

Implications of the East Asian Crisis for Debt Management¹

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I will argue in this paper that the proximate cause of the contagion that transformed a conventional exchange rate crisis in one country into a regional, or even global, crisis was the debt structure, and particularly the external debt structure, of the other countries that were in turn subjected to speculative assaults. Since this is in many ways the most serious economic crisis the world has had to confront since the Great Depression, it is extremely timely for the RBI and the Ministry of Finance to convene a conference to examine the issue of external debt management.

My paper starts by discussing conventional wisdom about what constitutes a desirable profile of external debt. It then proceeds to argue that it was the deviation from this profile that made the East Asian countries vulnerable to contagion. The next question discussed is how they built up their vulnerability. That lays the basis for consideration in the final section of the paper of how India can make sure that it does not expose itself to similar problems at some time in the future, when the international capital market again booms, as it surely will in due course.

A Desirable Debt Profile

A country's external debt profile has two dimensions, the magnitude and composition of its external debt respectively. I start by discussing the question of the desirable magnitude of external debt.

The main point to make about the level of external debt is that it should not become too large. While there is an obvious advantage in foreign borrowing from the standpoint of a capital-poor country where the rate of return on marginal investment exceeds the world interest rate plus the country-specific risk premium, this benefit is rather modest², and easily outweighed by the macroeconomic risks of foreign indebtedness. Debt should therefore be kept sufficiently modest to avoid it becoming a significant macro threat.

This poses the question as to the point at which debt is large enough to begin to pose a

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² If a country borrows an extra 1% of GNP abroad and invests it in a project with a rate of return of 20%, but pays interest of 10%, then the growth rate of GNP will increase by 0.1%. Even if the rate of return were as high as 30%, it would take a massive 5% of GNP current account deficit to add a modest 1% to the growth rate.

macro risk. Obviously this will vary by the size of the country: a debt that would be vastly too big for Bhutan would be very modest for India. But what measure of the size of a country is relevant? The two traditional answers are GNP and exports, the former measuring the ability to service debt in the long run, given time to adjust the balance of payments by shifting output from non-tradables into tradables, and the latter being a more relevant measure in the short run. Traditional rules of thumb are that external debt should not exceed 40% of GNP or 200% of exports, and that the debt service ratio (the ratio of debt service to exports) should not exceed 25%. The first two rules amount to the same thing for a country which exports 20% of its GNP, and they are consistent with the third when debt service (interest plus amortization) costs 12.5% of debt each year. Although I would not want to argue that these rules have any firm analytical foundation, they have shown sufficient staying power that it makes sense to use them until someone develops a more convincing approach and demonstrates that it works better.

Suppose that a country does not export 20% of its GNP: which rule of thumb should be used? A conservative approach is to focus on the more restrictive of the three rules of thumb. This implies, for example, that a country like India that exports less than 20% of GNP should be guided by avoiding its debt/export ratio going above 200% as long as debt service costs no more than 12.5% of the value of debt. If debt service were more expensive than that, e.g. because the debt were very short-term, the debt service ratio would become the binding constraint on the prudent level of debt.

What concept of debt is relevant in applying the first two rules of thumb? Should it be gross or net? If net, what should be netted off? Should concessional debt be included one-for-one? Should debt be interpreted to include non-debt external claims on the country, such as foreign direct investment (FDI) and foreign portfolio equity investment?

The traditional practice has been to count gross debt and to exclude equity claims. Here I am less comfortable in subscribing to traditional practice than I am in using the traditional rules of thumb about the maximum safe level of debt. At the very least, it would seem reasonable to deduct any foreign reserves in excess of the traditional 3 months of imports from the level of gross debt. Also, concessional debt should be included at its present value rather than its book value. Complete exclusion of all equity claims, although implied by a literal interpretation of the word “debt”, also seems rather dubious, for such claims do impose obligations for debt service that will compete with the servicing of debt strictly construed. (This provides an argument for focusing attention on the debt service ratio rather than the debt/export ratio, since debt service includes payments on equity claims. The debt service ratio also automatically makes an appropriate allowance for concessional debt. On the other hand, this measure is very sensitive to the maturity structure of the debt, which means that it is not a pure measure of the level of debt, but also responds to debt composition.) My own inclination, if I were devising a single indicator to monitor a country’s vulnerability to pressure from the international capital market, would be to give a fractional weighting to equity claims (as well as concessional debt) in constructing my measure of external debt.

