

1-1-2003

The Political Economy of Perverse Financial Liberalization: Examples from the Asian Crisis

Nancy Neiman Auerbach
Scripps College

Thomas D. Willett
Claremont Graduate University

Recommended Citation

Willett, Thomas D. and Auerbach, Nancy Neiman, (2003), The Political Economy of Perverse Financial Liberalization: Examples from the Asian Crisis, Claremont Colleges Working Papers, Claremont Colleges

This Presentation is brought to you for free and open access by the Scripps Faculty Scholarship at Scholarship @ Claremont. It has been accepted for inclusion in Scripps Faculty Publications and Research by an authorized administrator of Scholarship @ Claremont. For more information, please contact scholarship@cuc.claremont.edu.

**The Political Economy of Perverse Financial Liberalization:
Examples from the Asian Crisis***

Nancy Neiman Auerbach¹

And

Thomas D. Willett²

For presentation at the Conference of Korea and the World Economy, II
University of Washington, August 1-2, 2003.

* Earlier versions of this paper have been presented at the Annual Meetings of the International Studies Association, the Public Choice Society, and the Western Economics Association. Helpful comments from the participants in these sessions and from many of our colleagues are gratefully acknowledged as is financial assistance from the Freeman Program in Asian Political Economy at the Claremont Colleges.

¹ Associate Professor of Politics and Economics, Scripps College, Claremont, CA 91711.

Tel: 909-607-3549 Fax: 909-621-8323 Email: nneiman@scrippscol.edu

² Horton Professor of Economics, Claremont Graduate University and Claremont McKenna College, Claremont, CA 91711, USA, and Director, Claremont Institute of Economic Policy Studies.

Tel: 909-621-8787 Fax: 909-621-8460 Email: thomas.willett@cgu.edu

Introduction

Debates continue to rage about the causes of recent currency and financial crises around the globe and their implications for the desirability of domestic and international financial liberalization. Beneath the heated exchanges of the most vocal disputants, a quiet consensus is beginning to emerge among serious scholars and policy officials. The big lesson from these crises is that while financial liberalization is still a desirable goal, it must be approached very carefully. It's not just that without the proper pre-conditions liberalization will not provide full benefits. The results can sometimes be disastrous. What was once considered to be an arcane topic of interest only to a few economic and financial experts – the optimal sequencing of reforms – has forced itself front and center.

One of the reasons why this optimal sequencing literature has had relatively limited impact on actual reforms is that economists often disagree about what is optimal. Such disputes about the ideal helped obscure the wide range of agreement among experts about the ways in which financial liberalization should not take place. There is not a high degree of correlation, however, between these areas of agreement among financial experts and the ways that actual reforms have been carried out. We suggest that this is an important reason why so many financial liberalizations have been followed by crises.

Inadequate legal and social infrastructure and public and private risk management strategies can result in the less than ideal allocation of financial resources. More importantly, however, liberalizations in the presence of perverse incentive structures resulting from subsidized inputs and formal or informal government guarantees against losses leads to lending

that is both excessive and misallocated. Likewise, borrowers will not take adequate measures to guard against risk. The result is a recipe for financial crisis.

This process is referred to as perverse liberalization. Despite its enormous importance it has received relatively little explicit attention. This paper is intended as a start toward filling this gap.

There are rich literatures on which we can draw in order to develop a better understanding of why financial liberalizations so often contain perverse elements. We can draw on the economic and financial literature to offer us numerous examples of the types of liberalizations that should be avoided. To explain why such perversities occur, however, economics alone cannot take us very far. Undoubtedly the lack of knowledge of the best economic and financial theory sometimes played a role in botched reform efforts but other elements were also at work, and these require a political economy perspective.

