

Asia's 'Victorian' Financial Crisis

Michael Howell

1 The Global Background and Causes of the East Asian Crisis

'From 1919 to 1921 the losses of American speculators fed Europe But the practice of foreign investment, as we know it now, is a very modern contrivance, a very unstable one, and only suited to peculiar circumstances.'
John Maynard Keynes

There are three broad explanations given for the Asian crisis:

- *Fixed Exchange Rates* Their widespread use increased the mobility and leverage of global capital
- *Command Economies* State economic planning added to excess regional industrial capacity and limited the normal economic adjustment mechanisms
- *Speculative Attack* Large amounts of international capital quit Asia

In my view, each of these explanations contains some truth. However, none tells the complete story. Fixed exchange rates worsened the crisis, and, at the margin, state economic planning did not help. But speculative selling of Asian investments did not occur randomly; rather it was a result, not a cause of the crisis.

The real reason for the crisis was surplus (not deficient) global capital, particularly Japanese capital, which, saddled by falling investment returns at home, swiftly migrated into the smaller Asian economies; Japan, with its ageing population and high savings rates, suffered protracted overproduction problems. This led to rising exports and investment in other Asian countries. Japanese investment flows and the inflows from other developed economies that came in its wake pushed investment rates in East Asian emerging markets to unsustainably high levels. The immature financial systems of these countries leveraged these inflows into a rising spiral of speculative investment, and East Asia now is facing overproduction problems of its own. Moreover, the reorientation of Japan towards the region's countries as well as the rising importance of China suggest that East Asia is increasingly becoming a self-contained regional bloc.

Figure 1: Private sector financial capital flows to Asia, 1994–98E' (US\$ billion)

	1994	1995	1996	1997	1998E	1997 as % GDP
China	-8.3	-13.5	-17.8	-25.3	-38.0	-3.4
Hong Kong	15.3	25.2	11.0	32.2	12.9	20.9
Taiwan	3.5	-6.5	-12.0	-9.5	-0.2	-13.3
Korea	11.6	17.5	27.2	-13.0	-28.5	-2.8
Singapore	-6.1	-8.5	-7.2	-15.5	-11.2	-16.4
Malaysia	-1.7	1.3	2.8	-14.0	-6.4	-14.2
Thailand	12.0	19.3	15.1	-10.8	-8.9	-5.9
Philippines	2.7	-0.1	7.8	0.3	1.0	0.4
Indonesia	2.1	4.8	4.9	-6.7	-8.7	-3.0
Japan	-84.0	-31.9	-10.9	-53.4	-57.0	-1.2
Asia ex. China	39.4	52.9	48.8	-36.9	-34.2	-2.7
ASEAN 5	9.0	16.8	22.6	-46.7	-34.2	-6.8
ASIA TOTAL**	31.2	39.4	31.0	-62.2	-87.9	-2.9
China & HK	7.0	11.7	-6.8	6.9	-25.1	0.8

* E = Estimate ** Asia Total excludes Japan

Source: *CrossBorder Capital*

2 The Evidence: How Much Capital Really Fled From Asia?

2.1 Aggregate financial outflows

Ironically, it was ultimately capital inflows, not capital outflows, that caused the Asian crisis. Capital outflows are merely the expression of problems and the transmission mechanism. *Nonetheless, given last year's sharp falls in both currencies and asset prices, a key question is how much private capital actually flowed out of Asia?* If it did, which asset classes suffered most? And, who was doing the selling? According to popular myth, the culprits were US funds fleeing the domestic equity and bond markets. But Asia has few sizeable bond markets, and we doubt whether the stock markets had sufficient liquidity to facilitate much selling in practice.

Figure 1 shows that Asian countries suffered a huge outflow of private financial capital (stocks, bonds and banking flows, but excluding Financial Direct Investment (FDI) in 1997.¹ Total outflows in 1997 were roughly equal to the two previous years' net inflows. Japan also suffered large net outflows last

year. China and Malaysia suffered the largest outflows, but Hong Kong and the Philippines actually saw net inflows. Hong Kong attracted capital because it was most likely seen as the 'safe haven' market last year. However, the more protracted the Asian crisis the greater the odds that Hong Kong will also be affected.

These worries appear to be confirmed from the pattern of flows so far in 1998. The projections shown in Figure 1 have been extrapolated using data from January through April. Disturbingly, the Asian crisis shows no signs of abating. Indeed, problems appear to be worsening in China, Hong Kong, Korea and Indonesia.

Figure 2 examines data on monthly outflows. These show that November and December 1997 were the heaviest months for net selling, although July and August were also bad. The crisis appears to swirl around the region, even though Malaysia, for one, suffered seven consecutive months of outflow from July 1997 to January 1998. For example, Thailand's worst month was November 1997, whereas Korea

¹ These capital flows are implied numbers. I have estimated them using data on foreign exchange reserves, current account positions, net foreign direct investment

(FDI) and IMF lending. Private sector capital flows are taken as the balancing item.

Figure 2: Private sector financial capital flows to Asia, monthly 1997–98 (US\$ million)

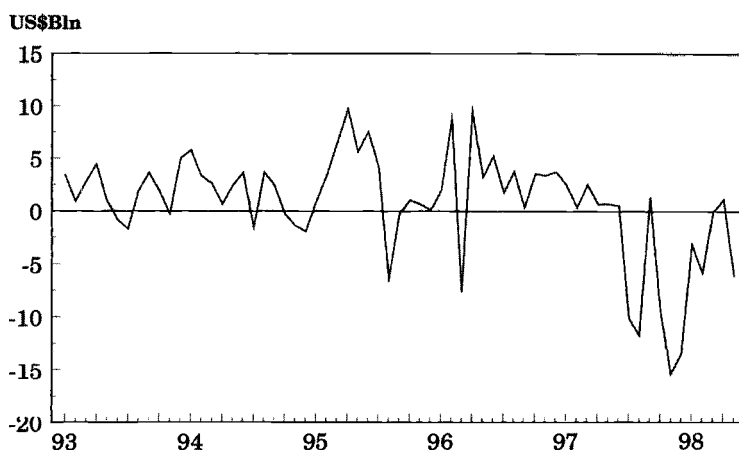
	China	Hong Kong	Taiwan	Korea	Malaysia	Singapore	Indonesia	Thailand	Philippines
1997									
May	-1914	270	827	3073	-471	210	431	-3544	139
June	-2009	7852	-215	1902	245	-988	-51	-481	118
July	-339	-930	-1620	563	-4055	-2474	28	-1465	-1767
August	-1040	3870	-1406	-822	-1762	-3632	-826	-6251	905
Sept.	-1954	3070	-2410	-31	-1417	-625	1130	3883	855
October	-1915	3570	-3289	973	-1463	-3979	-2540	1679	-535
Nov.	-4674	5370	-331	-6485	-1354	-1286	-4238	-5212	114
December	-3249	-3430	-82	-18429	-3469	-128	-2082	-158	-946
1998									
January	-3884	5321	192	-1785	-2660	-872	1082	-941	-148
February	-4536	-1237	-152	-3999	1107	-1460	-3217	-1184	499
March	-2230	371	-427	-844	-18	-90	-549	524	81
April	-2008	-150	321	-2870	-570	-1315	-208	-1353	-104

Source: *CrossBorder Capital*

and Hong Kong were both hit hard in December 1997. Overall the Philippines suffered least. It incurred only five months of net outflow in the 12 months to April 1998. This contrasts with Taiwan and China, which saw 11 and 12 months of net outflow, respectively, over the same period.