This focus on different types of external claims on the country brings us to the second major issue, that of composition of the “debt”. Here there is an obvious convenience in adopting a broad definition of “debt” that includes equity claims. With that definition, one can

distinguish four broad categories of external claims:

- FDI
- Portfolio equity
- Long-term loans
- Short-term loans.

Further disaggregation is of course possible, e.g. between bonds and loans from banks, or between loans to the public rather than the private sector, or between loans denominated in domestic rather than foreign currency. Only the latter distinction is crucial to the argument to be developed below.

Consider first the properties of FDI. This is usually thought of as stable, because investors cannot easily sell the factories and businesses in which they have invested and repatriate the proceeds. Indeed, since most such investment is driven by long-term corporate plans, one might expect a continuing inflow of capital even in periods of financial crisis, and recent experience confirms this. For example, FDI to East Asia has remained roughly stable in the past year, despite the crisis. This is not to deny that multinationals may well adjust their currency exposure in much the same way that financial investors do, by fleeing from a currency in trouble, and this will usually show up in fluctuations in the measured inflow of FDI. Nevertheless, this portfolio readjustment is limited in scope, leaving FDI as a rather stable source of capital. Another source of flexibility that may prove stabilizing to the host country is that profits, and therefore dividend remittances, will tend to decline if the economy runs into trouble.

Portfolio capital, in contrast, is traditionally regarded as highly volatile. It is true that investors often switch their funds between one asset and another, including assets in different countries, and so from a micro point of view it is certainly correct to regard this as a volatile source of capital. However, one needs to probe a little deeper and ask whether foreign portfolio investors are collectively likely to have a destabilizing impact. If they all want to sell at the same time, they will drive down the price of stocks. Indeed, if the shock that causes them to want to withdraw is one that seems equally pertinent to domestic investors (such as a change in the expected future profits of the companies in question), then foreign investors as a group will be unable to liquidate stocks and obtain domestic money that they can sell for foreign exchange, because the whole burden of the revision in expectations will be absorbed by a fall in the stock market rather than impact on the foreign exchange market. Doubtless a fall in the stock market may not be good news for policymakers either, but the short-run links between stock prices and the real economy seem to be rather weak, which suggests that this may be a relatively good place to absorb changes in expectations.

However, experience in East Asia, and indeed in India, over the past 18 months was that shocks did not impinge equally on domestic and foreign investors. For example, portfolio equity investment into the East Asian 5 (Indonesia, Korea, Malaysia, Philippines, and Thailand) went from an inflow of \$12.4 billion in 1996 to an outflow of \$4.3 billion in 1997 (World Bank

1998, Table 1.1).³ One source of such asymmetrical shocks arises when foreign investors run into trouble in third markets, which then compels them to liquidate positions in order to meet margin calls. In that event domestic investors buy stocks net from foreign investors and some of the shock gets transmitted to the foreign exchange market. Alternatively, foreign investors may develop more pessimistic expectations about the local market than domestic investors, which can again lead to an outflow of foreign exchange, as happened in East Asia.

