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FINANCE MODEL OF ECONOMIC RECOVERY: EAST ASIA EXPERIANCE

It is shown in the article how the liberalisation of currency accounts reduces the flow of funds and creates conditions for economic crisis. The authors suggest market mechanisms, that make immunity from financial fluctuations, and stabilize economy.

Key words: economic crisis, stabilization of economy, management of funds flow.

Financial liberalization

The establishing of the Bretton Woods system made system of flexible exchange rates to prevail over fixed ones. International capital flows other then FDI were considered as driven by speculative motives. Here it is necessary to underline that in the case of East Asia prior to the crisis even the FDI were oriented more towards mergers and acquisitions than towards green-field projects.

Financial liberalization was stirred by the demise of fixed exchange rates, while financial engineering created abundant financial instruments to facilitate diversification of investors' holdings. In 1995 foreign exchange spot transactions exceeded trillion US dollars per day and were 67 times higher than international trade in goods, indicating that financial sector has been driven apart from the so-called real economy. It was Keynes who advocated curtailing financial system in order to mitigate potentially harmful impact of wild liberalization.

Fatwall in 1997 underlined that the promises of financial liberalization had not materialized because:

- liberalization did not result in shifting financial resources from capital-reach to capital-poor countries;
- savers benefited most from higher real interest rates, while borrowers generally did not face the lower cost of funds (some analysts claim that lower cost of funds in the 70s stemmed from exceptional circumstances);
- New derivative instruments were expected to reduce risk, but even if they did to some extent achieved that objective, they led nevertheless to the surfacing of new types of risk;
- Macroeconomic results were overall worse after the liberalization, again contradicting the prevailing expectations;
- liberalization made governments more preoccupied with controlling inflation in order to avoid capital outflows able to destabilize the country, than with improving macroeconomic stability.

In short liberalization reduced the leeway that governments previously possessed in fiscal and monetary policy, reduced the room for maneuver in discretionary interventions by governments to promote economic development.

Massive capital markets are threatened with instability and therefore governments as well as private investors opt for strategies aimed at minimizing risk and thus the economic growth and creation of new jobs are slow. High interest rates justified theoretically by efforts to maintain financial stability make things even more difficult.

Long-term goal of price stability pushes aside low and stable unemployment to the second row of priorities.

Therefore liberalization of financial systems brings about:

- Liquidity crises and reduced real output;
- short-term investment horizons, resulting from private sector's risk aversion;
- deflationary bias of public sector, also deriving from risk aversion;
- pressure to increase flexibility as the possibility of ease of exit.

Participants in financial markets do not accept restrictions on the repatriation of profits, as FDI generally do. There is a proof that economic development requires active role of the state. Post – war reconstruction of Europe took place under tight capital control, and it was capital control which contributed to the industrialization and rapid capital accumulation in Japan, Republic of Korea and Taiwan.

There are some threats resulting from financial liberalization that are still not sufficiently recognized (not to mention debated and addressed).

Certain economic policies in order to bear fruits must be implemented by multilateral initiatives of governments involved, therefore controlling financial system requires of major economic powers to shift priorities and paradigms.

IMF's role

Crises in East Asia shed new light on the so-called "rescue" packages extended by the IMF to troubled countries. That organization calls for such drastic measures as bank closures, curtailing of budgetary spending and introducing higher interest rates. It can be asserted that in the case of Indonesia, Malaysia and the Republic of Korea IMF's prescriptions made currency crisis degenerate into a financial one and finally led to economic slump. But IMF was myopic enough to underestimate not only the severity of the crisis but also, the strength of the recovery that followed.

The approach taken by the IMF to the East Asian countries came under considerable deal of criticism and skepticism, and the majority of economists believe that the early programs for Indonesia, the Republic of Korea and Thailand were not well prepared, though there is no universal agreement over the reasons for that particular mistake.

One explanation is that the IMF emulated its approaches used towards Africa, Eastern Europe and Latin America and had to insist on anti-inflationary policies on

initial stage of its dealing with the crisis. Therefore many of the IMF's programs had contractionary results, disguised under assigning blame to ineffective social safety mechanisms. IMF's prodding to raise interest rates failed to stop capital outflows of great magnitude, but even worse higher interest rates led to the exacerbation of the crisis conditions. Even if the higher interest rates succeeded in checking capital flight it would have been only temporary success, attained at the expense of investments in the real economy.

IMF didn't take into account sound budgetary results of the regional economies (except for Indonesia all the countries had budget surpluses) in 1996 and advised them to cut government expenditures in order to boost lost confidence in their currencies.