The crisis visibly started in May 1997 in Thailand, which that month saw a US\$3.5 billion capital exodus. The Thai stock market, in fact, peaked on 18 May, following a period, lasting some 10 days, when the yen surged higher by around 10 per cent. Events temporarily settled down in June, before capital fled from Malaysia, Singapore and Taiwan in July.

Figure 3: Private financial capital outflows from Asia, monthly 1993–98 (US\$ billion)



Source: *CrossBorder Capital*

Figure 4: Aggregate net private sector financial flows to Asia, 1997–98 (US\$ million)

	Japan	Asia excl. China	ASEAN 5	Asia	China & HK
1997					
May	-2342	934	-3236	-979	-1644
June	-3980	8382	-1157	6373	5843
July	-4926	-11721	-9733	-12060	-1269
August	-3273	-9924	-11566	-10964	2830
September	-3468	4456	3827	2502	1116
October	-2712	-5582	-6837	-7497	1655
November	-5146	-13421	-11976	-18095	696
December	-13299	-28723	-6783	-31972	6679
1998					
January	-4716	189	-3539	-3695	1437
February	-4009	-9641	-4253	-14177	-5773
March	-4783	-952	-52	-3183	-1859
April	-5478	-6248	-3549	-8256	-2158

Source: *CrossBorder Capital*

Generally, the Asian crisis has two halves:

- May through October 1997 when ASEAN 5 countries (Thailand, Malaysia, Philippines, Singapore and Indonesia) accounted for the bulk of capital outflows
- November 1997 through April 1998 when China and the North-East Asian economies, particularly Korea, explain most of the outflow

Data problems make it difficult to break these private capital flows down further in order to see: (1) which specific asset classes were being sold, and (2) the nationality of investors doing most of the selling. However, I have tried to piece together the pattern of flows from four other sources:

- US Treasury data on the investment flows of US residents
- BIS (Bank for International Settlement) data on the change in net BIS area bank liabilities to Asia
- IMF data on new international bond issues by Asian borrowers
- Provisional international equity flows from *CrossBorder Capital's* database.

2.2 Activity of US investors

US investors have featured among the most active securities' market participants in recent years. However, US Treasury data indicate that US investors sold neither Asian stocks nor bonds during the 1997 crisis. Indeed, in both the third and fourth quarters of last year US investors bought nearly US\$2 billion of emerging Asian stocks, and during the third quarter they accumulated over US\$5 billion of Asian bonds. What's more, stripping out Hong Kong and Singapore shows that US investors consistently added cash into the smaller Asian markets.

I have argued before that US Treasury data fall short in their coverage (i.e. they exclude most hedge fund activity and the activities of off-shore managed ERISA funds). Nonetheless, these numbers are remarkable. There are, however, signs of last year's Asian crisis revealed in data on gross (i.e. turnover) as opposed to net flows by US residents. These show a jump of around one-third in activity levels for both bonds and stocks during the third quarter of 1997. In fact, the smaller Asian markets saw activity levels by US residents leap by almost one-half. This suggests that money was reshuffled both within and between the Asian markets. See Figure 5.

Figure 5: Net (new money) and gross purchases (turnover) of Asian (ex. Japan) stocks and bonds by US residents, 1997–98 (US\$ million)

	Net purchases				Gross purchases			
	*97:Q2	97:Q3	97:Q4	98:Q1	97:Q2	97:Q3	97:Q4	98:Q1
Equities	469	1810	1729	2698	32577	44662	33725	32730
Of which:								
Hong Kong	-387	-30	1170	2075	17347	24946	19426	17881
Singapore	217	957	31	-888	4825	7545	5837	5974
Other	639	883	528	1511	10405	12171	8462	8875
Bonds	2181	5182	713	27	15095	20172	13099	9721

* Q = Quarter
Source: *US Treasury*

Figure 6: Change in BIS area banks' net assets (exchange rate adjusted), 1997 (US\$ million)

	97:Q1	97:Q2	97:Q3	97:Q4	1997 year
China	4393	3747	4525	-1903	10762
Hong Kong	-7574	27481	-4585	-8333	6989
Taiwan	2010	1680	-1805	-1743	142
Korea	310	1245	-1018	-17376	-16839
Singapore	-9091	4197	960	-13336	-17270
Malaysia	3937	3176	3255	-3291	7077
Thailand	-541	1033	-10522	-8413	-18443
Philippines	846	2491	-2358	204	1183
Indonesia	2698	4336	4635	-4319	7350
TOTAL	-3012	49396	-6913	-58510	-19048
Ex.China	-7405	45639	-11438	-56607	-29810
ASEAN 5	-2151	15233	-4030	-29155	-20103
China & HK	-3181	31228	-60	-10236	17751

Source: *CrossBorder Capital*

Indeed, this observation appears to be borne out by a closer examination of Figure 2. Hong Kong was a consistent recipient of cash, at least until December 1997. What's more, surges in capital into Hong Kong broadly correlate with outflows from the ASEAN 5 economies, and notably from Singapore and Malaysia. Figure 5 confirms that US investors, at least, were net buyers of Hong Kong stocks in the six months to end-March 1998.

2.3 Debt flows

Figure 6 shows net banking flows from BIS² area

banks to Asia. These flows represent the changes in bank assets minus the change in bank liabilities, adjusted for currency changes. According to the data, BIS area lending to Asia surged during the June quarter of 1997, but turned down in the following three months before plunging rapidly by a whopping US\$58.5 billion during the December quarter.

Overall, 1997 saw banking outflows from Asia totalling US\$19 billion. Outflows were concentrated in Thailand, Korea and Singapore. Every Asian country except the Philippines saw banking outflows

² The BIS broadly consists of the central banks of the

major Western countries plus Japan.

Figure 7: Net equity flows to emerging markets, 1991–98F (US\$ billion) – regional breakdown

	1991	1992	1993	1994	1995	1996	1997E*	1998F**
Hong Kong & China	4.1	4.5	14.3	9.1	3.4	16.3	5.0	10.0
Singapore	-0.2	1.4	2.8	0.4	0.2	0.5	2.5	2.0
Other Pacific Rim	0.9	5.0	23.0	6.8	9.5	12.4	4.5	8.0
Latin America	11.2	9.6	20.0	15.6	4.0	8.8	10.0	8.0
Eastern Europe & Russia	0.1	0.0	1.0	3.2	2.9	4.0	5.0	3.0
Indian Sub-Continent & Sub-Saharan Africa	-0.8	-0.5	2.3	4.9	5.7	4.0	2.5	4.0
Other emerging markets	0.6	1.2	-1.1	3.0	1.5	2.2	4.0	2.5
TOTAL	15.8	21.2	62.4	43.0	27.2	48.2	33.5	37.5
% change	19.7	34.2	194.3	-31.1	-36.7	77.2	-33.5	17.9

* E = Estimate ** F = Forecast

Source: *CrossBorder Capital*

during the final quarter of 1997. For the year taken as a whole, three countries – Thailand, Korea and Singapore – explain the entire net outflow.