The third source of foreign capital distinguished above is long-term loans. This was the principal medium for capital exports during the previous era of capital mobility, in the decades preceding the First World War. Where one draws the line between long-term and short-term loans is inherently arbitrary, but a 5-year maturity seems a reasonable threshold. Long-term loans cannot be liquidated quickly, but a capital inflow can still turn into an outflow if new loans decline to a point where they are less than amortization payments. The burden of interest servicing may be predetermined, if the loan is on fixed interest terms, or it may vary in response to national or international economic developments, if the interest rate floats. This was common in the loans that had been contracted by the countries that succumbed to the 1980s debt crisis, and indeed the rise in real and nominal interest rates when the major industrial countries decided to tackle inflation was one of the factors that precipitated that crisis. It is worth noting that some of what looked like long-term loans (in particular, some of those made to Korea) had a bullet repayment clause which entitled the lender to demand premature repayment if the situation of the borrower became problematic. That is, just when the borrower most needed stable funds that would not be susceptible to panic withdrawal, it found a large part of its loans being withdrawn overnight! Needless to say, loans with such a clause should never be contracted and, if by some mischance they are, they should certainly not be counted as long-term debt.

The final source of foreign capital consists of short-term loans. Here it is worth distinguishing between trade credits, which provide a rather stable source of financing even though each individual loan has a short maturity, and other types of short-term borrowing. It is the latter, which includes much bank lending to the financial and corporate sectors, that has proved to be the source of most of the volatility in foreign lending to developing countries. For example, of the \$118 billion swing in capital flows to the East Asian 5 between 1996 and 1998, \$89 billion was accounted for by banks (Reisen 1998, Table 1), most of which was undoubtedly short-term.

If short-term loans exceed a country's stock of reserves, then a change in the sentiment of foreign lenders can certainly precipitate a financial crisis. It is therefore argued that countries should always be sure that they have a reserve stock greater than their outstanding short-term debts (excluding trade credit). But then one has to ask what function is served by such short-term borrowing. The country is acting as a financial intermediary that borrows abroad at one rate of interest and then on-lends the funds at a lower rate of interest (because the borrower must always expect to pay more than it can expect to earn on funds placed in the international capital market). Self interest is served by avoiding such borrowing as far as possible.

³ Using rather earlier estimates, the Institute of International Finance showed a somewhat larger swing to an outflow of \$6.8 billion in 1997, but then recovery to rough balance in 1998 and 1999.

Both long-term and short-term loans can in principle be denominated in either foreign currency or domestic currency. In practice developing countries, unlike the larger industrial countries, usually borrow in foreign currency denominated claims, although in recent years both Brazil and Mexico have sold large sums of short-term domestic currency debt to foreigners. Borrowing in foreign currency brings an additional source of vulnerability, in that any devaluation of the domestic currency results in an increase in the real (domestic currency) burden of the debt. However, it does have an offsetting advantage, in that it reduces the pressure on policymakers to raise interest rates in order to avoid a capital outflow when a crisis develops.

The above discussion suggests a partial rank ordering of the desirability of different forms of foreign borrowing, at least from the standpoint of limiting vulnerability. FDI is surely the most desirable form of foreign borrowing in terms of its lowest propensity to flee. (It also brings access to additional benefits like technology, managerial skills, and markets, although some people would be concerned about what they would perceive to be a countervailing cost in terms of increased foreign control over the economy.) It is difficult to know how to rank long-term loans, portfolio equity, and also trade credit, so I will group these three together in a second category. Finally, short-term loans other than trade credit fall in a third and unambiguously least desirable category, especially given that they are likely to be denominated in foreign currency.

The Causes of the East Asian Crisis

The debt profile of the East Asian countries differed profoundly from the profile that has just been argued to be desirable. To begin with, debt exceeded the 40% of GNP prudent threshold in 4 of the East Asian 5 crisis countries (see Table 1), even when the debt totals make no allowance for the stock of FDI or portfolio investment. In terms of composition, the stock of FDI was substantial (over 5% of GNP) in all countries except Korea, but the stock of the least desirable form of foreign debt, namely short-term foreign-currency denominated debt, was also substantial in Indonesia, Korea, and Thailand.