There is a rich literature on the political economy of financial liberalization on which we can draw. In the process, however, we need to un-bundle the dependent variable. The constituencies of perverse liberalizations may be quite different from those favoring liberalization in general. For example, sometimes one of the objectives of liberalization is to reduce the special benefits of crony firms.³ Liberalization of entry by new firms would be consistent with this objective. However, granting greater freedom to borrow abroad for already privileged firms and financial institutions could have just the opposite effect, as appears to have occurred in Korea.⁴

Of course, many of the more astute writers on the political economy of liberalization

3 See

4 See

have been well aware of these distinctions.⁵ Still we believe that they have received far too little systematic attention. In this paper, we lay out some of the basic elements of perverse liberalization and discuss their role in contributing to the Asian crisis. We then turn to a preliminary exploration of the political economy causes of these perversities.

The last two decades have seen notable developments in the financial sectors of many, if not most, developing and formerly communist countries. The good news is that the costs of financial repression have become much more widely recognized and (at least partially) as a result financial sector liberalization, both domestic and international, became the dominant mantra of governments across the globe. Thus, the apt relabeling of such countries as a emerging markets. While the international financial institutions (IFIs) such as the International Monetary Fund and the World Bank and the neo-liberal finance ministries in countries like the United States played a strong role in spreading the gospel of financial liberalization, the case for liberalization became accepted by many governments in the developing and transition countries, i.e., there has been a good deal of host government ownership of liberalization programs. Increasing financial globalization also played an important role, as this made the costs of financial restrictions more apparent. Indeed, with the collapse of the Soviet Union some opined that the philosophical debate over economic systems had reached an end.

By the late 1990s however, things looked rather less rosy than in those heady days in the early 1990s when the Berlin Wall came tumbling down. Although there were prior warnings that heaven had not yet come to earth such as the Mexican crisis of 1994-95, the real sea change came with the Asian crisis of 1997 and the Russian crisis in 1998. Suddenly financial liberalization did not look like such an obviously wise policy. Had the world been sold a bill of

⁵ See, for example, Haggard ().

goods by neo-liberal ideologies? Many on the left argued yes B that these crises showed the inherent instability of capitalism. Several prominent economists such as Jagdish Bhagwati [1998], Dani Rodrik [1998], and Joseph Stiglitz [1998] joined this chorus- although generally with more nuanced arguments that other economists had oversold the benefits of the free movement of financial flows internationally. It is not hard to agree with these critics that the benefits of liberalization were sometimes oversold and that the qualifications to the arguments for liberalization were not always stressed sufficiently, but this need not imply a wholesale rejection of the case for financial liberalization.

So far, despite the sharp rhetoric of critics, the policy reactions against domestic and financial liberalization have been surprisingly mild. The sharp reversal of liberalization called for by many in the late 1990s has so far failed to materialize on a broad scale. Some observers have noted the imposition of capital controls in Malaysia as an important exception to this liberalization trend. However, a closer look suggests that even Malaysia has become more liberal over time.⁶ Although Malaysian authorities imposed temporary exchange and capital controls, these controls exempted foreign direct investment. The Malaysian government has been slow to allow foreign competition in the banking industry in Malaysia, as has been the case in most of the emerging markets in Asia⁷ but since the beginning of the crisis, authorities have liberalized equity rules, permitting 100 percent foreign equity for new investments in the manufacturing sector. Also, foreign equity limits have been relaxed in telecommunications, energy, and insurance.

⁶ Ariff and Abubakar (1999), 432.

⁷ *ibid.*

How one interprets the apparent link between financial liberalization and financial crises is crucial to the evolution of much of the global economy. This paper starts with an acceptance that there has been a strong empirical link between financial liberalization and crises that goes far beyond the examples of the late 1990s.⁸ It argues, however, that this need not imply that liberalized financial markets are inherently highly unstable. There may be some degree of causal connection between liberalized financial markets and excessive (i.e., unjustified) volatility. Economists are divided on this issue. Efficient market types tend to make fun of those who argue that financial markets are susceptible to major swings of excessive optimism and pessimism while many market observers (including George Soros and Susan Strange) take such swings as axiomatic.⁹ The emerging sub-field of behavioral finance is attempting to bridge a gap between the extreme versions of these opposing views.¹⁰

While declining to take a stand on this important debate, we do feel brave enough to assert that while imperfections in private capital markets may explain some of the incidence (and more likely the depth) of recent crises, a much more important factor has been at work. As will be discussed below, in the crises that we have analyzed carefully, i.e. the Asian and Russian cases, a major cause can be traced to the rational behavior of private market actors responding to perverse incentive structures generated by government policies and/or market failures.