Later on countries concerned (except Indonesia) started to implement more interventionist policies in the second half of 1998, and those policies brought about the economic recovery.

IMF's prescriptions boiling down to deflationary policies and closures of financial institutions led two fourfold increase in the premiums on Thai Eurobonds.

Instead of allowing for restructuring of insolvent financial institutions in Indonesia, the Republic of Korea and Thailand IMF insisted on bank closures causing the panic to snowball.

IMF's priority rested in furthering the interests of foreign governments and financial circles, while constituencies of the countries involved paid the price of reforms.

High number of analysts believe that IMF approached Asian countries less delicately than Mexico in the tequila crisis, since it was stirred by the U.S. to help Mexico avoid associating tequila crisis with joining NAFTA.

IMF protected the interests of foreign banks, though they were – alongside domestic banks – responsible for bad lending practices, as in the first half of the 1997 bank lending to South East Asia continued unabated (e.g. in the period from mid 1996 to mid 1997 the Republic of Korea received 15 billion US dollars in loans while Indonesia 9 billion US dollars – most of this sums were in the form of short-term debt. Japanese and European banks (continental Europe) were the most prominent and generous lenders.

Summery

Oversight of banking operations suffered under financial liberalization, while liberalization of the capital account reduced management opportunities of financial flows making ground for the Asian crisis.

Comparison of Indonesia, Malaysia, the Republic of Korea and Thailand on one hand with Hong Kong, Japan, Singapore, Taiwan and China on the other doesn't show any conclusive evidence that countries from the first group experienced corruption, rent seeking, government interventions, FDI, productivity growth and democracy.

Capital account liberalization may not constitute sufficient – though it is necessary – conditions for the emergence of the crisis of new type.

The difference which stands out – is low level of the foreign currency reserves in afflicted countries prior to the eruption. The crisis had revealed the importance of the investor confidence for explanation of the gravity of the economic turbulences, and the concept of herd behavior merits particular attention here.

The Macroeconomic foundations of all the crisis-ridden economies were not the same, and cannot alone be quoted as an explanation of the crisis.

Since the market mechanisms weren't strong enough to offer immunity to financial collapses it is the task of policy makers to establish conditions for responsible financial governance.

Financial crisis spread rapidly across the region, from Bangkok to other countries taking heavy toll on the financial systems and real economies of those countries and external shocks led to recessions.

Reforms and recovery

In an ongoing debate over the implication of the situation in East Asia for the concept of economic development neo-liberal circles are of the opinion that it were the distortions of the model of welfare economics that led to the crisis.

Influential economists representing IMF, World Bank and US Treasury Department are critical of the 1993 World Bank publication entitled "East Asian Miracle". Particular critique is directed at the fact that such concepts of Joseph Stiglitz as acknowledgement of the success of direct credit and financial restraint. It was Mr. Stiglitz himself who objected to the way of handling the crisis by the IMF.

But the crisis had surfaced not long after Krugman questioned (1994) the sustainability of growth in East Asia, on the basis of growth's reliance primarily on accumulation of factors and as such bringing about diminishing returns instead of productivity growth.

Initially western countries showed little interest in the developments in East Asia. However Japanese authorities were instrumental in attempting to establish regional monetary facility of 100 billion US dollars in Q3 1997 to cope with the crisis, unfortunately such an initiative encountered opposition on the part of IMF, Western countries and China (the latter thinking in categories of geopolitics, hence afraid of Japanese attempt at leadership in the region). After one year had elapsed the scene changed dramatically and the crisis apparent widening towards West (after engulfing Russia and Brazil), coupled with much publicized problems of LTCM hedge fund (one that had to be rescued by the U.S. Federal Reserve Bank) aroused profound interest in the crisis, leading in turn to the debates on the need to promote so-called new international financial architecture as a foundation of greater financial stability worldwide. The IMF conditionalities that followed the debt crisis, reforms implemented in the framework of World Trade Organization and shifts in political and economic alliances were instrumental in promoting economic liberalization, while post cold war political situation and decreasing role of a nation states reduced the capacity of developing countries to act in a collective manner. Such conditions do not bode well to the possibility of much goodwill stemming from the Asian Crisis.

The crisis questioned the notion that invisible hand of the market will quickly punish economies characterized by weak macro conditions, as it rather shed light on the shortcomings of financial markets, evident in the fact that current account deficits back in 1995 were larger than two years later and it did not lead to market's reaction then.

