FINANCIAL CRISES IN EMERGING MARKETS AND REFORMS OF THE INTERNATIONAL MONETARY SYSTEM

DOMINICK SALVATORE (*)

ABSTRACT

The liberalization of international financial markets have led to huge international capital flows in search of higher returns in emerging markets during this decade. This has been very beneficial to industrial and emerging market economies, but it has also been a source of great instability when they were quickly withdrawn in large volumes at the first sign of trouble in the nation. A number of reforms have been proposed (and some have already been adopted) by the International Monetary Fund and other international institutions that could go a long way toward reducing the problem. What is important is to discourage excessive liquid or speculative capital flows to emerging markets without discouraging long-term capital flows. In the final analysis, it must be realized, however, that even if all the reforms being considered were to be adopted, they would not eliminate all future financial crises. Some international financial instability and crises may be the inevitable result of liberalized financial markets and the cost that we have to pay in return for the benefits that liberalized financial markets provide to industrial and emerging market economies alike.

RÉSUMÉ

Au cours de cette dernière décennie, la libéralisation des marchés financiers internationaux a mené à des flux de capitaux internationaux significatifs à la recherche de rendements importants dans les marchés émergents. Ceci a apporté des bénéfices aux économies des pays industrialisés et des marchés émergeants, mais a été également la cause d'une forte instabilité lorsque ces capitaux ont été retirés rapidement aux premiers signes de difficulté dans la nation. Un certain nombre de réformes ont été proposées (et certaines ont été déjà adoptées) par le Fonds Monétaire International et qui pourraient grandement contribuer à résoudre le problème. Il est important de décourager des flux excessifs de capitaux liquides ou spéculatifs vers les pays émergents sans décourager les flux de capitaux à long terme. Dans l'analyse finale, il faut quand même tenir compte que même si toutes les réformes considérées étaient adoptées, elles ne pourraient pas éliminer toutes les crises financières futures. Une certaine instabilité et des crises financières internationales pourraient être le résultat inévitable de marchés financiers libéralisés et le prix que nous devons payer en contrepartie des bénéfices que ceux-ci fournissent aux économies des marchés industriels ainsi que des marchés émergeants.

During the past five years, there have been six serious financial crises in emerging markets. In 1994-95, Mexico faced financial and economic collapse.

In July 1997, the financial crisis in South-East Asia started, which afflicted Thailand, South Korea, Indonesia, Malaysia, and the Philippines.

In the summer 1998 the Russian financial and economic crisis began, in January 1999 Brazil plunged into a crisis, and in 2000 Argentina and Turkey faced a financial and economic crisis. All of these crises have more or less been resolved, except the crisis in Argentina and Turkey, which are still evolving.

The danger is that financial and economic crises in emerging economies may infect other countries, including the industrial countries. As a result, many people are today calling for reforms of the international monetary and financial system in order to prevent or at least contain these crises and avoid their spreading to the entire world.

In this paper, I will first examine in general the causes of the financial crises that have struck emerging markets in recent years and then examine the various proposals advanced to prevent or contain these crises in the future.

