

FINANCIAL CRISES OF LATIN AMERICA AND EAST ASIA: A COMPARISON

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ABSTRACT

There are similarities and differences between the Latin American and East Asian crises. The economies of the regions had displayed a robust performance before the crisis. There were massive foreign capital inflows in both the regions before the crisis. The massive inter-bank credit had played a major funding role in East Asia whereas the bank credit went to public and publicly guaranteed projects in Latin America. The Latin American countries did not use the borrowings to develop resources, especially export industries adequate for future debt servicing. The foreign borrowings were used to cover current account deficits. These were also used to cover the huge losses of public sector units. In East Asia, a substantial part of the capital was channelled to unproductive and high-risk ventures such as real estate. Many property owners artificially inflated the value of their assets and kept borrowing against them and most real estate companies had a poor cash flow.

“Over borrowing” was the root cause of the financial crises in both Latin American and East Asian regions. In both the regions, markets had failed to adjust in many respects. The model of “credit rationing” in the international credit market failed in both cases while extending credit in the international market which led to the financial crises. The implicit guarantee in both the cases encouraged international banks to lend freely without a serious analysis of counter-party risk. Banks lent to these countries on the assumption of central bank support and the market would continue “to test central banks” mettle and when that mettle is in doubt, a severe credit rationing would result. Capital liberalisation is the root cause of Latin American and East Asian crises. Heavy government involvement and loose controls on ‘connected lending’ have played an important role in creating the banking crisis. The exchange rate regime can affect vulnerability to speculative attack, the way in which the real value of impaired bank assets is adjusted downwards and the ability of the central banks to act as lender of last resort to illiquid but solvent banks. The financial crisis of Latin American and East Asian economies fit the model of speculative cycles developed by Minisky. One of the measures to combat the crisis is to strengthen the domestic financial systems and institutions. Liberalisation of Foreign Direct Investment (FDI) should precede the capital account

opening process. A country that seeks to remain integrated into the international capital market should either float or devote its monetary policy to preservation of the peg through currency board and liberalise foreign access to domestic stock and bond markets before freeing the banks to fund themselves abroad. Capital account liberalisation should be sequenced with due regard to a country's macroeconomic situations, the stages of development of its financial markets and institutions. A sound and stable macroeconomic policy environment is needed where monetary and fiscal policy vulnerability are minimised. There should be a "World Financial Authority" to tackle international financial crises.

There have been 80-100 international financial crises over the past quarter century. There have been seven such crises in the 1980s and 1990s of which the Latin American crisis of the early 1980s and the East Asian crisis of the late 1990s are significant. Lindgreen *et al* (1996) have reported that over the 1980-96 period at least two-thirds of IMF member countries experienced significant banking sector problems. An analysis of the economic conditions, financial flows and specific events leads to the point that there are similarities and differences between the Latin American crisis of the 1980s and the East Asian crisis of the 1990s. It has become increasingly clear that financial and capital liberalisation done hurriedly, without first putting into place an effective regulatory framework, is at the core of the problem. There are some common elements in most of the crises. These are: a dramatic swing in the current account, a large real exchange rate depreciation, a significant decline in the real output and a fall in export growth rates. Various factors which have worked as antecedents to the financial crisis are weaknesses in the banking and financial sector, fixed exchange rates without the concomitant monetary policy and weak traditional macroeconomic fundamentals such as inflationary monetary policies, large fiscal deficits or even large current account deficits and short-term liabilities of the government or the private sector. Caprio and Klingebiel (1996) reported that 75% of the developing countries suffered a terms of trade decline of at least 10% prior to the crisis. Volatility in international interest rates and the induced effect on private capital inflows led to the crisis. Kaminsky and Reinkarf (1995) observed that a sharp real exchange rate depreciation typically preceded a banking crisis.

An attempt has been made in this paper to analyse the similarities and differences between the crises of Latin America in the 1980s and of East Asia in the 1990s. The paper is organised as: Section 2 is devoted to analysing macroeconomic fundamentals of Latin America and East Asia before and after the crisis. Section 3 will throw light on factors responsible for the crisis in Latin America and East Asia, Section 4 is devoted to measures that should be taken to combat the crisis. Section 5 concludes the discussion.