Asia also issued US\$44.5 billion of bonds in international markets during 1997. Korea proved the largest issuer with US\$13.6 billion, followed by Hong Kong and Indonesia with US\$7.8 billion and US\$5.8 billion, respectively.

2.4 Activities of non-US equity investors

Three other equity investor types must be considered: (1) UK-based funds, which traditionally have favoured Asia; (2) US hedge funds, located for tax reasons outside of the USA, and (3) local Asian investors.

No definitive data are yet available to confirm the actions of these investors. However, survey evidence undertaken by *CrossBorder Capital* suggests that UK based open-ended mutual funds were probably small net sellers in 1997. British closed-end funds typically enjoy a fixed and specific mandate, and this probably prevented them from exiting the Asian region last year. British pension funds, including money run under US ERISA mandates, were possibly small net buyers.

Similar anecdotal evidence from hedge funds suggests that they were not large net sellers of Asian stocks in 1997. This was not because they were positive on the markets, rather because it is practically difficult to execute 'short' trades in Asia. This would

not have prevented hedge fund managers from short-selling American Depositary Receipt (ADR) and Global Depositary Receipt (GDR) securities listed in New York, nor would it have stopped derivative activity in index futures contracts (e.g. the Hang Seng Index in Hong Kong) and in specialist OTC (over-the-counter) contracts purchases from investment banks. However, none of these activities would have shown up in the above capital flow statistics.

Finally, what of local investors? Japanese funds were likely general sellers of Asian equities in 1997. However, Japan's foreign equity holdings are no longer large. The major cross-border equity trading in Asia occurs between Thailand, Taiwan and Hong Kong. These flows correspond to 'Chinese' private money, based largely in Hong Kong and Taiwan. We estimate that last year probably saw sizeable net inflows of this Chinese money back into Hong Kong.

Figure 7 puts together the *CrossBorder Capital* estimates of net equity flows into Asia last year. Overall, they suggest that a small amount of cash actually flowed into the region in 1997. This may be almost definitional because foreigners had to sell to domestic investors, and domestics were not buying. In short, for every seller there has to be a buyer. Therefore, prices plunged. Other foreigners likely bought the shares at sharply lower prices. *In illiquid markets sharp price falls do not indicate significant selling.* Nonetheless, equity flows in 1997 were sharply below those enjoyed in 1996. Indeed, Latin America and Eastern Europe/Russia were the most

Figure 8: Asian financial market turnover, 1997 (US\$ billion and as a per cent of outstanding market capitalisation)

	Equity turnover	% Volume change	Market cap.	Bond turnover	% Value change	Market cap.
China	n.a.	n.a.	83.8	n.a.		33.3
Hong Kong	453.3	201.0	413.3	0.0	0.0	12.0
Taiwan	1290.0	86.5	296.8	0.7	86.7	32.9
Korea	170.8	55.7	41.9	4.1	140.0	132.2
Singapore	74.1	57.3	106.3	3.9	36.7	171.6
Malaysia	145.3	6.8	93.2	0.9	226.7	1.8
Thailand	24.4	54.4	22.8	0.0	0.0	0.4
Philippines	20.4	-15.4	31.2	0.0	0.0	0.0
Indonesia	42.6	159.4	29.1	0.0	0.0	0.1
TOTAL	n.a.	n.a.	1118.4	n.a.	n.a.	372.3
Ex. China	2221.8	36.3	1034.6	9.6	84.2	339.0
ASEAN 5	306.8	-11.1	282.6	4.8	53.4	173.9

Source: *FIBV* and *CrossBorder Capital*

popular equity areas in 1997. Equity flows to Asia are expected to rebound to US\$20 billion in 1998 from US\$12 billion in 1997.

2.5 Liquidity of Asian stock and bond markets

It seems unlikely that foreign investors could have sold significant quantities of Asian equities or bonds because Asian securities markets lack depth. What's more, the scale of selling implied by the aggregate flow data – circa US\$50-100 billion – is inconsistent with the extent of foreign ownership.

Overall holdings of emerging market equities by cross-border investors total around US\$275 billion, or around 12.5 per cent of the outstanding market capitalisation. At most, around half of these equities would be Asian, i.e. US\$125-150 billion. Therefore, it seems unlikely, even if it were possible to sell, that the bulk of foreign holdings of Asian equities were dumped last year.

Net sales (i.e. purchases less sales) of US\$150 billion would have generated turnover equivalent to at least US\$300 billion (i.e. purchase plus sale). This would have virtually matched the entire turnover in the ASEAN 5 markets for 1997. It would have represented 40 per cent of the turnover in the ASEAN 5 plus Hong Kong and 14 per cent of

all Asian turnover excluding China, but these aggregates include Hong Kong and Taiwan, the two regional markets dominated by local trading.

Therefore, it seems practically impossible for a mass exodus from equities to have contributed significantly to outflows from Asia in 1997. Figure 8 confirms that it is simply not worth looking to bonds for an explanation either, because their turnover is minimal.

Admittedly, there is some evidence of increased derivative activity in Asian markets in 1997, but this jump in trading often comes from a low base. Moreover, derivative contracts are not available for the smaller Asian markets (see Figure 9)

Another 'unknown' and hidden type of equity derivative transaction is 'swaps'. These are often employed by hedge fund managers. A 'swap' transaction involves the portfolio exchanging the return on a specific security or market index for an alternative return, such as LIBOR (London Inter-Bank Offered Rate). This effectively enables the fund to enjoy an enhanced relative return (if it is correctly negative on the stock) without selling immediately. The ultimate sale can be delayed often for several months. The risk of this transaction is carried by the bank that issued the swap. If it were a domestic Asian entity and wanted to 'cover' its exposure, at some stage it could sell short in the local market. Plainly, this short sale would be

Figure 9: Open interest (and percentage increase vs 1996) in Asian derivative contracts, 1997 (no. of contracts)

	Stock options	Index options	Index futures
Hong Kong	214,353 (+320.5%)	33,032 (-41.6%)	66,962 (+73.8%)
Korea	NT	206,904 (+90.9%)*	22,726 (+90.9%)
Singapore	NT	56,794 (+18.5%)	122,510 (-9.6%)
Malaysia	NT	7614 (+480.3%)	NT

NT denotes 'not traded'

* percentage changes for index options and index futures show the same increases. I have calculated the change in the aggregate of both items because stock index options were not traded in 1996.

