestic policy decisions to overvalue exchange rates.

Over the past quarter century, a new variety of crises has gradually developed in Asia and Latin America. Four features differentiate them from the previous type. First, the international capital market has been the major source of shocks, whether positive or negative. Second, flows have largely originated from and been received by the private sector. Fiscal deficits, in contrast, have played a secondary role, and in most cases public finances have been sound. Third, these financial crises have mostly hit emerging

*We appreciate the assistance of Angela Parra and Heriberto Tapia.

economies that were considered to be highly credible and successful. In fact, the bulk of private flows has been concentrated on a small number of relatively affluent and well-organized developing nations. Fourth, these flows have been characterized by a lack of regulation, on both the supply and demand sides. Domestic financial systems have often been liberalized without the parallel development of a significant degree of domestic prudential regulation and supervision.

In practice, the differentiation between old- and new-style crises is naturally somewhat less clear-cut than the above description would suggest. An early example of the new variety was the Chilean experience of the 1970s and early 1980s, but the old type of crisis was still prevalent in the rest of Latin America during that period, with other Southern Cone countries in an intermediate position. In the 1990s, the new type generally predominated in both Latin America and Asia, but there were some mixed episodes in which features of both new and old crises were intermingled, with budget deficits and terms-of-trade fluctuations.

The evolution of private capital flows over the past three decades is well known. During the 1970s, a large supply of funds was made available to many developing nations. The 1980s brought a severe and widespread shortage of financing, particularly for the Latin American countries. In contrast, the Asian countries that were affected by the disturbances in the international financial markets adjusted rapidly (with the exception of the Philippines) and were able to leave the contagion effects behind. External financing returned to Latin America in the 1990s, but it was volatile. The resurgence of capital flows between 1991 and 1994 was followed by a sharp scarcity, especially in Mexico and Argentina, with a rather generalized portfolio outflow in late 1994 and early 1995. The so-called tequila crisis gave way to renewed access in 1996–97, but in 1998–2000 external financing was again in short supply as a result of contagion from the crisis detonated in Asia in 1997. Worsening terms of trade aggravated the recession. On all those occasions, changes in external financing were supply-led.[1] They had a strong impact on the national economies on both sides of the cycle, with contagion first of overoptimism and then of overpessimism.

Through 1996, the successful emerging economies of Asia appeared to be immune to the instability associated with capital surges, as illustrated by their performance during the tequila crisis. In reality, part of the outflows from Latin American countries were reallocated to Asia during that

1. Evidence shows that these changes have originated, to a large extent, in the sources of supply. See Calvo (1998); Culpeper (1995); Griffith-Jones (1998); Larraín (2000).

episode. The subsequent events show that immunity was no longer a feature of the East Asian economies, and the two regions now faced common destabilizing external forces.

The following section outlines the three capital surges experienced by Latin American countries since the 1970s. Subsequently, the paper reviews the main macroeconomic effects generated by capital surges and their policy implications. We then compare the specific experiences of the emerging economies covered by this research project: Korea and Mexico in the 1990s and Chile in the 1970s were all regarded as highly successful until the sudden outbreak of severe crises. The study contrasts these experiences with Chile in the early 1990s and Taiwan throughout the last decade, which provide examples of economies that deployed a set of prudential macroeconomic policies and thereby avoided domestic disequilibria and mitigated contagion. The paper then addresses five misconceptions that are currently in fashion. The final section summarizes some robust lessons for domestic policies and reform of the international financial architecture.

Three Financial Capital Surges to Emerging Economies since the 1970s

Purely financial factors have been changing in the world at a much faster pace than international trade and the globalization of production. During the 1970s and 1980s, many countries began to liberalize their financial sectors and to relax or eliminate foreign exchange regulations.[2] This contributed to a boom in international flows, which was facilitated by the revolutionary innovations in data management and telecommunications technology and the emergence of increasingly sophisticated financial techniques. The financial booms generally occurred within a framework of lax or nonexistent regulations and supervision, and most existing regulations were in fact procyclical.[3]

Net capital inflows to Latin America averaged nearly 5 percent of gross domestic product (GDP) in 1977–81, 1991–94, and 1996–97. Exchange rates appreciated in all three periods, which naturally led to a rapid increase of imports relative to exports, with the corresponding current account deficit being financed (indeed, overfinanced) by a sharp rise in the

2. Díaz-Alejandro (1985); Devlin (1989).
3. Ocampo (1999, 2001); Griffith-Jones (in this volume); United Nations (1999); Turner (2000).

stock of external liabilities.[4] All these macroeconomic variables experienced some overshooting.[5] Adjustment was frequently anchored to one dominant balance, which generated imbalances in other macroeconomic variables, as in a falling inflation rate associated with real exchange rate appreciation and climbing external deficits. Such adjustment was obviously facilitated by access to external financing, which most probably would have been absent in a dry foreign supply.