Table 1 shows six measures of debt exposure for 10 Asian economies: the East Asian 5 that were at the core of the crisis plus China and four South Asian economies (India, Bangladesh, Pakistan, and Sri Lanka).⁴ The first column shows the traditional debt/export ratio, the second the equally traditional debt/GNP ratio, and the third the debt-service ratio. The only one of these that suggests Thailand might have been in trouble is the debt/GNP ratio, so in column (4) I have corrected the crude measure of external debt on the lines that I previously suggested would be appropriate, by adding on 25% of the value of cumulated FDI inflows over the years 1990-96 and 50% of the cumulated value of portfolio equity inflows over the same period, and deducting 60% of the value of concessional debt, and then taking the ratio of adjusted debt to GNP. Column (5) shows the current account deficit as a proportion of GNP. Although current account deficits have not performed well as forward indicators of crises in statistical crisis-prediction exercises, logic says that the rate at which debt is being accumulated has to matter if debt matters at all, especially since it is difficult to achieve large

⁴ Data were not available to permit including Hong Kong, Singapore, and Taiwan in the group.

adjustments of the current account quickly with a fixed exchange rate and without throwing the economy into recession. Opinions about how large a current account deficit is dangerous have varied somewhat, but most economists who have ventured an opinion on this have given a figure in the range of 3 to 5 per cent of GNP as the threshold. The final column offers a measure of “excess short-term debt” relative to reserves. Excess short-term debt is defined as short-term debt minus 11% of the value of imports of goods and services, the 11% representing an estimate of the amount of trade credit. (The 11% figure came by assuming that all of Malaysia’s short-term loans consisted of trade credit, an assumption motivated by the efforts that Malaysia has made to limit its exposure to short-term debt.)

How can one explain the crisis? While some journalistic rumblings have given the impression that the crisis is due to the countries having been insufficiently diligent in implementing free market orthodoxy, it is very difficult to sustain the case that the crisis was due to weak fundamentals. In fact, the East Asian victims of the crisis were the countries that had the strongest macroeconomic fundamentals in the world, if one focuses on the traditional fundamentals of low inflation, high savings rates, rapid growth, high reserves, and even, in several cases, modest current account deficits and low levels of foreign and domestic debt.⁵ Moreover, the existing crisis-prediction models all fail miserably in terms of their ability to select the East Asian countries as having been likely to succumb to a crisis in 1997 (Furman and Stiglitz 1998).

Most commentators who have sought to explain the East Asian crisis have agreed that it is not the traditional fundamentals but rather the financial structure was at the centre of the problem. That is true for Paul Krugman (1998), who emphasized the role of guarantees and claimed that these had initiated a series of asset price bubbles which were finally pricked by the Thai crisis. It is true of Michael Bordo (1998), who wrote that “the Asian problems were rooted in excessive credit to the private sector fueled by international capital flows to the banks and to corporate borrowers”. And it is true of Joseph Stiglitz and Jeffrey Sachs, who have been at the fore in attributing the crisis to financial panic. My own view is certainly that the structure of financial claims involved too much debt relative to equity⁶, too much short-term debt relative to long-term, and too much forex relative to domestic currency debt (with the first two weaknesses being manifest in the domestic as well as the external debt structure.) Such a structure of financial claims constituted a tinder box, awaiting some shock that would make investors question whether they ought to run for the exits, i.e. panic.

That shock was provided by the devaluation of the Thai baht on 2 July 1997. That devaluation can be explained in terms of rather orthodox fundamentals, namely an attempt to defend an overvalued almost-fixed exchange rate even though much foreign debt had accumulated, the current account was in substantial deficit, and export growth had turned

⁵ They also scored fairly well in terms of the economic freedom index compiled by the Heritage Foundation. Out of 148 countries classified in 1997, Thailand came 23rd and the others of the 5 ranked from 27th to 59th. Hong Kong, another victim of the crisis, was in first place.

⁶ The debt/equity ratio was over 900% in Indonesia, about 500% in Korea, and over 400% in Thailand, as opposed to ratios between 100% and 200% in most industrial countries. However, the ratio was fairly typical in Malaysia and low (below 100%) in the Philippines. (Source: *IMF Survey*, 14 Dec. 1998, p. 394.)

negative. This invited a series of speculative raids, which eventually exhausted the reserve stock and led to devaluation. This had a devastating effect on the solvency of both the financial system and the corporate sector, thus intensifying the crisis.