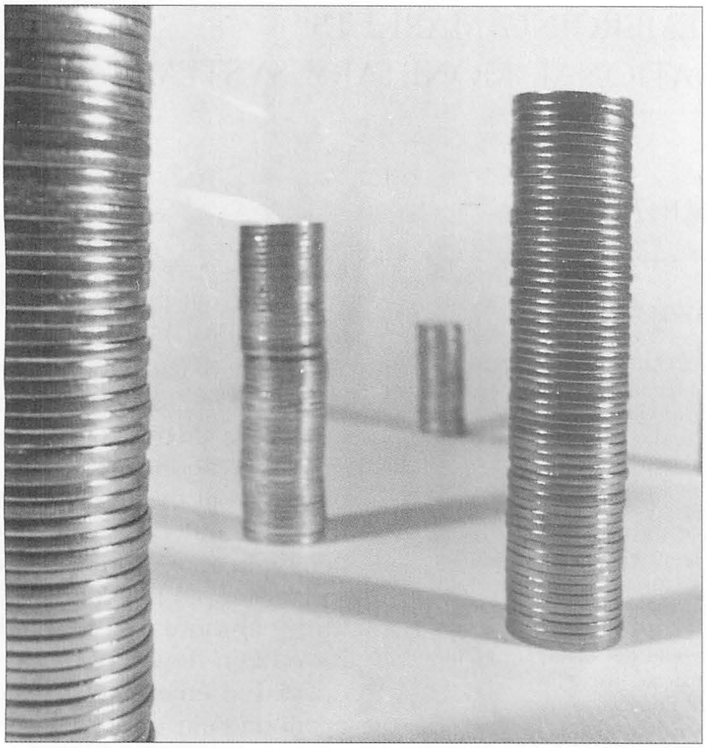
CAUSES OF THE RECENT FINANCIAL CRISES IN EMERGING MARKETS

The primary cause of the recent financial crises in emerging markets is the sudden withdrawals of liquid funds at the first sign of financial and economic difficulty. In recent years and a result of rapid liberalization, huge amounts of capital have been flowing from industrial to emerging market economies in order to take advantage of much higher returns in the latter. These higher returns resulted from the much faster growth rates and from the many new and unexploited investment opportunities arising in these markets.

The combination of financial liberalization, higher growth rates, and the existence of many investment opportunities with potentially higher rates of return led to huge capital flows to emerging markets during the past decade. Some of this capital flow was in the form of direct investments, which were long term in character and rather stable in nature. An increasing portion, however, has been financial in character and subject to quick withdrawal at the first sign of crisis. Then huge amounts of financial capital were quickly repatriated. This was in fact what happened and what precipitated each of the four crises that affected emerging markets during the past five years. Although the fundamental problem that led to the crises was different in each crisis, the process was very similar.

In the case of the 1994-95 **Mexican crisis**, the fundamental problem was an overvalued pesos, which led to huge trade deficits and loss of international reserves, until foreign and domestic investors, fearing devalua-

(*) Chairman, Department of Economics, Fordham University, New York City, USA.
Chairman of the Economics Section of the New York Academy of Sciences and consultant to the United Nations, the World Bank, the International Monetary Fund, and the Economic Policy Institute in Washington, D.C.



tion, rushed for the exit door at the end of 1994 and made a devaluation of the pesos a self-fulfilling prophesy. In the vain attempt to prevent further capital outflows, Mexico increased interest rates dramatically. But this not only failed to stem the capital outflows but also plunged the nation into a deep recession and forced Mexico to float its currency. Only with massive aid negotiated by the United States through the International Monetary Fund and some restructuring of its financial and fiscal sectors did Mexico come out of the recession and resolve the crisis by the end of 1996.

The fundamental cause of the financial crisis that started in **South-East Asia** in July 1997 was somewhat similar. Since the early 1990s, banks in South Korea, Thailand, Indonesia, Malaysia and the Philippines borrowed heavily in dollars and yens on the international capital market at the low interest rates prevailing. The banks then lent these funds in the local currency to domestic firms at much higher rates, thus earning huge profits. Foreign loans were not hedged for foreign exchange risks by the banks because of the belief that the nation's central bank would not change the par value of their currency (i.e., would not devalue) against the dollar. Local firms were willing to borrow at high rates because of the huge profits that they were earning in their rapidly expanding economies. But as local firms expended into more lines of production and into the production of more sophisticated products, they faced more and more world-class competition from leading foreign multinationals - it was one thing to produce bicycles and televisions and an entirely different thing to compete internationally in automobiles and computer chips. Then in 1994, China devalued its currency by about 30 percent and the Japanese yen depreciated by about 26 percent with respect to the U.S. dollar. Since the currencies of these nations were tied to the dollar and they competed head on with Chinese and Japanese products, the currencies of these nations became greatly overvalued and this led to huge trade deficits. The story then follows the Mexican pattern. Foreign and domestic investors, fearing devaluation, shifted their liquid funds abroad, making devaluation a self-fulfilling prophecy. Unable to repay their dollar- and yen-denominated foreign loans, local banks become insolvent and stopped making loans to local firms, forcing many of them out of business. In the meantime, in a vain attempt to stem the capital outflow, the central bank increased interest rates sharply, which not only failed to stem the capital outflow but also plunged these economies into recession. In 1998, all of these nations were in recession, with reductions in real GDP ranging from 2 percent in Malaysia to 15 percent in Indonesia. Only in 1999 have economic conditions in these countries (with the exception of Indonesia) begin to improve, but it may take at least another year of two before they are restored to full economic health.