However, as it may be hard to believe, the crisis had found reflections in the IMF's internal organization, as in September of 1997 during annual meeting of that organization held in Hong Kong (simultaneously with the annual meeting of the World Bank) Interim Committee agreed to amend the IMF's Articles of Association. IMF would have oversight over its members' balances of payments capital accounts in addition to current account. WTO in the end of 1997 managed to conclude financial services agreement, obligating members to keep the timetable of rapid liberalization in the area in question. Such changes will be beneficial to the developed countries and are likely to cause bigger problems for the less developed countries, as the bulk of financial services growing under protective clauses in such countries will not be able to stand their own against international competition.

Macroeconomic turn for better

The phenomenon of how the afflicted countries managed to overcome the crisis and recession hasn't been widely researched to date. It's evident that – except of Indonesia (due to its political situation) – all three economies of East Asian countries have entered the road to recovery and are moving down that road at a pace decidedly exceeding earlier predictions. Their bouncing back surprises IMF's experts who had been envisioning 3 to 4 years of economic stagnation, but the economies in question sprung back to life in 1999 following sharp downturns a year earlier.

Such miraculous recovery can be explained by resorting to Keynesian policies, as the authorities of Malaysia and Korea undertaken reflationary macroeconomic policies coupled by recapitalization of commercial banks. IMF's when talking of restoring liquidity within the framework of so-called structural reforms has somewhat different prescription, and doesn't generally endorse measures that were implemented in Malaysia and Korea.

Sharp reduction of interest rates was implemented - contrary to the wishes of the IMF. It has to be underlined that initial macroeconomic policy alongside the lines of IMF (involving significantly higher interest rates) led to soaring number of bankruptcies and thus made reforms on the corporate level impossible to introduce.

Another thing to note is that the depreciation of the currencies of the crisis-ridden countries may have helped in achieving turnaround on the companies level and allowed to ameliorate trade balances and increase the stocks of foreign reserves (as Table 1 and Table 4 do indicate).

Analysis of the tables from contained in the appendix reveals that the highest level of interest rates was evident when exchange rates were the lowest. Such connection proves that the authorities of four afflicted countries came with the same response, one that was based on responding to the currency crises by interest rates hikes. The depreciation of currencies was conducive to exports in the circumstances of global decline in the prices of primary and manufactured commodities caused by the liberalization of international trade. Authorities of the Republic of Korea were highly aware of the necessity to ensure competitiveness through controlling the pace of won's appreciation, as they intervene on the foreign exchange market starting towards the end of 1998.

Evaluation of the state budgets reveals that 1998 was a year of significant growth in budgetary deficits of the countries hit by the crisis, as authorities increased expenditures from the state coffers in order to stimulate the economy. Recapitalization of financial institutions, public works and "social safety mechanisms" (that particular solution was even advocated by the IMF and the World Bank). On general such policies were far from being the brain child of IMF's pundits.

The overhaul of corporate governance's

The dominant notion of paragon of virtue for corporate governance is modeled after criteria endemic to Anglo-American strain of capitalism. Such framework makes economic institutions in the countries discussed in this essay appear as far from perfection, particularly due to their lack of congruence to such model behavior. Those "blameworthy" institutions were accused of causing the crisis, and various pundits call for their abandonment. It is not a proved thing, that region's corporate structure was responsible for the eruption of the crisis (though there were signs of tension in the corporate sector in the countries involved). I would like to advert to worsening of corporate profitability - which was the most pronounced in the case of Thailand, but did not spare other East Asian states. I have already mentioned the problem of investment efficiency, as illustrated by ICOR index. Under such circumstances corporations in the region started to go under in the beginning of 1997, particularly in Korea and Thailand. These two countries joined Indonesia in applying for the emergency credit offered by IMF. However that organization did not cease to call for microeconomic (corporate level) reforms as a backbone of its programs. Thai and Korean authorities assented to the need of implementing corporate overhauling, even if such transformation amounted, more or less, to the molding of domestic corporations to the "American blueprint", implying that there is one optimal corporate structure for all regions and economies.

The peculiarity of the situation in East Asia emerged from the fact that it was better solution to start with rectifying macroeconomic aspects and eliminating systemic risks besetting the financial system. It hasn't been proved that the "kill two birds with one stone" approach, that combined tackling of both macroeconomic and microeconomic problems at the same time had been significantly conducive to the recovery. It appears that corporate reform shouldn't be introduced as an exercise aimed at testing the validity of textbook recipes or policy oriented agenda, but should rather derive from the analysis of particular case. Subsequent developments in East Asia indicated that macroeconomic foundations that resurfaced in 1999 (interest rates cuts and higher budgetary expenditures) were instrumental in making corporate restructuring possible.