SECTION 2: MACROECONOMIC FUNDAMENTALS OF LATIN AMERICA AND EAST ASIA BEFORE AND AFTER THE CRISES

Here the macroeconomic fundamentals of Latin America and East Asia before and

after the crisis in the 1980's and in the 1990's respectively are analysed to understand the circumstances which led to the financial crises. Both Latin America and East Asia had displayed an impressive real GDP growth before their respective crisis. During 1971-80 the Latin American countries showed a good performance of their economy. The real GDP growth rate of Brazil was 8.6% and that of Mexico 6.6% during 1971-80 (Table 1, Annex.). The East Asian economies also showed a significant performance of real GDP during the period 1981-97 (Table 1, Annex.). Gross domestic investments, as a percentage of GDP in the Latin American countries, increased significantly between 1961-70 and 1971-80 whereas in the East Asian countries these increased significantly from an average of 1981-90 period to 1991-95 (Table 2, Annex.). The gross domestic saving-GDP ratio also increased significantly before the crisis in both the regions (Table 3, Annex.). The current account deficits deteriorated in the countries of both the regions before the crisis by about 4-5% of the GDP on an average (Table 4, Annex.). However, a large percentage of these deficits was being used for private investments in East Asia as opposed to consumption in Latin America (Baer *et al*, 1999). Latin America experienced hyper inflation during 1971-80, whereas East Asia also experienced a relatively high inflation rate in 1991-97 (Table 5, Annex.).

There was a massive medium and long-term capital inflow in Latin America during 1970-84. The total accumulated debt of Latin America was \$ 301.3 billion in 1982 whereas that of East Asia, was \$428.1 billion (Table 6, Annex.). While the dollar value of the debt involved in the East Asian crisis was the highest, the difference was much less marked when debt was scaled by world GDP. The total external debt as a percentage of world GDP was 2.8% for Latin America and 1.5% for East Asia (Table 6, Annex.). Bank loans to the countries involved in East Asia had grown rapidly. The U S banks were exposed to Latin America (113%) whereas the European and Japanese banks were more exposed to East Asia in 1996 (90%). The capital inflow was the principal source of financing current account imbalances in the Latin American countries. Part of the increase in the capital inflow in Latin America was due to the building up of official reserve holdings because of attractive terms and conditions (that is low spread, longer maturity) and financial developments in the Euro currency market (e.g. syndicate lending)

Medium and long-term international bank credit to Argentina increased from \$0.2 billion in 1972 to \$2.8 billion in 1981 (Table 7, Annex.). In the case of Brazil it increased from \$0.6 billion to \$6.8 billion during the same period. Chile also amassed bank credit worth \$2.3 billion in 1981. In Mexico, the long and medium-term bank credit grew from \$0.4 billion in 1971 to \$10.5 billion in 1979 and \$7.9 billion in 1981. Venezuela was another Latin American country whose bank credit increased from \$0.3 billion in 1972 to \$2.9 billion in 1980. BIS report on bank's annual claim on East Asia is given in Table 8 (Annex.). It can be seen that bank claims on Indonesia grew from \$4.5 billion in 1991 to \$10.7 billion in 1996 but fell to \$2.9 billion and there was a net outflow of \$8.1 billion in June 1998. In the case of Korea, it increased from \$6.9 billion in 1996 but there was a net outflow of capital to the tune of \$21.7 billion in June 1998. In Thailand, bank claims fell from \$19.1 billion in 1995

to \$7.2 billion in 1996. In the case of Malaysia, bank claims increased from \$0.7 billion in 1991 to \$5.3 billion in 1997 but there was a net outflow of \$4.5 billion in 1998. Similar was the case of Philippines.

Table 9 (Annex.) suggests that bank loans, relative to the GDP, were much higher in East Asia than in Latin America. The average loan growth was also higher in East Asia than it was in the Latin American countries in the early 1980's. It is believed that high loan growth may engender inadequate assessment of the borrower's creditworthiness by the banks, which in turn could lead to poor loan repayment performance and hence financial sector weakness. The high loan growth in East Asia may be due to differences of supervision and regulation as well as the problem of moral hazard. In the aggregate, most of the claims to East Asian counterparties were short-term with 64 per cent of the total foreign claim having maturities for one year or less in 1997. In the case of Latin America, 60 per cent of the total foreign claims had maturities for one year or less in 1981. BIS reporting banks' foreign claims on counterparties in the East Asian countries were largely to local banking organisations with 45 per cent of the total claims, whereas public sector claims were only 6 per cent of the total claims in 1997. The distribution of foreign claims on Latin American countries was different from that of East Asia. The public sector in Latin America accounted for 39 per cent of the total foreign claims. European and Japanese banks' claims accounted for 72 per cent of the East Asian crisis. US banking system (60 per cent claims) was exposed to Latin American countries during the crisis.