In summer 1998, **Russia** plunged into deep financial, economic and political crisis. The immediate cause of the collapse was huge capital outflows which occurred when foreign and domestic investors realized that Russia was unable or unwilling to restructure its economy and the International Monetary Fund refused to provide additional loans to keep Russia afloat. The economic situation in Russia remains very grave and there are no signs that the crisis is coming to a complete end. In Russia there is today almost the complete breakdown of the rule of law and most of the banking sectors is in a state of insolvency. The central government collects only 8 percent of GDP in taxes and is unable to provide for even minimal government services without printing huge amounts of money, which led to a high rate of inflation. With the election of Putin, who replaced Yieltsin's, conditions in Russia improved somewhat but the nation still faces major difficulties in overcoming political and structural problems.

Brazil plunged into crisis on January 13, 1999 when it devalued the real by about 8 percent. Once again, this was triggered by huge capital outflows in the face of a sharp drop in international reserves and fear of devaluation. From July to December 1998, Brazil's international reserves declined from \$75 billion to \$36 billion. In addition, Brazil used \$9 billion of the \$41.5 billion it received from the International Monetary Fund (IMF) in the fall of 1998 to help Brazil defend the real while putting its fiscal house in order. The fundamental problem in Brazil was the huge and unsustainable budget deficit in excess of 8 percent of GDP in 1998. When foreign and domestic investors realized that Brazil would be unable to increase taxes and reduce expenditures sufficiently to abide by the agreement to cut in half its budget deficit by the end of this year (the condition for receiving the huge loan from the IMF in October 1998) they resumed their massive movement of liquid funds out of the country, thus forcing the devaluation of January 13, 1999.

But markets felt that this devaluation was entirely insufficient and funds continued to flow out at a rapid rate, thus forcing Brazil to let its currency (the real) float. By the end of March 1999, the real had depreciated by about 35 percent with respect to the dollar. In order to prevent further outflows of liquid capital, Brazil increased short-term interest rates to the incredible level of 39 percent. But this not only did not succeed in stemming the capital outflow but also plunged Brazil into deep recession in 1999. Even though economic conditions in Brazil seem to have improved (interest rates have been reduced to about 18 percent, the real appreciated from its low point in March, and inflation seemed contained), Brazil is still in a precarious situation because its budget deficit problem has by no means been resolved.

In 2000, **Argentina** faced very serious financial and economic difficulties as a result of the crisis in Brazil. The reason was that the devaluation of the currency (the real) by Brazil by about 35 percent in early 1999 made the Argentinean peso (which was rigidly tied to the dollar) grossly overvalued. This sharply reduced Argentinean exports to Brazil (its main trade partner) and pushed its economy into recession. Internal political problems made matters worse. Only in 2001, and as result of a large loan that Argentina received from the International Monetary Fund, did the nation seem to lowly come out of the recession.

In 2000, **Turkey** also plunged into a financial crisis, which soon became a full-fledged economic crisis that drove the economy into a deep recession. The trouble started in the financial sector when foreign investors pulled their liquid funds out of Turkey when they began to fear that the nation was going to be hit by a crisis. This lead to many Turkish banks becoming insolvent and suspending loans to businesses. Thus, a purely financial crisis soon became also an economic crisis. The problem was further aggravated by a political crisis. Only by the middle of 2001, again with the aid of large loan from the International Monetary Fund, did conditions begin to stabilize and Turkey seemed to be overcoming the crisis.