The increased supply of external funding in those three episodes generated a greater demand for such financing. Recipient countries that adopted procyclical or passive domestic policies experienced real exchange revaluation and large current account deficits. Because these were heavily financed by volatile flows of mostly short-term, liquid capital, the economies tended to become increasingly vulnerable to changes in the mood of external creditors; the outstanding case was Mexico in 1991–94 (see Ros, in this volume). Creditors with financial assets placed in the region became more sensitive to bad news as their exposure increased. The sensitivity rose steeply with the size of net short-term liabilities.[6]

The dramatic increase of international financial flows was more diversified in the 1990s than in the 1970s. The situation is potentially more unstable, however, inasmuch as the trend has shifted from long-term bank credit, which was the predominant source of financing in the 1970s, to portfolio flows; medium- and short-term bank financing; time deposits; and foreign direct investment (FDI; including acquisitions and other than greenfield investment). A very high share of the newer supply of financing is short term or liquid or both. The region thus saw a paradoxical *diversification toward volatility* in the 1990s. The relative improvement after the tequila crisis, with a rising share of FDI, still included a significant proportion of volatile flows.[7] The foundations of a broad liquid market for portfolio investment were laid down in the late 1980s through the Brady bonds and developed vigorously in the 1990s, with Latin America as a major destination for both bond and stock financing. This market offered the expectation of high rates of return during the upswings of the two cycles in the 1990s.

4. ECLAC (1995, 1998, 2000a).

5. When significant macroeconomic disequilibria persists despite repeated statements on the need to maintain equilibria, it reveals an inadequate understanding of how to achieve sustainable equilibria that are consistent with development. See Ffrench-Davis (2000, ch. 6).

6. Rodrik and Velasco (1999).

7. The positive link between FDI and productive investment is well documented (see Ffrench-Davis and Reisen, 1998, chap. 1). The link was weakened, however, by the fact that about 40 percent of FDI inflows in 1997–99 corresponded to acquisitions of Latin American firms rather than the creation of new capacity (ECLAC, 2000b, chap. 1).

In 1991 the stock of assets invested in Latin America by the new investors that had *discovered* the emerging markets was evidently below their desired stock level, but by 1994 it had become considerably larger. Net capital inflows were used to finance rising current account deficits, and external liabilities accumulated through time. This was sometimes accompanied by significant mismatches in the maturity structure of the balance sheets of domestic financial intermediaries, when short-term external funds were used to finance longer-term domestic credits. This issue was particularly severe in the dollarized segment of the domestic financial system and in those cases in which external interbank credit lines were used as a major source of domestic financing. Consequently, the region moved into a *vulnerability zone,* with the economy becoming increasingly sensitive to adverse political or economic news and "hostage to the whims and fancies of a few country analysts in London, Frankfurt and New York."[8] This situation was likely to "put the economy at the mercy of the capital markets' occasionally whimsical moods."[9] The longer and deeper the economy's incursion into that zone, the more severe was the *financierist trap* in which authorities could get caught, and the lower the probability of leaving it without undergoing a crisis.[10]

Mexico and Argentina were particularly vulnerable in 1994, while Chile had deliberately avoided venturing into the vulnerability zone. Meanwhile, East and Southeast Asian countries were just starting to take that risk in the first half of the 1990s, and the resulting mismatches in the maturity structure of the balance sheets of domestic financial intermediaries proved to be even more severe than a worsening net debt position. By the next cycle, several economies in both Asia and Latin America had penetrated deep into the vulnerability zone. Both regions suffered severe crises when the mood of the external market changed.

Worsening of Macroeconomic Fundamentals Led by Inflows

The economic activity of Latin American countries exhibited significant vulnerability to changes in international financial markets over the last three decades, which worked as an intensely procyclical factor for the

8. Rodrik (1998).

9. Calvo (1998).

10. The financierist trap refers to a macroeconomic policy approach that leads to an extreme predominance of or dependency on agents specializing in microfinance, positioned in the short-term and liquid segments of the market.

emerging economies. This vulnerability was associated with the volatility of international markets since the 1970s, as well as with the procyclical macroeconomic policies adopted by recipient countries. Several Asian emerging economies followed suit in the 1990s.