The basic idea of contagion is that developments in one country provoke investors to ask whether other countries, which would otherwise have been under no particular pressure, may be vulnerable to the same problems that have emerged in the first country. Looking at Table 1, we see that investors would have observed that Thailand had a high debt/GNP ratio, a large current account deficit, and short-term debt obligations that exceeded its stock of international reserves. They then presumably asked themselves: what other countries in the same geographical area suffer from the same weaknesses? Table 1 reveals that they would have observed that Indonesia, Malaysia (marginally), the Philippines, Pakistan, and Sri Lanka were also over-indebted, although Pakistan and Sri Lanka are eliminated from that list once one looks at adjusted rather than crude debt, because most of their debt is concessional. He would also have realized that Malaysia, Korea, the Philippines, Pakistan, and Sri Lanka, and (marginally) Bangladesh and Indonesia, were in current account deficit, although he might also have recognized that the deficits of the South Asian countries were financed to a substantial extent by aid inflows, and therefore were less worrying than those of the East Asian countries. Above all, he would surely have realized that Indonesia, Korea, and Pakistan had a big overhang of short-term debt, which meant that each individual investor needed to worry that, if other investors were to run, he would be in trouble unless he had got out first. That is precisely the situation in which a financial run, or panic, can develop, which it did, in Indonesia and Korea and, to a somewhat lesser extent, in Malaysia and the Philippines. Why did it not also happen in Pakistan, the one South Asian country that the indicators would suggest ought also to have been vulnerable? Presumably because the investors who were players in Thailand were not also involved in Pakistan (and remember that a few months later Pakistan was indeed forced to freeze its foreign currency deposits, in response to a country-specific shock).

How Did the Vulnerability Arise?

If the crisis became a general East Asian crisis, rather than just a Thai crisis, because the countries had built up a level and structure of liabilities that made them extremely vulnerable to adverse shocks, the next question to ask is how they got themselves into this vulnerable situation.

Many observers have focused on inadequacies of the system of financial supervision, which permitted banks to take on a dangerous level of short-term and/or foreign currency debt. It has also been argued that transparency was inadequate, resulting in foreign lenders failing to appreciate the extent to which the countries had already borrowed abroad and accumulated short-term foreign exchange debts. And Paul Krugman has emphasized the role of explicit and implicit guarantees in creating moral hazard and generating asset price bubbles. All of these factors may well have contributed to the problem. Nevertheless, a consideration of which countries succumbed to the crisis, and which succeeded in riding it out, makes it difficult to believe that any of these was the critical factor. Consider the 13 economies listed below (the 10 from Table 1 plus Hong Kong, Singapore, and Taiwan), which are divided between those that fell victim to the crisis and those that did not according to whether GDP growth is believed

to have been negative or positive in 1998.

Negative growth in 1998:⁷

Hong Kong
Indonesia
Korea
Malaysia
Philippines (marginal)
Singapore (marginal)
Thailand

Positive growth in 1998:

Bangladesh
China
India
Pakistan
Sri Lanka
Taiwan.

Now ask what the countries within each group have in common but that distinguishes between the two groups. It is surely not the quality of bank supervision, which is notoriously bad in several of the non-crisis (positive growth) countries, and is probably somewhat better on average in the crisis countries. Nor is it transparency, which is, once again, somewhat less of a problem in the crisis countries. Nor is it the extent to which banks enjoy implicit guarantees, which is at least as strong in South Asia as elsewhere. And it is certainly not the strength of the macroeconomic fundamentals, or the exchange-rate regime. The one feature that discriminates correctly between the two groups is whether or not they had liberalized the capital account of the balance of payments. (Malaysia had made some effort to limit short-term capital inflows in the past, but its regime was still more liberal than that which prevailed in any of the non-crisis countries prior to its imposition of comprehensive capital controls in August 1998.)