In many cases, problems were exacerbated by poor management practices in the private sector. As we will argue in the following section, these resulted in the absence of sufficient early warning signals in the financial markets, lack of sufficient protection against the risk of crises,

⁸ See, for example, Eichengreen, Rose, and Wyplosz (1996), Alesina, Grilli, and Milesi-Ferretti (1994), and Montes-Negret and Landa (2001). Include Caprio et al and Kaminsky & Reinhart.

⁹ Soros (1998) and Strange (1988)

¹⁰ For a discussion of efficient markets versus overshooting see Dean (2000) and (2001), Shefrin (2000) and Shleifer (2000). For an application of aspects of this view to the behavior of international financial markets see Willett

and possibly overreactions to the early stages of crises, but they were not the major reasons for the crises. If our argument is accepted, even in part, then this focuses key attention on why financial liberalization so often takes place in ways that generate perverse incentives for private sector behavior.

One obvious answer is the rent-seeking behavior of the private sector actors themselves. Who does not want access to subsidized credit and government guarantees to cover their losses? What rational rent seeking financial sector actors would like is partial liberalization that gives them increased freedom of action to pursue profit opportunities while retaining barriers to competition from others, access to subsidized inputs, and protection against losses. The resulting increase in rents can be used to reward the consenting bureaucratic and politicians with plenty left over for the financial sector actors themselves. Thus we would expect that much, if not most, of the support for liberalization coming from the financial sector is for partial, not full, liberalization.

We know from the economic theory of the second best that where there are a number of sources of inefficiency, improving efficiency on one margin can sometimes reduce rather than increase overall efficiency. The experience with financial sector liberalization demonstrates that this is not just a theoretical curiosity. For example, take Charles Calomiris' description of a not atypical process of banking sector privatization in an emerging market country.¹¹ Because of some combination of political connectedness and the too big to fail@ doctrine, what one often gets is only privatization of profits combined with the continued socialization of losses. As the theory of moral hazard demonstrates, such a regime creates incentives for insufficient evaluation of loans and excessive risk taking. Combined with an absence of effective prudential regulation

(2001).

and oversight, such a regime is a prescription for high levels of non-performing loans (NPL's) and eventual bank insolvency. This problem is especially severe in emerging markets, where well-trained regulatory personnel are often scarce. However, the savings and loan crisis in the United States, the Swedish banking crisis of the 1990s and the ongoing difficulties of the Japanese financial system show that this is not just a problem of underdevelopment. Perverse incentives can strike anywhere.

Nor do we think that their prevalence is due entirely to rent seeking behavior. Also important we suspect is the use of incorrect theories or wrong mental models by government officials who are attempting to do a good job. We use theories and mental models in a broad sense to include not only formal economic models but also how issues are framed and what important assumptions are overlooked. Thus we will argue that one of the problems with the process of international financial liberalization in Korea was that influential actors viewed this primarily as a balance of payments issue rather than one of financial stability. Likewise, especially in the transition economies, many economists advocated liberalization without a good understanding of the legal and other types of infrastructure necessary for financial markets to work well. (This occurred in large part because many Western economists took the infrastructure which exists in their countries as a given and hence did not focus on the implications of its absence in countries they were advising).¹²

Of course, one might question who are we to decide what is correct and what is incorrect in theory. We think we have a reasonable answer. We do not take sides on specific disputes about what is correct. And there are many of these. But even monetarists and Keynesians agree

¹¹ Calomiris (1998)

¹² After the recent Anderson and Enron scandals, economists are rethinking just how good is the financial infrastructure in industrialized countries.

about some things. In a similar vein, there is a large literature on the optimal sequencing of financial liberalization, which is far from free of dispute.¹³ But while there is considerable disagreement among experts about the optimal sequence (and on what it depends), there is widespread agreement on some sequences that should be avoided. Yet we see such bad sequencing behind many crises. Thus while we will typically be agnostic about the correct model, we do feel justified in characterizing some models or views as wrong.