Annual GDP growth rose in Latin American countries from 1.3 percent in the 1980s to 4.1 percent between 1991 and 1994 and 4.5 percent in 1996 and 1997. Recessive adjustments took place in 1995 and 1998–99 (see table 1-1). Overall, GDP rose by a mere 3.3 percent in the decade (1991–2000). Given that GDP was highly unstable, however, the precise figure depends on the period chosen. For 1990–99 the growth rate was 2.8 percent, because the period starts and ends with a recession. From peak to peak (between 1989 and 2000), average growth was 2.9 percent.

A growth of productive capacity of around 3 percent (1.3 percent per capita) is remarkably low compared with the expectations generated by the structural reforms. Comparison with the previous golden age is striking. During the three decades from 1950 and 1980, GDP growth averaged 5.5 percent a year (2.7 percent per capita), with rather high domestic investment ratios sustaining these vigorous rates. In the 1980s, gross domestic investment dropped sharply, by 7 percentage points of GDP. The recovery in the 1990s was weak (see figure 1-1). In fact, investment grew much less during this decade than did capital inflows; a significant proportion of external flows thus financed increased consumption, crowding out domestic savings.[11]

Recovery from Recession

The domestic conjuncture has crucial implications for the link between capital flows and economic activity. When there is a binding external constraint, any inflow will contribute to relaxing it, thus facilitating a recovery of economic activity. Binding external constraints predominated during several episodes in many Latin American countries, and they were particularly widespread from the early 1980s up to 1990, in 1995 and in 1998–2000.

In the early 1990s, renewed capital inflows thus contributed to a recovery of economic activity, and they facilitated the adoption of successful anti-inflationary adjustments. Argentina and Peru, for example, both featured huge underutilization of capacity and hyperinflation; the disappear-

11. See Ffrench-Davis (2000, chap. 1 and 5); Uthoff and Titelman (1998).

Table 1-1. *Latin America and East Asia: Gross Domestic Product, 1971–2000*

Annual growth rate (percent)

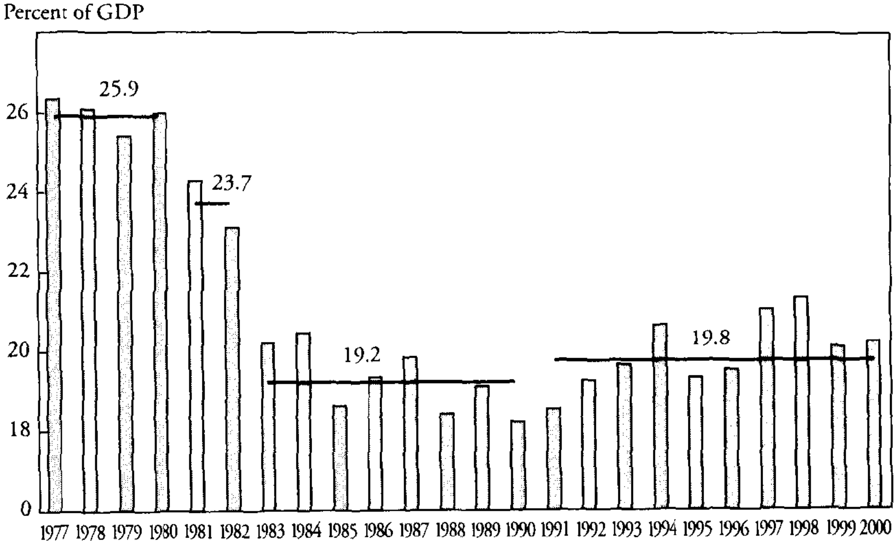
Region and country	*1971–80*	*1981–89*	*1990*	*1991–94*	*1995*	*1996–97*	*1998–99*	*1991–2000*
Latin America								
(19 countries)[a]	5.6	1.3	−0.6	4.1	1.1	4.5	1.2	3.3
Argentina	2.8	−0.7	−2.0	8.0	−2.9	6.7	0.4	4.2
Brazil	8.6	2.3	−4.6	2.8	4.2	3.0	0.5	2.7
Chile	2.5	3.0	3.3	7.5	9.1	6.9	1.5	6.1
Colombia	5.4	3.7	4.3	4.3	5.2	2.8	−2.1	2.6
Mexico	6.7	1.5	5.1	3.5	−6.1	6.1	4.3	3.5
Peru	3.9	−0.7	−6.0	5.1	8.6	5.4	1.0	4.5
Venezuela	1.8	−1.5	5.5	3.2	−1.9	3.4	−3.6	2.1
	1971–80	*1981–90*	*1991–92*	*1993–96*	*1997*	*1998*	*1999*	*1991–2000*
East Asia								
(6 countries)[b]	8.1	7.0	7.3	7.3	4.8	−4.2	6.5	5.6
Indonesia	7.7	5.5	8.1	7.7	4.7	−13.2	0.2	4.2
Korea	9.0	8.8	7.3	7.3	5.0	−6.7	10.7	6.1
Malaysia	7.8	5.2	9.2	9.7	7.5	−7.5	5.4	7.1
Philippines	5.9	1.7	−0.1	4.2	5.2	−0.6	3.3	2.8
Taiwan	9.3	8.5	7.5	6.7	6.7	4.6	5.7	6.5
Thailand	7.9	7.9	8.3	8.0	−1.7	−10.2	4.2	4.5