The external debt indicators of Latin America and East Asia are given in Table 10 (Annex.) and Table 11 (Annex.) respectively. Total external debt to exports of goods and services of Latin America increased from 102 per cent in 1980 to 188 per cent in 1983 and further to 277 per cent in 1986 (Table 10, Annex.). Latin American countries also had a high debt-GNP ratio. The debt-GNP ratio increased from 19.1 per cent to 37.4 per cent to 46.3 per cent during the same period. Debt servicing as a percentage of export of goods and services also increased from 21.4 per cent to 25.2 per cent to 30.3 per cent during the same period. Interest payments as a percentage of export of goods and services increased from 10.2 per cent in 1980 to 15.8 per cent in 1983 to 20.4 per cent in 1986, whereas interest payment as a percentage of GNP increased from 1.9 per cent to 3.1 per cent to 3.4 per cent during the same period.

Debt indicators of East Asia were also similar to that of Latin America before the crisis. The debt-GNP ratio was as high as 65 per cent on an average for Indonesia and Philippines and around 40 per cent for Malaysia and Thailand during 1990-96 (Table 11, Annex.). Korea had the lowest Debt-GNP ratio of 18 per cent in 1995 (Table 11, Annex.). The debt-export ratio in Indonesia was as high as 230 per cent in 1995 whereas in Philippines it was 187 per cent in 1992. In Korea, Thailand and Malaysia it was around 45 per cent in 1992 (Table 11, Annex.). The total debt-service ratio as a percentage of exports was around 33 per cent in Indonesia, 20 per cent in Philippines, 18 per cent in Korea, and 13 per cent in Thailand (Table 11, Annex.).

Capital inflows put an upward pressure on most Latin American exchange rates. Substantial real effective appreciation was preceded by a long period of real depreciation during much of the 1980's as an implication of the debt crisis. There was

a large real appreciation of 37 per cent in Argentina during 1979-81 (See Sachs (1985) p. 541). The Mexican Peso appreciated by 13 per cent, the Colombian peso by 10 per cent, the peso of Chile and Bolivia and Venezuela by 7 per cent. These currencies also suffered when the US dollar appreciated sharply in the 1980 because these were pegged to the US dollar. The real appreciation of these currencies encouraged capital flight and the current account deteriorated under the impact of high imports.

In East Asia also, there was a significant real exchange rate appreciation in June, 1997, over April, 1995. The extent of real appreciation was 21.5 per cent for Indonesian rupiah, 14.3 per cent for Thai baht, 18.4 per cent for Malaysian ringgit and 4.3 per cent for Korean won.

SECTION 3: FACTORS RESPONSIBLE FOR THE FINANCIAL CRISES OF LATIN AMERICA AND EAST ASIA

Banking crises are caused by excessive credit creation and unsound financing during the expansion phase of the business cycle; a crisis is triggered when the bubble bursts (Kindleberger, 1978). "Overborrowing" was the root cause of the financial crisis in Latin America in 1982 and in East Asia in 1997. There was indiscriminate and imprudent lending by international banks and there was imprudent macro-economic management by the borrowers of international funds. One plausible explanation for the financial crises in Latin America and East Asia was market failure. The model of "credit rationing" in the international credit market failed in both the cases while extending credit in the international market which essentially led to the financial crises. In Latin America, the credit went to public or publicly guaranteed sector whereas credit went to private domestic banks (inter-bank credit) in East Asia with an implicit guarantee given by the governments. Latin America and East Asia could raise money because of the low rate of interest in the international market. The lack of information on potential international inter-bank borrowers is in many cases, arguably "compensated for" by implicit public guarantee of repayments. In this environment, low interest rates changed the selection of projects otherwise creditworthy borrowers would invest in. At low interest rates projects with high risk but low expected returns appeared attractive with implicit guarantee from governments with good international credit standing which compensated for any reluctance to lend at low rates. The provision of subsidies in the form of government guarantees designed to mitigate adverse selection problems appeared in international lending. The implicit subsidy lowered the international cost of credit and expanded international liquidity.