There are opinions that corporate reform in the region did not bring about desired effects of ameliorating the structure of high corporate indebtedness and increasing profitability. On the other hand such reforms carried high costs to the economy. Such opinions are justified mostly by the analysis of the developments in Malaysia but merit interest when analyzed at the background of situation in Korea and Thailand. Of course developments external to the management of well-performing enterprises may leave them in financial dire straits. East Asian crisis brought about sharp and unexpected devaluations of currencies in turn leading to increases in corporate costs and magnifying their unhedged foreign currency denominated external liabilities (bulk of those was denominated in US dollars). Such devaluations were simultaneous with crisis of the financial system, and therefore the existence of companies was threatened due to the insufficient access to emergency financing. Particularly difficult fate befell small and medium enterprises, as they were becoming insolvent or were falling pray to takeovers at "bargain prices". Of course it is impossible to argue that such a demise of enterprises was conducive to improvement in managerial capabilities and in turn to rapid development.

Gomez and Jomo called in 1999 for eradicating of politically powerful rentiers as they are an obstacle to real progress, but it is quite reasonable to suggest that second stage catching - up systems for Korea should not follow the Anglo-American blueprint. Governments of the countries located in the region are responsible for developing new institutions able to allow for more selective state interventions, as such interventions should stimulate the development of multifarious capabilities (in the area of industry, technology, organizational structures and managerial know-how) well prepared to look up to new generation of tasks and challenges.

It has been already said that recovery in East Asia was possible thanks to Keynesian policies not because of reforms in corporate governance, and we have to remember that foreign investments started to arrive again after economy started to bounce back in November of 1998, and that IMF's hope of foreign investments leading the recovery did not materialize.

Is the New Financial Architecture more conducive to future crises prevention?

Keeping the capital account open and maintaining the freedom of capital movement across borders makes it difficult to come up with mechanisms of prevention of financial crises, but also poses difficulty to the establishment of effective financial safety schemes domestically. IMF's reluctance to advise countries to control short-term capital inflows in the wake of a looming crisis is not conducive to the prevention of crises. The only exception to IMF's rigid position on capital controls are its tacit acceptance of such controls being deployed among others in Chile and Colombia.

There are also researches, who look for connections between large changes in the exchange rates of major industrial economies and crises in the emerging economies. In 2000 Akyuz came out with the analysis that covered the last twenty years and he found that the latter development predated such crises. Such observation vindicates the need for the introduction of stability of major currencies, as a precondition for other currencies in the world.

There were also calls for improved transparency and greater availability of information, though there is no proof that had the two conditions been met, the crises would have been prevented.

The effective solution to the need of prudential controls should encompass the existing differences between countries, as well as derive from regional frameworks. Unfortunately the dominant approach to prudential regulations is "from top to down" as international standards are formulated in "headquarters" and subsequently implemented by subordinated units (countries). Akyuz warns that such standards are not centered around the risks stemming from international lending, are tailored to the protection of creditors and overlook important local characteristics.

Regarding the feasibility of controlling short-term capital inflow, it is theoretically possible for the developing countries to implement them, but in practice lack of international support for such measures doesn't encourage authorities of interested countries to do so.

When it comes to the exchange rate policy the prescriptions for developing countries are either to fix their currencies (currency boards or dolarization) or freely float them. It would be beneficial for developing countries (as Akyuz asserts) to chose their own exchange regime instead of having one imposed by an IMF.

Crisis in East Asia illustrated the need to ensure international liquidity by rapid provision of funds to affected economies. However there are still obstacles to such a solution since:

- multilateral institutions most of the time do not have sufficient resources to be quickly earmarked for such action. IMF's even if it nominally has such potential must in real life secure approval of its principal shareholders;
- IMF conditions disbursement of its financial resources on meeting very stringent criteria. As evidenced by the East Asian turbulences such a "bitter pill" can be more harmful than the disease and may worsen the macroeconomic crisis;
- Emergency funds went to pay of creditors as currencies were not effectively protected from collapsing, because they were not supported against speculation by disbursement of the funds discussed here.

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Анотація

У статті показано як лібералізація валютних рахунків, зменшуючи можливість управління фінансовими потоками, створює достатньо умов для виникнення економічної кризи. Автори пропонують ринкові механізми, що виробляють імунітет на фінансові коливання, стабілізуючи економіку.