Source: FIBV

Figure 10: Breakdown of Asian private financial capital flows, 1997 (US\$ billion)

	Bank credit	New bond issues	Other	Total private capital
China	10.8	4.1	-40.2	-25.3
Hong Kong	7.0	7.8	17.4	32.2
Taiwan	0.1	2.7	-12.3	-9.5
Korea	-16.8	13.6	-9.8	-13.0
Singapore	-17.3	1.7	0.1	-15.5
Malaysia	7.1	3.3	-24.3	-13.9
Thailand	-18.4	2.3	5.3	-10.8
Philippines	1.2	3.2	-4.0	0.4
Indonesia	7.4	5.8	-19.9	-6.7
TOTAL	-19.0	44.5	-87.7	-62.2
Ex. China	-29.8	40.4	-47.5	-36.9
ASEAN 5	-20.1	16.3	-42.9	-46.7
China & Hong Kong	17.8	11.9	-22.8	6.9

recorded as a transaction by a domestic investor, not by the foreign entity that is the ultimate beneficiary.

2.6 Comparison with the 1994/95 Mexico crisis

The overall fundamental deficit (current account plus FDI) of the Latin American region peaked at an annualised US\$44.1 billion in November 1994. Mexico alone accounted for over 40 per cent of this total.

Strangely, private sector capital outflows were insignificant compared to Asia's recent experience. Mexico actually recorded net inflows of private capital from May to October 1994. Only November

through January 1995 saw large outflows. These totalled US\$9.7 billion. Indeed, the entire Latin American region lost a mere US\$8.2 billion of capital over this period. With the exception of a significant US\$8.1 billion outflow in March 1995, caused by concerns over Argentina and Brazil, the entire region attracted US\$29.1 billion of private financial capital in 1995. This compares to Asia's US\$62.2 billion 'loss' of private financial capital in 1997.

2.7 Overall Asian private financial flows in 1997

Figure 10 brings together my estimates of private financial capital³ flows to Asia in 1997. I have broken down flows into three categories: (1) bank

³ FDI is excluded

credit from BIS area banks to Asia; (2) new international bond issues by Asia, and (3) other asset flows.

This latter category is a residual, but it is also, in many ways, the most interesting because of its large size. In short, neither bank nor debt flows appear to explain last year's exodus of private capital from Asia. For example, overall I estimate that US\$62.2 billion of private financial capital fled, but 'other' outflows totalled a massive US\$87.7 billion.

What could explain these other flows? We believe that there are two broad explanations:

1. OTC currency derivatives
2. Chinese trade credit

Hedge funds and the proprietary trading desks of many international investment banks plainly made substantial profits from the 1997 Asian crisis. However, the data we gathered on debt and equity flows show few signs of their activity. What's more, the smaller Asian stock markets lack the liquidity to support such large and active trading. The only parties able to provide liquidity of the scale demanded by these speculators are governments when trying to protect their domestic currencies. This is where we must look.

Anecdotal evidence suggests that several hedge funds made their returns from 'short-selling' the Asian currencies, largely with the help of OTC derivative contracts written by major investment banks. In other words, foreigners likely borrowed heavily in local Asian currencies in the expectation that the respective economies would be forced to devalue. They, of course, helped by converting their Asian borrowing into US dollars. The size of these trades would likely be large. What's more, they could be easily absorbed by foreign exchange markets.

However, a recent IMF study* disputes the speculative role played by hedge funds. It argues that hedge funds are comparatively small in aggregate relative to the large size of institutional investors, whose assets total around US\$20 trillion. Latest estimates suggest that hedge funds control some US\$118

billion, or 0.6 per cent of this total, and 'macro-funds' (hedge funds that take currency positions) control a 'tiny' US\$30 billion.

However, what the study misses is that the proprietary trading desks of major investment banks probably control a similar figure, i.e. circa US\$100 billion. Far more of this would be employed in 'macro' trades. What's more, hedge funds and proprietary traders would likely leverage their positions between 3 and 8 times. This suggests that far from controlling merely US\$30 billion, these hedge funds probably control nearer US\$1 trillion of leveraged capital.

This more significant total for hedge fund or 'speculative' capital must be compared to the proportion of the US\$20 trillion that is committed to global investments. This is unlikely to exceed 10 per cent, or US\$2 trillion. In other words, the 'macro' speculators can deploy broadly similar amounts of capital to the more conservative institutional investors, and they will likely trade and position their capital more aggressively and more rapidly.

Therefore, with the possible exceptions of Singapore and Thailand, which saw small 'other' inflows, currency speculation probably explains the bulk of Asia's net private capital outflows in 1997. So, despite the lack of bond markets; the shallowness of many stock markets, and the probable net equity buying by US and possibly some UK investors, the region still suffered a large net outflow of private capital last year.

China and Hong Kong probably should be counted together, particularly given the well-known problems of determining where Chinese capital outflows end and where Hong Kong's capital inflows begin. But when the data for both countries is combined, there is an aggregate net 'other' outflow of US\$22.8 billion for 1997. Plainly, some of this outflow may have arisen because of speculative activity against the Hong Kong dollar. However, there is another, more compelling, answer.

China currently runs a whopping trade surplus – circa US\$30 billion – with the USA. Indeed, many

* See: 'Hedge funds and financial market dynamics',

IMF, May 1998.

Figure 11: Capital flows to developing countries, 1990–98F* (US\$ billion)

	1990	1991	1992	1993	1994	1995	1996	1997E
Private financial flows	29.8	32.0	57.1	107.2	87.9	83.9	170.6	156.5
Portfolio flows	15.5	25.9	31.1	98.3	72.3	55.7	128.1	108.5
equities	13.2	15.8	21.2	62.4	43.0	27.2	48.1	33.5
bonds	2.3	10.1	9.9	35.9	29.3	28.5	79.9	75.0
Commercial banks	3.0	2.8	12.5	-0.3	11.0	26.5	34.2	45.0
Others	11.3	3.3	13.5	9.2	4.6	1.7	8.3	3.0
Official financial flows	56.3	65.6	55.5	55.0	45.7	52.9	40.8	100.0
Total financial flows	86.1	97.6	112.6	162.2	133.6	136.8	211.4	256.5
Foreign direct investment	32.8	41.7	49.6	73.0	90.4	96.3	128.7	125.0
TOTAL CAPITAL FLOWS	118.9	139.3	162.2	235.2	224.0	233.1	340.1	381.5
Private flows as % of total flows	25.1	23.0	35.2	45.6	39.2	36.0	50.2	41.0
Equity flows as % of total flows	38.7	41.3	43.6	57.6	59.6	53.0	52.0	41.5
Portfolio as % of total flows	13.0	18.6	19.2	41.8	32.3	23.9	37.7	28.4

* F = Forecast

Sources: *CrossBorder Capital*, *World Bank* and *BIS*

commentators cite this fact as a measure of China's economic success. But, strangely, the Chinese firms that are producing this economic miracle remain obscure. Surely, the names and identities of at least one or two Chinese multinationals would roll off the tongue? They do not, and the simple reason is that these firms probably do not exist.

This is not to say that China's large bilateral trade surplus is fictitious. Rather, it suggests that these companies may be US transplant factories, operating in China and shipping the goods back to America. In this case, these firms probably obtained their working capital domestically in China. This would be equivalent to a US company borrowing from China and would cause foreign net assets in China to fall, thereby explaining the large 'other' outflow. Conveniently, these figures are of similar magnitudes.