Gavin and Hansmann (1996) found that bank-lending booms had been preceded by banking crisis in Latin America. The cumulative debt outstanding in Latin America in 1982 was \$301.3 billion whereas it was \$428.1 in East Asia (Table 6, Annex.). In East Asia, it was the massive inter-bank credit which played a major funding role, whereas bank credit had gone to public, or publicly guaranteed projects in the case of Latin America.

Inter-bank credit to East Asia and direct credit to Latin America were of short maturity and carried in many cases an implicit guarantee. The perception of guarantees

of international inter-bank lending grew overtime and helped the banking system to compete with the capital market in lending to those countries. The implicit guarantee in both the cases encouraged the international banks to lend freely without serious analysis of counter-party risk. As Giddy (1981) argued that banks lent to these countries on the assumption of central bank support, and that the market would continue to grant credit without any discrimination. The market would continue "to test central banks" mettle and when that mettle was in doubt, severe credit rationing would result. That is what happened in Latin America and East Asia.

Much of the lending was inter-bank financing in East Asia and direct lending to the non-bank sector in Latin America. Again private sector borrowings were higher in East Asia while public sector borrowing dominated in Latin America. When the crisis hit Latin America in 1982 and East Asia in 1997, there was mass exodus of bank funding from these regions which could not be prevented even by the strong assumption of implicit government guarantees.

Latin American and East Asian borrowers differed not only in the amounts borrowed, but also in the uses to which the loans were put. The Latin American countries did not use the foreign borrowings to develop resources in tradable goods, especially export industries adequate for future debt servicing. The foreign borrowings were used to cover current account deficits. These were also used to cover the huge losses of public sector units. In East Asia, a substantial part of the capital was channelled to unproductive and highly risky assets like real estate. Many property owners artificially inflated the value of their assets and kept borrowing against them and most real estate companies had a poor cash flow.

Capital liberalisation was the root cause of the Latin American and East Asian crises. It was the removal of restrictions, which allowed foreign capital to enter the countries with ease and flee just as quickly when the trouble surfaced. This freedom of entry and exit of global capital provided a few long-term benefits, but it caused the destruction of the economy of the developing countries. Rodrick (1998) and Bhagavati (1998) argued that there was no evidence that opening an emerging market to foreign financial inflows significantly raised its output or rate of growth. Rodrick (1998) found that there was no correlation between capital account liberalisation and growth. However, Rossi (1999) found that the presence of controls on capital inflows was associated with significantly slower growth.

The argument for capital liberalisation has been built on the premise that it would promote a more efficient allocation of capital across the world. Domestic firms facing high interest rates could access inexpensive funds in the global markets. Capital liberalisation would broaden the channel through which trade and investments could be financed and income increased. It would give more opportunities for portfolio diversification and hence a potential higher risk would adjust the rate of returns. It would also increase the efficiency of the domestic financial system.

However, capital liberalisation is highly sensitive to the conduct of macroeconomic policies and perceived soundness of domestic banking. It would lead to excessive capital inflows and outflows and possible attack on the currency as it happened in Latin America and the East Asian countries. It does not permit the monetary policy

to take on an excessive burden of the adjustment. However, it enhances the effectiveness of the fiscal policy by reducing real interest rates applicable to public sector borrowing, bringing about an optimum combination of taxes to international levels with beneficial effect for tax revenues and reducing the crowding out effect in the access of funds.

Increasing bank liabilities with large maturity/currency mismatches led to a banking crisis in Latin America as well as in East Asia. When the growth of bank liabilities is very large relative to both the size of the economy and the stock of international reserves and when the banks' assets differ significantly from the banks' liabilities as to liquidity, maturity and currency of denomination, and when bank capital and / or loan loss provisions have not expanded to compensate for the volatility of bank assets and when the economy is subject to large shocks to confidence, then the banking system becomes fragile. As said earlier, 65 per cent of the total bank credit to both Latin American and East Asian countries consisted of short-term loans.