It is well known that the abolition of capital controls has often been followed by a large inflow of capital. Moreover, this inflow has often been disproportionately in the form of short-term capital, which is the form that foreign lenders often seem most willing to supply, presumably believing that it gives them the opportunity of liquidating their position if things begin to go wrong (a belief that cannot be simultaneously right for the majority of them, at least without a bailout from the international community). Hence it seems all too easy to believe that the observed association between the absence of capital controls and the occurrence of financial crisis was causal and not merely coincidental.

Policy Implications

⁷ Estimates made in late 1998 and presented in World Bank, *Global Economic Prospects*, Dec. 1998.

Given that the size and structure of external financial obligations that tend to develop in the absence of deliberate policy make a country vulnerable to contagion, the authorities have a responsibility to try and limit the size of the external debt and, even more, to avoid a build-up of short-term loan obligations (other than trade credit). This implies, in the first place, taking care with how they structure their own borrowings, both international and domestic. International borrowing should not only be long-term, but it needs to be phased so as to avoid a bunching of maturities. Some of the domestic borrowing should be short-term, to provide the base for active domestic financial markets, but it is still important to avoid a preponderance of short-term claims, inter alia so as to make it more difficult for a run on the currency to gather steam.

In the absence of capital account convertibility, the authorities can also manage the level and structure of the rest of the external debt, by limiting the amount and terms of the external borrowings of the private sector. Obviously this does not mean that the economy will be immune from capital outflows, which can still occur through leads and lags and evasion as well as the rundown of foreign loans without rollover. Moreover, capital outflows can originate with domestic rather than foreign investors. Nevertheless, leads and lags have a limit, and lags and evasion and amortization take time to build up, so that the problems are distinctly more manageable in the absence of capital account convertibility. (It is well-known that administrative measures seem to be more effective in keeping capital inflows under control than in limiting capital outflows.)

Before concluding that this shows the desirability of postponing capital account convertibility (CAC) indefinitely, one needs to consider (a) whether CAC promises other benefits that outweigh its risks, and (b) whether there are other policy instruments that could be deployed to avoid the risks.

So far as the first question is concerned, empirical studies have so far failed to detect any benefit from overall capital account liberalization in terms of the promotion of a faster rate of growth (see Alesina, Grilli, and Milesi-Ferretti 1994; Rodrik 1998; and Carrasquilla 1998). Despite this, it is easy to believe that benefits would flow from the liberalization of particular types of capital flow, and the recommendations of the Tarapore Committee as to the phasing of liberalization provide an excellent guide as to where the priorities should lie. FDI is one such area (except, presumably, to those who dislike foreign control per se). Small personal transactions are another (on grounds of personal liberty as much as economic policy). The restrictions that apply to exporters deserve particular attention: a study being undertaken by the World Bank concludes that the current foreign exchange regulations are a severe deterrent to exporting by new firms that are not already established exporters, and that they deter firms with a well-developed home market from adding export lines as a marginal activity, since the risks incurred by inadvertent violation of the regulations are substantial⁸ and the costs of certain transactions that are considered routine in most countries⁹ are prohibitive.

Are there mechanisms other than capital controls that can be deployed by the

⁸ For example, offences against the foreign exchange regulations are non-bailable criminal offences.

⁹ Such as getting credit (in terms of reducing the sum to be remitted into rupees) for returned goods.

authorities to avoid a dangerous build-up of international debt, particularly at short maturities? The one that has been most discussed in the literature is that which has been pioneered by Chile and Colombia. Chile instituted a minimum holding period of one year for equity investments, both FDI and portfolio investments. For loans (other than trade credit) by foreigners to any Chilean entity, the central bank imposed an obligation to hold with it an unremunerated “*encaje*” (reserve requirement) of 30% of the value of the loan for one year. This created a prohibitive deterrent to short-term inflows, while only modestly raising the interest rate to the borrower for a long-term loan. As a result, Chile (and even more Colombia) largely avoided any build-up of short-term debt. In recent months the *encaje* has been reduced to zero, since Chile was no longer faced by the problem of an excessive inflow of short-term capital. Contrary to the view in some quarters that this demonstrated that the Chilean system had failed, what it actually showed is that variations in the *encaje* can be used as a flexible instrument of short-run macro policy to help insulate a country against the vagaries of boom and bust in the international capital market.