3 Trampolines Not Shock Absorbers

3.1 Two types of crises

Financial market crises fall into two categories: crises of economic success and crises of economic failure. Paradoxically, the latter are rare. World financial history is dotted with crises generated by economic success. Victorian Britain experienced recurring ten-year financial crises that punctuated a

long period of sound economic growth. The 1929 Wall Street crash was another example. It followed the 1920s boom and led on to banking failure and deep depression. Indeed, the 1994/5 Mexican and 1997 Asian crises similarly resulted from too much capital inflow following economic success. In these two latter cases, visible economic success explains why the IMF, the World Bank and other pundits failed to foresee the subsequent financial crises.

Too much money unquestionably creates problems for emerging markets. This is the paradox of the 1990s. At the start of the decade, the major concern among emerging markets was a lack of capital, but today the chief worry is having too much, and particularly too much low-quality capital. Emerging markets: (1) are too dependent on foreign finance, and (2) much of their recent foreign inflows have consisted of low-quality, short-term flows.

Consequently, both their currencies and their financial markets have suffered from extreme bouts of volatility. Interestingly, the two years following surges in aggregate flows to emerging markets, namely 1994 and 1997, were years of crisis for the sector. In both 1993 and 1996, flows to emerging markets jumped by around 45 per cent, or well above the typical 10–20 per cent annual rise (see Figure 11).

What's more, because many emerging financial systems act as trampolines rather than shock-absorbers, when global capital floods into a successful economy its effects are magnified many-fold. The results are a consumer boom and a swelling trade deficit, or a long period of overinvestment (in securities, real estate and new capacity) that culminates in severe debt and banking problems when these schemes are discovered to have been ill-judged. But the common ending is always a real devaluation. *Not surprisingly, every major emerging market crisis of the last ten years has featured a plunging currency.*

3.2 The crisis model

Currency fragility occurs because emerging economies typically have underdeveloped financial markets, both absolutely and relative to the size of their domestic economies. In short, the depth, i.e. liquidity, as well as the breadth, i.e. choice of instruments, of financial markets is lacking. In our view, this explains much of the emerging markets' higher relative risk characteristics. It becomes a particular problem when large foreign investors suddenly wake up to mouth-watering investment opportunities in small, emerging countries and try to plough in vast volumes of liquidity.

Put simply, many emerging markets have insufficient domestic financial instruments and too shallow domestic financial markets to sterilise the effects of large foreign inflows. Because foreign currency is a reserve asset of the domestic banking system, it can then be leveraged up several times, forcing domestic credit growth to soar. Thus, after a downpouring of global capital there are just too few mops and buckets available locally to mop up the foreign liquidity. The floods are simply too big, and they swell more as domestic rivers and reservoirs break their banks.

This problem is highlighted in the asset composition of the monetary bases of emerging economies. *In emerging markets, the ratio of foreign exchange reserves (a national asset) to the monetary base is substantially higher than in developed economies (140 per cent compared to 70 per cent).*⁵ In developed economies, other domestic assets, such as

government bonds and bills, comprise the bulk of the monetary base. Open market operations are undertaken by the Central Bank in these asset types in order to sterilise the monetary effects of foreign inflows. Plainly, if there are no domestic assets, or only very thin markets exist in them, full sterilisation cannot occur and a domestic liquidity boom may be triggered.

3.3 Mexico and Asia revisited

Multinationals and foreign pension and mutual funds poured new investment into the emerging economies during 1993–95. In an open and competitive world economy, excess liquidity is more likely to lead to more consumption or more investment, than to express itself in higher inflation. Indeed, more consumption and more investment were the two problems that, respectively, hit Latin America in 1994–95 and Asia in 1997.

With its higher propensity to consume, Latin America, and most notably Mexico, quickly blew these funds on imported consumer goods. Heavy consumer demand, fuelled by this cash, sucked in imports which caused Mexico's trade deficit to spin out of control. Foreign exchange reserves fell heavily, triggering a currency crisis. *Mexico was a classic excess demand problem.* Excess consumer spending is a short-term problem that can be speedily tackled by currency devaluation and other wealth destruction, such as falling equity prices, inflation and higher taxes. Not surprisingly, after savage falls in spending in 1995, Mexican GDP was able to bounce back to a healthy near 8 per cent rate by 1997, led by strong export sales.

Whereas Latin America suffered a short sharp shock, Asia has endured a protracted slide. Her problem was excess supply not excess demand. Asia's 1997 overproduction crisis was radically different in character to Mexico's, although its roots were the same: excess liquidity. *Fast-growing economies are prone to overinvestment, and overinvestment breeds overproduction.* Britain suffered in the mid-Victorian period. Germany was a victim in the late nineteenth century. America experienced an investment boom in the 1920s, as did Japan in the 1980s. Each episode coincided with a major financial crisis.

⁵ More dramatically, the foreign reserves to monetary base ratio ranges from 12 per cent for the US to 605

per cent for Singapore.

Excess savings result in unusually low interest rates, and more specifically they encourage a wide gap between the expected return on investments and the cost of funds. Not surprisingly, fixed investment spending vaults higher. Thus, Thailand's near 45 per cent fixed investment share of GDP was the counterpart to her 8 per cent capital surplus (i.e. current account deficit). But Thailand was not alone: typically, overinvestment became most pronounced among the lower value-added producing countries in East Asia. Thailand was by far the worst culprit. She directed a whopping 43 per cent of GDP into fixed investment, on average, over the three years to end 1995. Thailand just edged out Korea and Singapore, which recorded investment rates of 37 per cent and 36 per cent, respectively.

With so much new capacity slated to come on stream at once returns were soon dented severely. And with disappointing profits, debt defaults began to escalate.⁶ Five years further on, Japan was still adjusting to a similar glut of capacity that was left over from the late 1980s.

Nonetheless, Asia's crisis presents a puzzle: either financial markets completely mistimed their reaction to the region's financial troubles, or some other influences were at work. For example, a key measure of economic disequilibrium, the fundamental balance (the current account adjusted for the large imports of capital goods associated with FDI) peaked at a deficit of US\$48.9 billion in 1996, the year before the Asian financial crisis. During the crisis year, the deficit improved radically to US\$20.7 billion, and Asia looks set to record a fundamental surplus touching US\$40 billion this year.

If financial markets have perfect foresight, surely Asian share prices should have tumbled ahead of the huge 1996 deficit and should be soaring now? That neither is true suggests that something else is going on. The most likely explanation is that the roots of the Asian crisis centre on skidding domestic demand in Japan and China during early 1997, rather than on policy botch-ups by Thailand, Korea and Indonesia. China and Japan together add up to a massive four-fifths of Asian GDP in what is a highly integrated economic region. Japanese firms, for example, operate a network of assembly

industries across the region and are among the largest employers in both Malaysia and Thailand. *In short, core Asia's demand slowdown exposed regional overproduction and punished capital returns in the emerging Asian rim.*

3.4 Regional contagion

Private sector capital flows are increasingly procyclical. Strong economies attract capital; weak economies repel capital. Shifts in capital between regions, based on actual and perceived changes in economic fundamentals, have lately been more important than swings in the supply of new global liquidity through falling world interest rates.

