

The growing importance of private capital flows to developing countries creates a serious risk of cyclical disturbances to the development process. These capital flows and especially portfolio investment can be very volatile. In a period of expansion when prospects seem rosy, capital inflows can accelerate beyond the absorptive potential of some countries. In addition it can then become tempting for governments and private firms to borrow in international credit markets – sometimes even short-term and denominated in foreign exchange. In that way a serious overinvestment situation can develop, with a large deficit on current account of the balance of payments.

These risks are different for three forms of capital movements. They are limited for direct investment. This can go up and down according to the economic prospects of a country and the psychology of investors. But this capital is invested in real assets and cannot be withdrawn. Portfolio investment, which has begun to play an important role, can be very volatile because of the psychology of investor expectations. And while individual investors can withdraw their money, net withdrawals are only possible in so far as domestic investors are willing to take over their shares, probably at lower prices. Thus, an inclination to withdraw portfolio investment will lead to falling stock prices but only to a limited extent to net capital outflows from the country.

The greatest risks for a country are created by short-term bank loans in foreign currency. For, while borrowers may count – optimistically – on their being renewed, this need not happen. If the confidence of the banks diminishes, they can request repayment; this will immediately cause a net capital outflow on the balance of payments. The consequence of such a credit crisis and the most appropriate remedy for it, will depend on whether the bank loans have mainly been given to the government or to the private sector. The government sector was the main problem in the Latin American debt crisis of 1982. The IMF has tackled this crisis adequately by a combination of adjustment programmes under regular fund drawings with negotiated loan reschedulings by commercial banks.

The Volatility of Private Capital Flows to the Developing Countries

*Lessons from
the Asian Crisis*

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The present credit crisis in East Asia has a very different character. It is mainly caused by short-term bank lending in foreign currency to a large number of local banks and businesses. These bank loans served mainly to finance private investment, not government deficits. It was a situation of over-investment, stimulated by optimistic expectations in the climate of rapid economic development. Such a situation bears the seeds of a crisis in it. Sooner or later over-optimistic expectations will be disappointed. Bottlenecks may appear; profit margins may not come up to expectations; over-optimistic investment projects may fail and – or as a consequence of some disappointments – capital inflows will not increase but decrease, so that exchange rates, which may already have become somewhat overvalued, come under pressure. This can then easily undermine investors' confidence to such an extent that foreign investors try to withdraw some of their money, leading to a stock-market crash in addition to the currency crisis. And as foreign banks will then refuse to renew their short-term loans, a dramatic liquidity crisis will also develop with many business failures as a consequence.

This kind of crisis has the same character as the classical overinvestment crisis at the upper turning point of many nineteenth century business cycles in the industrial countries. But developing countries run a greater risk in the present financial system. While in business cycles in the nineteenth century overinvestment was mainly caused by a large expansion of internal bank credit,¹ some developing countries now finance their investment boom in addition through portfolio investment and bank credit from abroad. These flows originate in international capital markets that are of enormous size in comparison to these economies. And besides the large internal capital markets of the advanced countries, there is the highly elastic supply of international credit in the unregulated Euromarket. (Witteveen 1995, pp.419–431.)

This market, like money-creating banks within a country, can create additional international liquidity. Additional lending can always be financed through the Eurodollar market because part of it

will be redeposited automatically, while the rest, flowing back to the United States, can be attracted easily to the Eurodollar market by a minimal increase of interest rates. As I explained earlier, this lending in the Euromarket will therefore not form a capital movement out of the United States, but it will create international credit and liquidity (Witteveen 1995, pp.423–24). This may have been an aggravating factor in the present Asian crisis.

All this gives mass-investment psychology enormous scope to cause inflows and outflows of capital of a magnitude that can overwhelm completely the financial systems of these still relatively small economies. It goes without saying that corruption or cronyism in government or in the banking system greatly increases the risk of overambitious and failed investments.