Another much discussed possibility is the Tobin tax. This would consist of a small tax (figures of 0.5% to 0.05% of the value of the transaction have been mentioned) on all foreign exchange transactions. There would doubtless be administrative difficulties in getting all the countries with actual or potential foreign exchange markets to agree to impose such a tax, but the more fundamental issue is whether such a tax would help to stabilize the markets. It is far-fetched to suppose that in a crisis like that which overtook East Asia in late 1997 investors would have been deterred from withdrawing their funds by the prospect of paying a tax of 0.5% or less, so the only issue is whether the prospect of paying such a tax at the time of entry would have deterred the build-up of short-term debt in the first place. What one can surely say is that one would get more mileage out of a tax that discriminated between money that was going in and that which was going out, as the Chilean system does, than out of a Tobin tax which is imposed equally on stabilizing and destabilizing flows.

Some observers would classify both the Chilean *encaje* and the Tobin tax as forms of exchange control and incompatible with CAC. They might want to know whether there are not methods for avoiding the East Asian problems that do not operate at the frontier. So far as the financial system is concerned, it is possible to use prudential regulations in a way that would have avoided a number of the East Asian problems.¹⁰ Banks can be limited in the magnitude of the foreign exchange exposure they incur, and maturity mismatches might also be subjected to discipline by the supervisory authority. On-lending by financial intermediaries in foreign currency could be prohibited. The East Asian countries had failed to institute such measures (indeed, Korea had liberalized only short-term inflows), which is one reason that they were so exposed to the crisis.

Another relevant measure is to prohibit borrowing from the domestic financial system by foreigners. This would have prevented the sort of speculation that occurred in Thailand prior to the initial devaluation of the baht, when hedge funds borrowed baht and

¹⁰ The Tarapore Committee (paragraph 3.47) suggested several ways of doing this in India.

then sold them for dollars. It is reported that Hong Kong banks are now restricting loans denominated in Hong Kong dollars to foreign borrowers as part of an effort to defeat the speculative attacks to which Hong Kong has been subjected for the past 15 months (Dieter 1998).

However, foreign borrowing does not all take place through the financial sector. In Indonesia, in particular, the bulk of the borrowing was undertaken by the corporate sector, most of it by exporters who believed that their export activity gave them a natural hedge against devaluation. It is difficult to envisage substitutes for border controls that would impose effective discipline on the exposure of the corporate sector. Some of the most pernicious practices, such as the insertion of bullet repayment clauses subject to the discretion of the lender (a widespread practice in Korea's borrowing, as already mentioned), might be declared illegal and thereby rendered unenforceable. One might also be able to impose a tax surcharge on interest income incurred on obligations denominated in a foreign currency, or on short-term obligations denominated in foreign currency, although there is a danger of that penalizing normal trade credit as well as the sort of debt that seems undesirable. But it seems to be the case that the simplest way of avoiding the danger of an excessive accumulation of short-term foreign debt is to maintain controls at the border. In retrospect it seems clear that the advice to dismantle these controls rapidly, as was urged by many in the West prior to the East Asian crisis, was misguided. While one can identify some interest groups that benefited from the implementation of this advice, notably those who make a living by churning funds in financial markets, the broader social interest was not well-served.