These regional shifts of capital occur along three axes, where each axis relates to a core economic zone, i.e. the US, Japan and core Europe (i.e. France, Germany and Benelux). Each core economy dominates a region of closely tied but smaller neighbouring economies. Economically (and often geographically) more distant, but still affiliated to the core economy, sit regional emerging economies. Thus, each major region has a developed economy at its core, e.g. the USA; the core economy's currency, i.e. US dollar, dominates regional transactions, and around the core is an emerging economic periphery, i.e. Latin America.

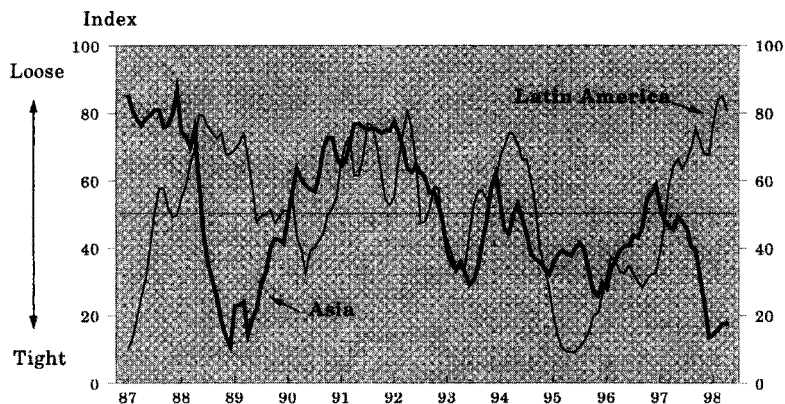
Thus, capital mainly flows between these core economies. Consequently, the Yen–US dollar, Euro–US dollar and Yen–Euro cross-rates are the three main currency cross-rates. *The regional periphery is economically leveraged to flows into or out of its respective core, because the monetary base of the fringe largely consists of core financial assets.* Thus, capital outflows from Japan will have a significantly worse effect on Thailand than on Japan itself. Similarly, capital inflows into the Euro will likely boost the Spanish economy and Spanish financial markets more than core Europe's.

In 1997 global capital quit Asia because of the region's relative economic weakness. US supply-side strength (i.e. rising returns on physical capital) attracted sizeable capital inflows into the US dollar. Asian outflows were accelerated by the weakness of the core economies of Japan and China. Capital

⁶ Asia's private debt to GDP ratio in 1997 was far higher

than Latin America's in 1994.

Figure 12: Financial liquidity conditions – Asia versus Latin America, 1987–98 (indexes)



Source: *CrossBorder Capital*

flowing into the US dollar zone helped to buoy the US currency and boost regional liquidity, especially in the leveraged Latin American fringe. Not surprisingly, our liquidity indexes show strong gains in Latin America over the last year.

The reverse side of this picture is the simultaneous fall-off in Asian liquidity conditions. Thus, as money is sucked from Asia's financial core, the fringe economies suffer a more dramatic liquidity meltdown. As Argentina and Mexico enjoyed a rush of money in 1997, Thailand and Korea experienced plunging liquidity (see Figure 12).

4 The Growing Need For Financial Development

Developing countries must have the means to absorb large foreign funds productively: (1) without rapidly driving up their real exchange rates and thereby wrecking the growth prospects of export industries, and (2) without the extra cash triggering a short-lived economic boom and bust.

In order to preserve trade competitiveness, most emerging countries have chosen to manage (i.e. limit) the movement of their currencies, typically versus the US dollar. However, by solving one problem they have created another, potentially worse, problem. Under managed exchange rate regimes, foreign liquidity inflows often have multiplicative effects on domestic credit markets which subsequently spill-over into spending, thereby de-railing

economic progress. These fierce liquidity swings are a recurrent problem for many emerging countries.

The remedy must involve some combination of:

- More enlightened currency management, e.g. more flexible exchange rates, such as a wider target band, or pegging to an appropriate regional core currency with shared intervention
- The deepening and widening of domestic financial asset markets
- The 'export' of the domestic capital markets
- The limitation of volatile speculative global capital inflows.

In the wake of the Asian crisis, the IMF is currently touting ways to limit capital flows. Citing Thailand's recent financial deregulation as an example, some even argue for slower financial liberalisation in emerging markets. However, while many would be sympathetic to the ideal of reducing speculation, in practice it remains difficult to police and likely to re-introduce distortions into capital-asset pricing. It is also a case of kicking the dog to hurt the cat, because it misses the real issue concerning the financial immaturity of emerging financial markets. *Consequently, any attempts to correct financial market volatility must focus on currency arrangements and domestic capital market development.*

4.1 New currency arrangements

But most emerging economies are, by definition, too

small to qualify for sufficiently deep capital markets to cushion global savings flows because their savings bases are tiny. Consequently, they need to consider more flexible currency policies in order to protect the real economy from liquidity shocks.

National governments are well used to imposing a currency on their domestic economy. But in the global economy, the currency of choice is determined by the markets, and now overwhelmingly by financial markets. Hence, Robert Rubin's publicly confessed awe for world bond investors.

The rise in financial leverage and the associated jump in the value of financial instruments show that more money is held as a store of value than is used as medium of exchange. In short, the volume of financial transactions determines the worth of a currency. This fact should underscore to policy-makers in all markets the need to manage their currencies as stable international stores of value because international investors will demand a strong currency.

The volume of financial transactions in a currency depends on three factors: (1) cheap underlying investment assets; (2) low transactions costs; and (3) a dependable store of value. The first is more a cyclical question and anyway likely to be quickly arbitrated away in efficient markets. Low transactions costs are plainly important, but by themselves they pale against the critical role played by a currency as a reliable store of value.

The key to maintaining a stable store of value is matching supply to demand, or more generally keeping money supply tight. This is a difficult if not impossible task for emerging markets, given their growing need for bank credit for domestic growth, the leverage of their financial markets and the volatility of global capital flows. Only large economies or countries with strong demand growth can control money supply easily.

If a currency's ability to store value is questioned through a monetary policy that allows its value to weaken or fluctuate dramatically over time, then a waiting army of hedge-fund investors, with stores of cheap, leveraged capital, will test the mettle of the monetary authority. Shifts in the perceptions of currency values can trigger rapid and volatile capital

movements, which could be self-sustaining. But a firm, and perhaps even strong, currency policy is likely to demand more supply-side flexibility than most economies can muster.

Therefore, like national airlines, independent currencies are more a luxury than a necessity in a global capital market. Globalisation cannot and should not be stopped. The most obvious answer is for emerging countries to join up to a currency area that is based around a large economy, such as the US, Core Europe or Japan. Regional economies will have to pool their resources and capital markets to form larger units. Together, they can muster the necessary financial clout to defend themselves against currency attack. United they will stand: divided they will fall.