Heavy government involvement and loose control on connected lending played an important role in the generation of the banking crisis. 'Connected lending' refers to loans extended to banks' owners or managers and to their related businesses. They allow the political objectives of governments or the personal interests of bank insiders, (owners or directors) to intrude on almost all aspects of bank operations, damaging the banks' profitability and efficiency. There was significant participation of state governments in banks. Loan decisions of state owned banks were subject to explicit or implicit government directions. Even when the banks are privately owned, government may still influence the allocation of credit to particular sectors, extend favorable loan discounting privileges to certain borrowers, prevent private banks from engaging in certain profitable banking activities, require banks to hold government bonds at below market rates, impose high reserve requirements or taxes on banks and direct the banks to borrow in foreign currencies and assume the currency risk. Lindgren *et al* (1996) and Sheng (1996) argued that connected lending was the key bank governance problem in Argentina, Brazil, Chile, Indonesia, Malaysia and Thailand.

Existing accounting systems, disclosure practices and legal frameworks hinder the operations of market discipline and the exercise of effective banking supervision. These weaknesses also often work to the detriment of bank profitability. Because of lack of accurate, current, comprehensive and transparent information, non-performing assets are accumulated. For example, the non-performing assets in Thailand constituted 12 per cent of the total loans in mid 1997. Distinguishing the healthy from the unhealthy banks is often hindered by the absence of financial statements on the consolidated exposure of banks.

The exchange rate regime can affect vulnerability to speculative attack, the way in which the real value of impaired bank assets is adjusted downwards and the ability of the central banks to act as lender of last resort to illiquid but solvent banks. Gavin and Hausmann (1996) found that unsustainable exchange rate pegs contributed more to the relatively high volatility of growth rates in Latin America. Kaminsky and Reinhart (1995) and Goldstein (1996) have shown that a sharp appreciation of the real exchange rate had led to the banking crisis. Gavin and Hausmann (1996) argued that, under a

fixed exchange rate regime an adverse shock would lead to a balance of payments deficit, a decline in the money supply and a higher domestic interest rate. The reduced availability and high cost of credit will put pressure on the banks and their customers and add to problems associated with the effect of the stock on the quality of bank assets. Under flexible exchange rates, by contrast, the stock would be associated with a depreciation of the nominal exchange rate and a rise in the domestic price level, which would serve to reduce the real value of bank assets and bank liabilities to a level more consistent with bank solvency. With a fixed exchange rate, the central bank must ensure that any liquidity it injects into the system to provide temporary assistance to illiquid but solvent banks does not undermine its exchange rate obligations.

The financial crisis of Latin America and East Asian economies fit the model of speculative cycles developed by Minsky (See Bordo, 1986 pp. 199-200).

According to Minsky, as the economy proceeds through the upswing of the business cycle, the financial structure becomes more fragile. A crisis occurs when a fragile financial structure is shocked by some event that triggers a sell-off of assets in a thin market, producing a sharp decline in asset prices. The fragility of a financial structure is determined by three factors viz. (i) the mix of hedge, speculative and Ponzi finance (ii) the liquidity of the portfolio and (iii) the extent to which on-going investment is debt-financed.

Minsky's terms are defined as follows: If a unit's cash flow commitments on debt are such that over each significant period cash receipts are expected to exceed cash payments by a significant margin, the unit is said to be engaged in hedge financing. Speculative financing is defined as "cash flow payments over some period exceed the cash flows expected over this period." A ponzi finance unit is one for which the interest portion of its cash payment commitments exceeds its net income cash receipts. A ponzi unit has to increase its debts to meet its commitments on outstanding instruments. The importance of speculative and Ponzi finance is that a rise in the interest rate can convert a positive into a negative present value, precipitating insolvency.

According to Minsky's approach, in the upswing of the cycle, the demand for new investment in response to improved profit opportunities leads to a demand for finance. Part of the new investment is directly financed by short-term debt, partly by equity and partly by long-term debt. As the economy expands, it generates an excess demand for finance, raising the rate of interest. However, the excess demand is partially and temporarily offset by financial innovation, which in turn fuels the finance for further investment, which would raise the rate of interest.

As the rate of interest rises, four factors create a fragile financial environment (a) an increase in debt finance (b) a shift from long-term to short-term debt (c) a shift from hedge to speculative to ponzi finance and (d) a reduction in financial institutions' margin of safety.

Once a fragile environment takes place, any further rise in interest rates by shifting hedge to speculative to ponzi financing, renders firms unable to 'roll over' their debts. However, the crisis can be aborted by the central bank acting as a lender of last resort.