Another possibility that should be recognized is that reforms in the lending countries will help to reduce the intensity of the boom-and-bust cycles to which international lending has traditionally been subject. For example, under the 1988 Basle Accord for bank supervision, short-term bank credit to non-OECD banks carries a low 20% risk weighting while long-term credit (for over one year) is discouraged by a 100% risk weight. Similarly, claims on banks carry a 20% risk weighting while claims on non-banks carry a 100% risk weighting, thus encouraging banks to lend to unregulated hedge funds in preference to blue-chip companies. One can hope that the negotiations on reconstructing the international financial architecture will eliminate such distortions and encourage longer-term and more direct lending, where the ultimate lenders have a chance of knowing what they are really lending for. One may also hope that they will tackle the problems caused by the requirement that many financial institutions put money only in investment-grade paper, a requirement that proved highly destabilizing in East Asia when the credit rating agencies rapidly downgraded the countries in trouble in the midst of the crisis. But, while India can hope for such helpful outcomes to the ongoing international negotiations, it is not going to be in a position to determine their outcome, and it therefore needs to be prepared with its own agenda in case international agreements fall short of the desirable.

Concluding Remarks

The conventional interpretation of the Latin American debt crisis of the 1980s was that it resulted from macroeconomic indiscipline. Governments ran excessively large deficits and

financed them by sovereign borrowing on the international capital market, which resulted in large current account deficits and overvalued currencies as a natural by-product. When debt servicing capacity was undermined by increased oil prices and the world recession of the early 1980s, at the same time that interest rates soared because the West decided to bring inflation down, crisis ensued.

This explanation did not fit one country, Chile, which had a fiscal surplus and whose borrowing was undertaken overwhelmingly by the private sector.¹¹ The Chilean authorities assumed that private sector debts could not create a macro problem. This proved to be wrong, but it seems to have been implicitly assumed subsequently that this was because the banks bullied the Chilean authorities into socializing the debt, so that when a similar sequence of events started unfolding in East Asia, with a high level of private borrowing in countries with exemplary macroeconomic fundamentals, there was euphoria rather than concern. With the benefit of hindsight, this was clearly a mistake. Once the crisis began to develop, these countries did their best to honour their obligations to service their debts, but, even with substantial assistance from the international financial institutions, they found this impossible. They were simply unable to borrow more, or even to roll over their existing debts on a voluntary basis, as panic swept through the investment community. One crystal clear conclusion from this experience is that in future we need to consider a country's financial structure, and particularly the structure of its external debt, to be among the fundamentals.

The question is: what can be done to keep a low-risk structure of external debt? I have argued that it is not enough to keep a good structure of public debt and the traditional fundamentals in order: indeed, it is precisely when the international financial community is impressed by fiscal rectitude and market-friendly policies and so on that the danger of euphoria and an excessive capital inflow arises. The problem I see is that full CAC means giving up the most obvious weapon to maintain a prudent debt profile. This is not to argue against liberalizing particular segments of the capital account, but it is to ask whether there exist policy weapons capable of assuring a prudent debt profile that are consistent with full CAC. I have done my best to explore what these might be, but I am not confident that I have succeeded.

¹¹ Colombia also had a fiscal surplus, but it avoided the worst of the crisis (it, alone in Latin America, avoided having to reschedule its debt).

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Table 1: External Debt Indicators: Selected Countries in East and South Asia, 1996

	EDT/XGS	EDT/GNP	DS/XGS	Adj. EDT/ GNP	CAB/GNP	Excess Shor-term debt/Reserves
Indonesia	219.6	58.3	36.7	56.6	-3.5	132.1
Korea, Rep.	84.0	27.4	9.4	27.4	-4.8	135.6
Malaysia	43.4	42.0	9.2	54.8	-4.9	4.1
Philippines	119.5	46.5	16.0	45.8	-4.6	29.6
Thailand	127.2	51.3	13.3	52.8	-8.3	74.0
China	75.1	16.0	9.2	20.5	0.9	7.6
Bangladesh	355.1	38.3	15.5	16.7	-3.9	-36.0
India	235.6	28.3	30.4	23.4	-1.4	4.4
Pakistan	278.6	46.1	30.7	35.0	-6.5	101.3
Sri Lanka	164.7	58.5	8.7	33.2	-5.0	-5.3

Source: World Bank, SIMA(Statistical Information Mangement & Analysis) , Working Live Database.