Because perverse financial liberalization causes resource misallocation and financial crises, we argue that it is not safe to assume, as economists and officials often have, that imperfect liberalization is always better than no liberalization. This is not to support continued financial repression, but to argue that liberalization must be carried out carefully and with full attention to the dangers of capture of the liberalization process by special interests. Thus advocates of financial liberalization need to focus as much on political economy as on purely technical considerations.

In order to aid this process, there is much we need to learn about the positive political economy of financial liberalization. This has become a major topic of research in recent years.¹⁴ Most of this literature has focused on the causes of liberalization without differentiating between perverse and benign forms of liberalization. Thus while there is much in this literature on which we can draw, this paper highlights the need to focus explicitly on the causes of perverse liberalization in hopes that this will give us clues about what to try to avoid and how to steer reform processes into safer and more productive channels.

¹³ See Wihlborg and Dezseri (1997), Edwards (1994), Harwood and Smith (1997), McKinnon (1991)

¹⁴ See, for example, Haggard, Lee and Maxfield (1993), Haggard (2000), Keohane and Milner (1996), Horowitz and Heo (2001).

As an initial step, we discuss several major categories of perverse liberalization and give examples from the Asian crisis. We also offer initial conjectures about the political reasons why such perverse liberalizations were adopted. This is obviously only a preliminary step, but we hope that it will help stimulate interest in developing a more complete typology of perversities to be avoided and in undertaking careful case studies of the political economy of the liberalization process across different countries and episodes in order to give us insight into how to do it right, at least in the sense of knowing what to avoid.

It will also be important to focus on the costs of different types of crises. Crises are not something that should always be avoided at all costs. Indeed, it has been argued that crises may often be a necessary and desirable way of attracting the high level political attention necessary to undertake fundamental reforms. As R. Barry Johnston [1997] points out, in some countries, financial crises may have been necessary to promote a consensus on the need for action on restructuring the banking system and to overturn entrenched vested interests.¹⁵ He also notes the danger that crises can likewise result in the reversal of reforms. Furthermore, even if we were sure that the net effect on the reform process would be positive, one must balance this against the costs of the crises. In the case of currency crises in the European Monetary System in the early 1990s, these costs were low and may even have been negative in the relatively short term as depreciation freed national governments to follow more expansionary economic policies. In Asia the situation was quite different, however. Thus while some crisis may be optimal from the stand point of the political economy of the reform process, not all will be.

¹⁵ See also the discussion in Wihlborg and Willett (1997), 41.

The Asian Currency and Financial Crisis¹⁶

It is not difficult to understand why so many commentators have blamed the Asian crisis on financial panic and the poor workings of liberalized international financial markets. There was a substantial international dimension to the crisis, and there had been a great deal of financial liberalization. Huge capital inflows in the early and mid-1990s came to an abrupt halt, followed by massive outflows. Furthermore, one could not find a justification for this sharp reversal of flows in the behavior of the countries traditional macroeconomic variables. In all of the crisis countries, inflation was low, investment was high, and budget deficits were small or non-existent. Thus it is easy to see the attraction of explanations based on destabilizing speculation, financial panic, and self-fulfilling speculative expectations.

The problem with this story is that it does not look at a broad enough set of fundamentals. The primary causes of the Asian crisis were the interactions of exchange rate and financial sector problems. The crisis started in Thailand and was due to a combination of a good old-fashioned overvalued exchange rate and severe weaknesses in the domestic financial sector. In fact, several Asian countries were experiencing real exchange rate appreciation by December of 1996, including Indonesia, Malaysia, and the Philippines.¹⁷ The high level of aggregate investment in Thailand tended to obscure the fact that many of these investments had not been wisely chosen. While the domestic macroeconomic indicators remained strong, at the micro level the loan and investment portfolios of many of the Thai banks and finance companies were

¹⁶ This section draws heavily on the analysis in Willett (2000) and Willett et al (2001). For a representation sampling of other views on the Asian crisis see Agenor et al (2001), Classen and Frobos (2001), Dean (2001), Glick et al (2001), Horowitz and Heo (2001), Haggard (2000), Noble and Revenhill (2000), Woo, Sachs and Schwab (2000), Pempel et. al. (1999), Goldstein (1998), Furman and Stiglitz (1998), Macleod and Garnaut (1998), Radalet and Sachs (1998).