If we analyse the financial crisis of Latin America and the East Asian economies, Minsky's model explains these crises to a certain extent.

Latin American and East Asian economies had shown sustained high growth rates before the crises. Their savings and investment rates were very high and inflation rates were low. As these economies grew, they attracted huge capital inflows. There was a shift in the composition of external financing from foreign equity investment to bond and from long-term to short-term. There was noticeable increase in inter-bank claims in these countries. The ready availability of foreign short-term credit contributed to "the development of get-rich-quick casino mentality" which led to the division of resources from productive activities to speculative ones (Piei and Ariff, 1998).

Foreign capital inflows intermediated through the banking system in East Asian countries were used to fuel a boom in asset prices in equity and real estate. Rising asset prices increased the value of collateral assets, inducing further lending by banks. Real assets used as collateral increased the credit limits as their market value rose. This could spark the beginning of an asset price bubble leading to a demand for fixed assets, such as real estate whose higher market price raised collateral values, further increasing credit availability, borrowing and asset prices. This dynamic multiplier of credit lines and asset values became all the more rapid. The increase in credit was encouraged by the relatively easy monetary policies in the major industrial economies reflected in low interest rates and abundant liquidity. The high liquidity was directed at the high growth countries based on implicit credit guarantees given by the governments for the banking system and borrowing countries. Growth in the real sector of these economies did not improve with additional flow of finance, particularly in deregulated financial markets. As a result, a large part of these inflows were deployed in speculative ventures covering property and stocks, thus chasing the available financial assets in the secondary markets and bidding up prices in real estate markets. The stock and real estate prices shot up as a result of high liquidity.

When the stock prices and property market started tumbling by the second quarter of 1995 in Thailand, it caused heavy damage to the asset value of banks. As a consequence the share of non-performing assets held by banks and corporate units went up sharply in these countries. In addition, the indices for private investment and construction activity in Thailand started declining from the first quarter of 1996. This process led the Thai economy to break down. In mid-1997, the Thai baht was hit by a massive selling pressure.

Short-term interest rates soared as domestic liquidity was squeezed. Creditors withdrew their funds from the region and the crisis spread. The Thai government abandoned its fixed exchange rate mechanism and adopted managed float which depreciated the baht by 20 per cent within a few days of its announcement and 40 per cent by November, 1997. The drop in the currency's value raised the burden of external debt on the banking and corporate sectors. The downward trend in the Thai currency had a contagious effect on other eastern countries. Between July, 1997, and February, 1998, the Korean, Malaysian and Philippine currencies depreciated at the rate of 34 per cent to 47 per cent and the Indonesian rupiah declined by 76 per cent.

Capital inflow put upward pressure on most Latin American exchange rates. There was a long period of real depreciation during much of the 1980's as an implication of the debt crisis.

In the wake of the fall in the currencies, short-run interest rates shot up by 30 per cent in Indonesia, 25 per cent in South Korea and 15 per cent in Thailand by the end of November, 1997. The real rate of interest relative to export prices of Latin America rose from a negative 3-6 per cent in the late 1970's to a positive 16-20 per cent in 1982.

The long period of inflow was abruptly reversed and a net outflow of capital started. As the currencies fell and capital flows reversed, several forces came into play to turn a self-reinforcing spiral into panic. As the exchange rate depreciated and the domestic currency costs of serving foreign debts rose, foreign creditors became more reluctant to extend new loans and roll over the existing loans. Domestic debtors had to buy foreign exchange to return these debts, putting more pressure on the exchange rates, which in turn further encouraged the creditors not to roll over the loans. Secondly, domestic debtors, many of whom had not hedged their foreign exchange exposure, began to purchase foreign exchange to try to close their position. Thirdly, the major rating agencies belatedly downgraded countries in the region triggering further withdrawals by creditors.