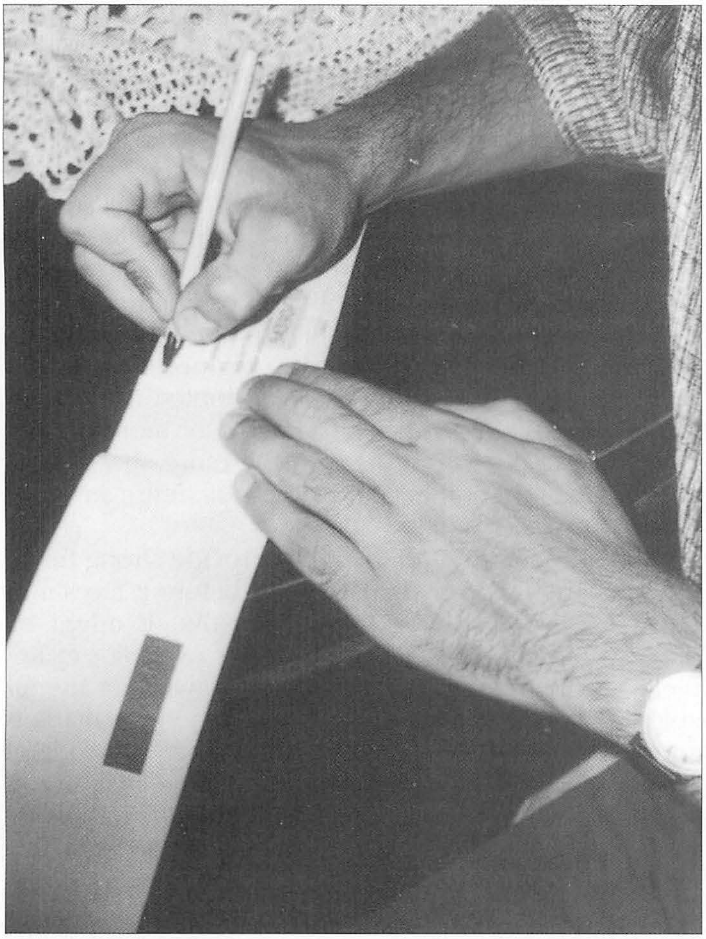
Reforms of the international monetary system and financial crises in emerging markets

It is clear from what was said above that a world of liberalized capital markets and huge international liquid capital flows is prone to serious financial crises, especially in emerging markets. The danger is that such crises could also spread to the rest of the world, including industrial countries, thus leading to calls for reforms of the architecture of the entire international monetary system. As a result of the financial crises in emerging markets during the past eight years (just as after each previous financial crisis), grandiose plans for reform were advanced, such as introducing a system of target zones for the exchange rates of the leading countries, adopting a system of formal and extensive international macroeconomic policy coordination among the leading countries, or moving to a freely flexible exchange rate system. There is no chance that any of these far-reaching reforms will be adopted in the near future. More likely is the introduction of more modest and down-to-earth reforms with the more specific aim of reducing the number and depth of future financial crises.

One reform that the IMF has is to provide strong financial backing to an emerging market before it faces a financial crisis, if there is a danger that it might be dragged into a crisis for no fault of its own. For example, it often happens that international investors are unable to make any distinction among emerging markets and withdraw funds from all of them when only one or a few of them face a crisis. Thus, when the crisis erupted in Russia in the summer of 1998, international investors withdrew funds also from South-East Asia and Latin America even though conditions were very different in these other markets.