The IMF has come in with great courage and massive financial support to contain and solve the crisis. But its approach seems to have been ill-fitted to the particular character of this crisis. It has been unable to prevent dramatic currency depreciations, which renders it practically impossible for many businesses to make the required repayments on their bank loans, which now need a multiple amount of local currency. The reason is that the IMF did not see its way to arrange a rescheduling of bank loans, as they were scattered unclearly over a large number of borrowers. Neither was the disbursement of the financial support sufficiently adjusted to the repayment needs of short-term debt and speculative outflows. The hope was that tough conditions of fiscal and monetary restraint and structural improvement in the financial system would restore market confidence and exchange-rate stability. But instead, market participants were frightened by the serious recessionary consequences of the liquidity crisis combined with restrictive IMF conditions. In fact, the apparently unforeseen recessionary consequences of the liquidity crisis became so severe that most of the restrictive measures the IMF prescribed were unnecessary and only worsened the downturn. The result was an extraordinary fall of exchange rates in the affected countries, making the liquidity crisis extremely serious. There was then no alternative to some debt

¹ The crisis of 1873 in the United States was quite similar to the present Asian crisis and very serious

because European investors pulled out their money. (C. J. Bradford, 13 February 1998.)

rescheduling and that was instigated informally by the Federal Reserve and other central banks.

In this way the crisis is causing a serious recession or even depression with grave social problems because of business failures and rising unemployment. It will take a number of years before economic growth can start again. As a consequence, the convergence of growth between advanced and developing countries that was just beginning will probably have to be postponed for a few years.

However, we can hope that the painful IMF programmes will by then have eliminated serious weaknesses in the economic and financial systems of these countries. Greater openness, competition and integrity, together with an improved quality of financial services and banking supervision, would then give better prospects for healthy and balanced growth.

The question remains, whether and how such painful disruptions of the development process can be prevented or limited in the future. Such questions are now being explored and debated in different official gremia. One proposal is to improve information. This is the easiest approach; but a great deal of information has already been available. Alexander Lamfalussy noted that BIS data had signalled fully the worrisome increase of short-term debt in Asia; but these published warnings from the BIS were ignored (Lamfalussy, *International Herald Tribune*, 16 February 1998).

Nevertheless, there seems to have been confusion about the total short-term debt of particular countries. The figure that would be essential in this respect is net short-term foreign exchange debt of a country compared to its foreign exchange reserves. Comprehensive figures for this magnitude should be calculated by all central banks and made publicly available.

But, then, if – notwithstanding this information – warnings are ignored and short-term lending continues to grow dangerously, restrictive monetary policies should be focussed on these specific credit flows. This could be done on both sides: in the receiving and in the source countries. Central banks in the receiving countries affected by the crisis could, for example, impose non-interest-bearing

foreign exchange deposits with the central bank on additional borrowing. At the same time monetary policy should become generally restrictive and part of the capital inflow should be sterilised. On the other side, central banks in source countries could impose such foreign exchange deposits on further lending to the risk countries. These restraining monetary policies should be internationally coordinated by the IMF and BIS. Such a cooperation could create a nucleus for a more systematic surveillance system for international liquidity, where the focus would become more global: i.e. the total increase of international credit and liquidity. This will become increasingly desirable. As I argued earlier, the central banks' exclusive focus on their own money supplies is no longer sufficient in our internationally integrated financial markets (Witteveen 1995, pp.429–30).

Finally we can ask what the best approach would be if a similar crisis were to develop in future, notwithstanding warnings and restraining policies. Two questions arise here:

1. Should the IMF be able to act more forcefully against speculative capital outflows? We have seen how seriously exaggerated depreciations of a currency can dislocate the economic and financial system. To counter speculative outflows and maintain the exchange rate within a reasonable range a larger part of the IMF's financial support should be available on a sufficiently large scale immediately – and not meted out gradually in successive instalments. This could to some extent diminish the power of the IMF to enforce correct performance under its conditions. But in those cases where the problem emerges through capital outflows, there is less need for restrictive measures. With respect to structural problems, conditionality should still be required; and part of the financial assistance should still be disbursed over time under performance criteria. Exchange rates should be a central concern of the IMF. In recent developments the stability of exchange rates seems to have received insufficient attention.
2. Problems of short-term bank loan repayments should be tackled at the same time. The international financial community could design an internationally accepted rescheduling mechanism – also for private bank debt – under IMF

guidance and related to IMF programmes. Such a mechanism would provide essential help in preventing a melt-down in currency markets, while limiting the amount of financial assistance that would have to be made available by the IMF. It would also lead to a more equitable distribution of pain among debtors and creditors which would at the same time remove or reduce moral hazard. In this field, the global economy demands the creation of international institutions, comparable to those that we have inside countries. There are essential tasks here for international monetary cooperation. Further healthy growth in the global economy will be more and more dependent on this cooperation.

References

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