There were clear differences in the export promotion policies followed by Latin America and East Asia during the pre-crisis period. While Latin America had followed import substitution policies, East Asia had followed export promotion policies. The Latin American countries were in favor of protecting their domestic industry by countervailing movements. Currency devaluation that might help exporters was accompanied by discounts of the national currencies in the "black market". The sharp divergence of the official and "black market rates" often represented an implicit tax on the exporters. In the case of the East Asian countries, they enjoyed a high international trade orientation. The export-GDP ratio varied between 25 per cent and 85 per cent. The collapse of export performance in 1996 might lead to a crisis. There was a collapse of export growth both in value and volume. This might be due to a fall in the prices of manufactured exports by 2 per cent and over supply of their export basket because of the entry of China and Mexico in the global markets. A depreciation of the Chinese Yuan and the Japanese Yen vis-à-vis the dollar which was the link currency for the East Asian countries hit the export competitiveness of the products hard. The sharp real appreciation of the US dollar relative to the European currencies and the Japanese Yen after 1994 might also have played a role in the Asian financial crisis. The appreciation of the dollar pulled down dollar prices of a wide variety of goods and services in world markets, including East Asian exports to Japan and Europe. Given that the bulk of East Asia's foreign debt was denominated in dollars, a modest appreciation of the dollar increased the real debt-servicing burden of these countries. The slowing down of exports of East Asian countries probably raised concern among the creditors about the ability of East Asian firms to repay their debts which precipitated the final crisis in East Asia.

SECTION 4: MEASURES TO COMBAT THE CRISIS

Recent years have witnessed a sea change in the global financial system as the flow of private capital from industrial to developing countries has increased from \$ 174 billion in the 1980's to \$1.3 trillion during the 1990's (Summers, 2000). International financial integration represents an improvement in financial intermediation. It offers a potentially significant increase in economic efficiency with benefits both for consumers and investors around the world. In the right kind of environment, financial flows can provide important benefits. There must be financial innovation, which assures a safe framework so that the benefits can be realised.

We have seen that common elements of the financial crises of Latin America and East Asia were the dramatic swing in the current account, large real exchange rate depreciation and a significant decline in real output. In order to prevent a financial crisis, such situations in an economy should be avoided where bank run psychology takes hold and the core institutions and economic fundamentals should be strengthened.

Various factors which affect major financial crises include: serious banking and financial sector weaknesses, fixed exchange rate without the concomitant monetary policy commitments, weak macroeconomic fundamentals in the form of overly inflationary monetary policies, and large fiscal deficits.

One of the measures to combat the crisis is to strengthen the domestic financial systems and institutions. If well capitalised and supervised banks, effective corporate governance and bankruptcy codes and credible means of contract enforcement along with other elements of a strong financial system are present in an economy, significant amounts of debts can be sustainable.

Liberalisation of Foreign Direct Investment (FDI) should precede the capital account opening process. FDI should be packed with managerial and technological expertise. FDI gives a strong basis for domestic financial management and upgrading the banking skills and their risk management capacity.

A country that seeks to remain integrated with the international capital markets should either float or devote its monetary policy to preservation of the peg through currency board. While strong policies and institutions are needed for economic stability, the demands placed on an economy with a peg are likely to be severe and require not only a monetary policy directed to the defence of the peg, but also a sufficiently strong fiscal policy and robust financial, particularly banking, system that make it possible to deploy monetary policy for that purpose. Once a country has adopted a firm peg, it has given up many of the potential advantages of an independent monetary policy, but may still be subject to the danger of devaluation and thus may have to pay a premium over the interest rates in the country to whose currency it is pegged. This problem has led to arguments for dollarisation—the complete abandonment of the national currency—in Argentina and in other Latin American countries. Several emerging economies have avoided the heightened vulnerability associated with a seriously overvalued fixed exchange rate by making a transition to one of several forms of flexibility. Changes in exchange rate arrangements have ranged from a simple widening of bands during periods of heavy capital market

pressure to the adoption of a crawling band. Some have changed to managed floating along with domestic inflation targets.

Three important caveats should be noted to the bipolar approach (see Citrin and Fischer, 2000). First for countries with very high inflation, even those open to international capital flows, an exchange rate peg (typically a crawling peg) may well provide the most effective nominal anchor for disinflation—provided the country at an appropriate time effectively exits from the crawling peg. Second, for countries not yet significantly involved with international capital markets, maintaining a pegged exchange rate regime is less demanding. For such countries, a pegged exchange rate regime can provide a credible and simple anchor for monetary policy. Third, while bipolarity is the underlying tendency, in practice countries are likely to be placed along spectra of the extent of integration into the world capital markets.