The IMF inaugurated this reform and activated in the fall of 1998 by providing a line of credit of $41.5 billion to Brazil to help to shielded it from being infected by the Russian crisis and avoid a devaluation of the real, while buying time for Brazil to put its fiscal house in order. But when it became clear at the end of 1998 that Brazil would be unable to resolve its fiscal problem, investors, fearing devaluation, resumed the transfer of huge quantities of liquid funds abroad, thus precipitating the crisis. It is important to recognize, however, that Brazil plunged into a crisis not so much because it was infected by the financial crisis in Russia but rather because it was unable to resolve its internal (fiscal) problem, and it does not necessarily mean that preventive medicine cannot help against contagion in future crises. In 2001, the IMF also provided billions of dollars in loans to Argentina and Turkey to help restore confidence in financial and banking sectors and lift them out of the deep crisis into which they had fallen.

Another reform being considered by the IMF is to control the supply of liquid funds made available to emerging markets. There are various ways being explored to accomplish this. The first is to devise a number of early-warning financial indicators, such as the budget and current account deficit, long-term and short-term foreign debts, and international reserves as percentages of GDP for each emerging market econo-



my to signal which country or countries might be heading for trouble. The hope is that foreign investors would take note of the potential problem and avoid pouring excessive funds into the nation or nations, thus avoiding a crisis.

This would be helped if the IMF conducted semi-annual reviews of each emerging economy and made the results public. Today, such evaluations are conducted annually and cannot be released without the consent of the nation involved.

The hope is that semi-annual evaluations that are automatically made public would alert foreign investors to stay out of emerging markets that seem to be heading for trouble, thus helping to avoid a crisis.

Still another method, being considered by the IMF is to set up some kind of a clearing house to keep track of all the loans and liquid investments made by foreign banks and other financial institutions in emerging markets.

Lack of this information has led to excessive loans and other liquid investments in emerging markets in the past, which eventually led to crisis. Finally, consideration is being given to the imposition of some kind of restriction or tax on liquid capital flows to emerging markets, similar to the one adopted by Chile from 1991 to 1997, in order to discourage speculative capital inflows. But this is difficult to do because money is fungible and investors can easily find ways around the tax or regulation.

Such a tax or restriction may also reduce long-term capital flows, such as foreign direct investments, which are very important to the growth and development of emerging markets.

CONCLUSIONS

The liberalization of international financial markets have led to huge international capital flows in search of higher returns in emerging markets during this decade. This has been very beneficial to industrial and emerging market economies.

For investors from industrial countries it provided higher returns and the ability to better spread their investment risks.

For emerging markets, this source of capital has been very helpful in promoting a much higher rate of growth and development than would otherwise have been possible. However, huge capital flows to emerging markets have also been a source of great instability when they were quickly withdrawn in large volumes at the first sign of real or imagined trouble.

The reforms being proposed by the IMF and other international institutions, if adopted, would go a long way toward reducing the problem. What is important is to discourage excessive liquid or speculative capital flows to emerging markets without discouraging long-term capital flows, especially foreign direct investments, which are much more stable in character and are greatly needed to allow emerging market economies resume their high growth rates of the first half of the 1990s.

In the final analysis, it must be realized, however, that even if all the reforms being considered were to be adopted, they would not eliminate all future financial crises.

All we can hope is that these reforms would reduce the frequency and severity of financial crises in the future. In short, some international financial instability and crises may be the inevitable result of liberalized financial markets and the cost that we have to pay in return for the benefits that liberalized financial markets provide to industrial and emerging market economies alike. ●

REFERENCES

Dominick Salvatore, *International Economics*, 7th edition. New York: John Wiley & Sons, 2001, Chapters 11, 20-21. (Italian Translation, Carocci Editore).

Dominick Salvatore, *International Finance in the New Global Economy*. New York: Oxford University Press, 2001.

Dominick Salvatore, Editor, "Symposium: Lessons from the Financial Crisis in East Asia", Special Issue of the *Journal of Policy Modeling*, Vol. 21, No. 3, May 1999 (with contributions from Rudi Dornbusch, MIT; Michael Mussa, Chief Economist of the International Monetary Fund; Joseph Stiglitz, Chief Economist of the World Bank; Edmund Phelps, Columbia University; and Dominick Salvatore, Fordham University).