The formation of an optimally sized currency zone depends on two considerations: (1) the interdependence of trade, and (2) the availability of foreign savings. While the first factor is purely economic, the second is largely political. For example, in the current debate over the single European currency, the entry of Portugal is difficult to argue against on economic grounds because a large proportion of Portuguese trade is intra-European. However, why should other European economies use their savings to purchase Portuguese financial assets if the Escudo comes under downward pressure? *Consequently, countries entering into a currency zone must have common economic and political interests.*

With much of her trade and two-thirds of capital flows sourced within the region, it is logical that the Asian currencies form a bloc. The region could share its foreign exchange reserves, and together its combined financial markets have (or could have) sufficient size and depth to absorb likely foreign inflows. But, more importantly, with greater regional economic integration, there would be more willingness among the member countries to allow the pan-regional currency to appreciate or depreciate.

Some action certainly needs to be taken quickly in Asia to reduce the risk of continued crisis. The economic picture in Asia is eerily reminiscent of the problems faced by the Transatlantic economies during the inter-war years (i.e. 1919–39). The

over-capacity problem following the end of the First World War was met by a series of competitive devaluations, as one Western country after another left the gold standard. These divisions led on to protectionism, tariff wars, capital flight and, ultimately, to debt crises. Could the same happen today?

A vicious circle of competitive devaluations would quickly bring on a pan-Asian debt crisis, given that the bulk of external borrowings are denominated in US dollars, and in some of the acute cases, such as Thailand, in Japanese Yen. If future history were to unfold like past history, the likely result would see Japan stepping forward to act as the regional 'lender of last resort', as the United States did after the Second World War. In short, Japan would take over Asia's debts and arrange a (not too difficult) debt work-off programme, in return for the formation of a Yen-based currency zone.

Currency zone leadership would dovetail neatly with Japan's long-run regional ambitions. Like America in the immediate post-war years, Japan today needs to export capital to emerging Asia. As America will confirm, the easiest and cheapest way to do this is, through convenient currency relationships, to 'force the host countries to take your currency, e.g. as much as half of US notes and coins circulate outside the geographical boundaries of America. This way Japan would export her paper currency, not her precious savings.

But Japan currently appears starved of cash and politically reluctant to undertake such a role. Moreover, for cultural reasons, the region may be too cautious to encourage her. Given the parlous state of Japanese banks, it is more likely that the ultimate Asian currency zone is shared between three 'core' currencies: the Yen, the Chinese RMB and the Singapore dollar. *Indeed, the upcoming formation of the Euro may precipitate similar events in Asia.*

For similar reasons, the Eastern European economies should ultimately nestle in with the proposed new Euro, and it makes sense for the Latin American currencies to trade with the US dollar. Currencies would then be fixed (or even abolished) between regional members, but the currencies of each major bloc would float freely against each other.

So, George Orwell may have got it right in his book 1984 when he wrote of the three regional powers: East-Asia, Eurasia and Oceania. Each regional bloc has its emerging economies, its dominant developed economy, and a key currency. With intraregional trade and capital spiralling, it is logical for the smaller economies to take shelter behind a regional giant. In the next century, three Big Brothers could be watching over us!

4.2 'Off-shore' financial markets

There is another solution to the problem of excess foreign liquidity. That is to encourage the development of an international market in securities. One feature of international equity trading data shown in Figure 13 is the growing importance of what we dub 'cross-exchange trading'. These transactions mostly comprise ADR and GDR deals. They arise when a local investor buys or sells a foreign share on an exchange that is not the share's main listing centre. In other words, increasing cross-exchange activity reveals that foreign companies are seeking secondary listings in centres that are close to the pools of global money, e.g. New York and London – together these two centres account for over 90 per cent of all cross-exchange trades.

Last year, over 36 per cent of trading on Africa's Nairobi Stock Exchange was for foreigners. Plainly, this degree of buying and selling of securities between domestic and foreign investors can have dramatic implications for the value of the local currency. Surely, it is better to 'fix' the volume of trading that involves a foreign currency transaction by creaming-off the foreign ownership into a separate class of shares, such as GDRs. These can then be traded between foreign institutions without any foreign currency implications because they are, say, quoted in US dollar terms.

By encouraging the foreign listing of their major companies, emerging countries can effectively export their capital markets and the bulk of foreign speculative activity. This is what Mexico achieved by the US listing of the TelMex company. In the mid-1990s, TelMex became the world's most heavily traded equity security.

The advantage of foreign listing is that new capital can still be raised (and probably more easily), while active buying and selling in the secondary market

Figure 13: Gross international equity flows – value of trading by category, 1991–98F (US\$ billion)

	1991	1992	1993	1994	1995	1996	1997E*	1998F**
Cross-border trading:								4800.0
developed markets	1233.9	1284.1	1910.1	2350.2	2679.9	3435.0	4200.0	550.0
emerging markets	88.6	120.8	356.0	299.1	321.8	315.3	475.0	5750.0
Cross-exchange trading	779.1	968.7	1547.5	1842.7	2049.3	2737.8	5000.0	11100.0
TOTAL	2101.6	2373.6	3813.6	4492.0	5051.0	6488.1	9675.0	5.0
Emerging markets as a % of total	4.2	5.1	9.3	6.7	6.4	4.9	4.9	51.8
Cross-exchange as a % of total	37.1	40.8	40.6	41.0	40.6	42.2	51.7	

* E = Estimate ** F = Forecast

Source: *CrossBorder Capital*

have no capital flow, and hence no currency implications, for the economy. In short, there is a one-off capital inflow into the emerging country as the foreign shares are created. Thereafter, all transactions occur in the 'off-shore' market, e.g. New York, between foreign investors trading what appears to be a US dollar security.

Foreign listing essentially enables the capital-raising function of a stock market to be split from its capital-distribution role. In other words, the capital-raising function is preserved and targeted at those investors, i.e. foreigners, who have surplus savings. What's more, the domestic stock market can still be used as a mechanism of wealth creation and small-scale privatisation for nascent domestic investors.

5 More Debt-Future Cross-Border Capital Flows

The 1997 Asian crisis will radically alter the structure of future cross-border flows. Aggregate portfolio equity flows are forecast to drop below US\$200 billion, while the strong up-trend in FDI flows is severely dented in 1998. Overall, direct and portfolio equity flows are set to drop from nearly 55 per cent of all cross-border flows in 1993 to less than 28 per cent in 1998. The strong rebound in both bank lending and bond flows that we predict itself assumes that the International Monetary Fund (IMF) and World Bank can successfully stem the current Asian crisis and, more importantly, provide some official loans and collateral guarantees. *Indeed, a large part of cross-border flows to emerging markets in 1998 are part of the enormous re-financing that we envisage.*

Surprisingly, our analysis shows that overall capital flows to emerging markets will reach a record US\$445 billion in 1998. In fact, despite the Asian traumas, capital flows in 1997 only slowed from the previous year's 46 per cent leap. *They did not decline.*

However, this rosy overall picture disguises some radical underlying changes. Last year's Asian crisis unquestionably reduced equity flows to emerging markets – both portfolio equity and FDI. Looking ahead into 1998, debt flows will further displace them. The growing importance of debt is partly accounted for by greater bond issuance, but it mostly takes the form of increased bank lending which more than doubles from its 1996 level.