Another important measure to prevent the crisis relates to capital account liberalisation. Capital account liberalisation is the root cause of the East Asian and Latin American collapse. Capital account liberalisation should be sequenced with due regard to a country's macroeconomic situation, the stages of development of its financial markets and institutions. McKinnan argued that trade reforms, strong balance of payments positions, fiscal discipline, financial sector reforms, banking reforms, inflation control, good foreign reserve position, strengthening of prudential regulation, etc. are pre-requisites to capital account convertibility. Controls on long-term inflows, especially those that take the form of foreign direct investment, should be reduced to a great extent as these inflows are least volatile. However, there is a case for attempting to control short-term inflows in countries with weak institutions.

Foreign access to domestic stock and bond markets should be liberalised before freeing the banks to fund themselves abroad. Creating an active stock market requires putting in place a regulatory framework requiring disclosure, discouraging insider trading and protecting the rights of minority shareholders. Corporate bond markets develop only once a deep, liquid and reliable market has first grown up in a benchmark asset, typically treasury bonds.

A sound and stable macro economic policy environment is needed where monetary policy and fiscal policy vulnerability are minimised, including especially the avoidance of fiscal deficits that are substantially beyond the country's sustainable domestic financing capacity. What this deficits level will be depends on a country's savings behavior and the quality of its capital markets.

Countries should reduce their vulnerability to liquidity/roll over risk and balance sheet risk. Foreign reserves need to be compared to meaningful measures of liabilities that can become a claim against a country's reserves. A measure of sound management of short-term flows is implicit in any prudential regulation of banks. Policy biases that led to an excessive accumulation of short-term debt should be addressed via policy change that eliminate such biases. Fieldstern (1999) has suggested accumulating foreign exchange reserves as insurance against the disruptive domestic financial system, which can prevent capital outflows. Greenspan (1999) has suggested that countries hold foreign exchange reserves equal to all the short-term debts scheduled to fall due over the next 12 months.

There is a sufficiently robust set of domestic institutions and national economic system that the crisis is contained and is not allowed to reach the stage where a country's capacity to meet its international obligations comes into question.

International Institutions have got responsibility to see that a country and its creditors come out of the crisis through a series of mutually consistent and reinforcing actions. The goal must be the restoration of confidence and the normal flow of private capital.

During the Latin American crisis, the international financial institutions provided only relatively minor sums to countries in crisis. The international institutions should make arrangement to get sufficient funds to the crisis-affected countries at penalty rates on collateral that is sound in normal times. Eatwell and Taylors (1999) suggest a 'World Financial Authority' to tackle international crises. It can encourage the countries to adopt capital account liberalisation. It can give sanction to the retention of controls by countries that have not yet upgraded their domestic financial system and put in place the other pre-requisites for capital account liberalisation.

SECTION 5: CONCLUSION

The Latin American crisis of the early 1980s and East Asian crisis of the late 1990s are significant events of the last two decades. There were similarities and differences between these two crises. Both the regions had displayed a robust performance of their economies before the crisis. There were massive foreign capital inflows in both the regions before the crisis. The cumulative debt outstanding in Latin America was \$301.3 billion whereas it was \$428.1 billion in East Asia in 1997. It was the massive inter-bank credit, which played a major funding role in East Asia whereas the bank credit went to public and publicly guaranteed projects in Latin America. The Latin American countries did not use the borrowings to develop resources in tradable goods, especially export industries adequate for future debt servicing. Foreign borrowings were used to cover current account deficits. These were also used to cover the huge losses of public sector units. In East Asia, a substantial part of the capital was channeled to unproductive and highly risky assets like real estate. Many property owners artificially inflated the value of their assets and kept borrowing against them and most real estate companies had a poor cash flow.

"Overborrowing" was the root cause of the financial crises in both Latin American and the East Asian regions. In both the regions the markets had failed to adjust in many respects. The model of "credit rationing" in the international credit market failed in both the case while extending credit in the international market which essentially led to the financial crises. The implicit guarantee in both the cases encouraged the international banks to lend freely without serious analysis of counterparty risk. Banks lent to these countries on the assumption of central bank support and that the market would continue "to test central banks" mettle and when that mettle was in doubt, a severe credit rationing would result. Capital liberalisation was the root cause of Latin American and East Asian crises. Heavy government involvement and loose controls on 'connected lending' played an important role in