Source: For Latin America, the United Nations Economic Commission for Latin America and the Caribbean (ECLAC). For East Asia, the International Monetary Fund (IMF), *International Financial Statistics*, November 2000; Asian Development Bank; J.P. Morgan.

a. National accounts expressed in U.S. dollars at 1980 prices for *1971–80*, at *1990* prices for *1981–89*, *and at 1995 prices for 1990–2000*.

b. In each period, each country's GDP was weighted by its average share in the regional output, expressed in current dollars.

Figure 1-1. *Latin America: Gross Fixed Investment, 1977–2000*



Source: Author's calculations, based on ECLAC figures, scaled to constant 1995 prices.

ance of the binding external constraint and the reintroduction of macroeconomic discipline to combat hyperinflation were strongly complementary. The monetary effects of reserve accumulation and the wealth effects of exchange rate appreciation tended to push up aggregate demand, which facilitated the recovery of economic activity. At the other end of the spectrum, capacity underutilization was not significant in Chile and Mexico. Consequently, the positive link between capital flows and GDP growth was not automatic, but rather was contingent on the capacity to transform additional external financing into increased productive investment.

On average, Latin American GDP rose faster in 1991–94 than the expansion of the production frontier thanks to increased capacity utilization. An estimated one-third of the 4.1 percent annual GDP growth in 1991–94 was based on this factor. In 1995, the binding external constraint again became a crucial variable, with GDP growth lagging behind capacity growth. Renewed capital inflows in the following years contributed to a recovery of economic activity, based to some extent on the excess capacity generated in 1995. However, the return of a binding external constraint in 1998–99, particularly in South America, led to a new recession.

One implication of this analysis is that any serious research should control for the huge swings in the rate of capacity utilization when measuring productivity and the performance of policies and reforms. In the presence of excess capacity, recovery naturally yields high private and social returns, but they are built on preexisting disequilibria, that is, on forgone profits, wages, taxes, and employment that exist whenever the economy is operating below its productive frontier or economically potential GDP. Whether economic recovery opens the way to more sustained growth depends crucially on two dimensions. First, the speed at which capacity is expanded—through physical investment, investment in people, and productivity gains—determines future potential growth. Second, the sustainability of the macroeconomic environment that develops during the recovery—namely, exchange and interest rates, current account deficit, domestic financial vulnerability, fiscal accounts, and asset prices—determines whether growth in aggregate demand can be sustained or whether it will be subject to corrections associated with imbalances accumulated during recovery.

Overshooting in Emerging Asia and Latin America

The increased availability of financing in the 1990s removed the binding external constraint that had been responsible for the decade-long recession in Latin America. The bases for growth were not laid down, however, as investment did not increase rapidly and macroeconomic imbalances built up. Effective output thus approached the production frontier, while exchange rate appreciation led to overvaluation.[12] Asset markets also overshot, and a large stock of mostly liquid external liabilities accumulated (see figure 1-2). The region's economies therefore became more vulnerable to future negative external shocks. With some variation, this story applies to both 1991–94 and 1995–97, reproducing the path toward the crisis of 1976–81.

In 1995, the tequila crisis had negligible effects on the Asian region, even in economies with large current account deficits, such as Malaysia and Thailand. Many outstanding researchers and observers therefore asserted in 1996 that such deficits were not relevant if investment ratios and economic growth were high. Several Asian countries had successfully regulated capital inflows and foreign exchange markets for long periods.[13] Economic growth was actually sustained and extremely high. From 1970 to

12. Several Latin American countries implemented sharp import liberalization at the same time that the exchange rate was appreciating. See Ffrench-Davis (2000, chap. 3) and ECLAC (1998, chap. 5; for an English version, see ECLAC 1995). The average import tariff was cut from 45 percent in the mid-1980s to 13 percent in the mid-1990s; nontariff restrictions were also reduced significantly.

13. On Malaysia, Indonesia, and Thailand, see Sachs, Tornell and Velasco (1996); on Korea and Taiwan, see Agosin (in this volume).