The Asian crisis is unusual in that given the likely giant US\$1–1.5 trillion insolvency bill, the amount of foreign debt is *comparatively small* at around US\$150 billion. With foreign, and particularly Western debt exposure low, foreign banks are likely to have a greater appetite to re-finance on favourable terms. The key criterion that banking groups will watch is debt service capacity. This should be directly related to the re-appearance and size of current account surpluses.

Indeed, the very fact that several Asian economies are either already in, or else close to, current account surplus gives us great confidence that banking inflows will jump higher in 1998. The IMF is also likely to speed the flow of private bank finance by encouraging and policing local economic reform.

Direct lending by the IMF and other multilateral institutions will rise slightly in 1998. But there is understandable unease, especially in the US, about the IMF playing a larger direct lending role. On our estimates, private flows still make up 73 per cent of all emerging market flows in 1998.

Equity's overall share of emerging market flows in 1998 will fall to 31 per cent, its lowest slice this decade. Portfolio equity flows should rebound slightly in 1998, but they remain below the 1996 figure and well below the US\$62 billion peak seen in 1993. Direct investment slides further this year, but mostly for technical reasons associated with the absorption of Hong Kong by China. Nonetheless, the depth of industrial over-capacity in the Asian region explains why underlying FDI inflows slow.

We anticipate a small rebound in equity flows to emerging markets in 1998 to US\$37.5 billion. Last year equity flows to emerging markets slumped to US\$33.5 billion, or close to their lowest share of total cross-border flows this decade. Even in 1998 we anticipate that foreign allocations to emerging markets will barely reach 20 per cent of all foreign equity purchases, compared to a peak of nearly 40 per cent in 1992.

6 Conclusion: Asia's 'Victorian' Financial Crisis

We are living in the Age of Global Capital. In a free capital market, private investors choose which deficits they finance. This competition for funds has triggered a financial beauty contest among prospective borrowers, and thereby underscored the economic reform process as each potential recipient tries to leap-frog over his opponents.

The central theme of this report is that the growth and globalisation of production over the last decade has inevitably brought with it greater international financial leverage. Consequently, the swelling size of the global financial economy has outpaced the expansion of the world real economy. The ratios between financial flows, financial assets and world GDP have all raced higher. *The key result is that as the world economy has got bigger, its financial markets have become more volatile.*

Two particular features are:

- *The jump in the size and velocity of financial money* – because of overproduction, low inflation, ageing/ high savings populations, large institutional investors, and new investment methods, such as derivatives.
- *The rise of regional currency/investment blocs* – economic regions have become the dominant entity in the world economy. Each currency zone must create its own demand.

Contrary to common belief, regional financial bubbles are both endemic to today's financial system and are not the result of errors by local policymakers. Asia does not have a monopoly on bad bankers. Neither do these crises result from speculative selling of stocks and bonds. Asia's domestic markets were insufficiently liquid. I have argued that the huge outflow of capital from Asia in 1997–98 more likely involved sophisticated currency derivatives trade, and some element of trade credit to foreign multinationals operating in China.

Paradoxically, most financial crises, including Mexico in 1994–95 and Asia in 1997, were crises based on economic success and not economic failure. Successful economies attract too much capital, although it fed domestic demand in Mexico and over-capacity in Asia. In fact, there are three ways in which sizeable global liquidity flows create economic instability in financial markets and notably in emerging financial markets:

- *Volatility* These flows are volatile partly because they are affected by global monetary policy shifts and partly because their source is a few large global investing institutions.
- *Leverage* Emerging market financial systems often act like trampolines by leveraging up these inflows rather than as shock-absorbers, and thereby add to the effective size and volatility of flows.
- *Vent* Excess national liquidity is typically dispersed through (a) higher inflation; (b) surging consumer imports and a trade deficit, i.e. a Mexico-like crisis; or (c) an investment boom leading to surplus capacity and falling profits, i.e. an Asia-like crisis.

The solution to the Asian crisis lies in Asia's own hands rather than in the IMF's wallet. The region is crying out for domestic demand, but the demand problem may be structural: Japan's consumers are too old to spend, and China's are too poor and cannot easily be economically enfranchised without radical political change. *Simply put, Asia's savings ratios are too high.*

Throughout the 1990s Asian investment spending was generally buoyant, fuelled by easy monetary policies and strong inflows of FDI. This capacity build-up stood awkwardly against a backdrop of weak domestic demand potential and it looked embarrassingly excessive when domestic demand skidded badly in Japan and China from early 1997.

An immediate solution to both domestic overproduction and domestic overconsumption is a lower real exchange rate, which should encourage a switch of resources into exports and away from imports.

Whereas a permanent solution to excess demand is to destroy income, the only permanent solution to the problem of overproduction is to destroy capital. Unfortunately, capacity destruction takes time.

But how can emerging markets as a whole avoid future crises? Over recent years, many Asian governments refused to let financial and currency markets function freely, while Latin American governments have typically imposed or sanctioned controls on the free working of real goods and labour markets. The Mexican crisis could have been avoided if the Latin American real economies had been efficient enough to have supplied the domestic consumer boom: thereby side-stepping a fundamental deficit in international trade.

Equally, Asia's current problems could have been avoided by allowing Asian currencies to appreciate during 1993–95, so preventing the flood of foreign money distorting local liquidity conditions. In both cases, policymakers stood in the way of free markets. Latin American policymakers focussed on the soft targets, e.g. financial market reform, and (with exceptions) ignored the more pressing issues of labour and bureaucratic reform. Asia's policymakers were not prepared to suffer export uncompetitiveness, and so typically locked their currencies to the US dollar.

The capital outflows from large developed economies cause problems elsewhere. Instead of worrying about a lack of quantity, policymakers in the emerging countries are now more concerned about a lack of quality capital. Too much low-quality capital brings with it the threat of greater financial market volatility which could potentially de-rail economic development.

Barring controls on global capital flows, only one policy can promote a lasting remedy. *Emerging markets must club together under the shelter of a single broad currency zone: national currencies are luxuries few can afford. They must also deepen domestic financial markets sufficiently so that they can deal with unexpected capital inflows.*

Policymakers must also foster financial as well as industrial development, whenever possible. One cannot occur successfully without the other. The emphasis must be on encouraging greater inflows of long-term capital, e.g. FDI, and raising each economy's overall rate of long-term savings, e.g. more pension funds. Domestic financial institutions should become more-and-more significant as a result. It is the growth of domestic savers, the proliferation of domestic savings instruments, and the growth of domestic capital markets across emerging markets, i.e. capital market deepening, that could characterise the next and most important stage of economic development.

Plainly, this solution is unlikely to unfold quickly. Therefore, global capital markets will continue to be plagued by volatility, and often this volatility will spill over into economic hardship. All that investors and policymakers can do is to watch out for the tell-tale signs of excess.

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