¹⁷ Furman and Stiglitz (1998), 17.

in bad shape. But published statistics such as the level of non-performing loans failed to give an accurate picture of this worsening situation.

As the problems in the financial sector began to become more apparent, this interacted with growing concerns over the extent of overvaluation of the Thai baht's pegged exchange rate, generating a reversal of capital flows and mounting speculative pressure on the baht. The vulnerability of the Thai financial system to a currency crisis was exacerbated by the high levels of unhedged short term borrowing from abroad that had been stimulated at least in part by beliefs that the government would not allow major depreciations of the currencies, thus in effect eliminating exchange rate for foreign denominated loans at least in the minds of the borrowers and perhaps lenders as well. Excessive capital inflows may also have been generated by the expectation of IMF bailouts as many critics on the right have charged, but the composition of capital inflows shows that this cannot be the whole story.¹⁸ As depreciation of the baht became a plausible possibility, borrowers scrambled to cover their positions, leading to large capital outflows and in turn making depreciation more likely. There were some outflows by outright speculators such as hedge funds, but they were small in comparison.¹⁹ The baht was in a sense brought down by self-fulfilling expectations, but these were based largely on sound, if belatedly recognized, analysis of the problems in the Thai financial sector and the overvaluation of the baht. As will be discussed below, each of these salient features of the Thai crisis was due in substantial part to the operation of perverse incentives generated by government policies. Financial liberalization gave private sector actors more scope to operate on these incentives and

¹⁸ See Willett (1999); and Willett et. al. (2001)

¹⁹ See Eichengreen and Mathieson (1998); and Willett et. al. (2001)

this magnified the size of the resulting problems, but it was the perverse incentives, not liberalization, that was the basic cause.

Another reason why financial markets have been blamed so often as the cause rather than the messenger of the Asian crisis was the spread of the Thai crisis to a number of seemingly innocent victims. While most analysts agree that the Thai baht was overvalued, this was not obviously the case for Indonesia, Korea, or Malaysia. And their domestic macroeconomic indicators were good. Thus the spread of the crisis could easily look like unjustified financial contagion resulting from panic.

There is some truth to this argument, but it misses the main story. There was some panic after the Thai devaluation and this was felt in a fairly indiscriminating way in currency and financial markets throughout Asia.²⁰ These blanket repercussions were short-lived, however. The serious speculative attacks against Korea, for example, did not start until October, while Thailand abandoned its peg in early July. It is hard to tell a story based on panic that is delayed by a number of months. Rather, the causes of the crises in countries like Indonesia and Korea were the growing recognition that their financial sectors faced problems similar to those in Thailand that had not been clearly visible in the aggregate statistics available.²¹ As in Thailand, this was combined with large unhedged short-term debt. Recognition of the seriousness of the situation rationally turned capital inflows into outflows and this caused the previously reasonably priced currencies to become seriously overvalued and hence generate rational speculative outflows. (Political instability was also an important factor in Indonesia). This then set off an interrelation of currency and financial sector problems similar to what had occurred in

²⁰ See, for example, Baig and Goldfajn (1998).

Thailand. Thus in our judgment, the Asian crisis was due primarily (although not necessarily exclusively) to fundamentals- but these were financial, not macroeconomic fundamentals.

Even if one takes a less favorable view of the rationality of market behavior than we do, there can be little question that perverse incentives generated by national governments played a major part in the Asian tragedy. Thus it is clearly important to try to gain a better understanding of why these perverse incentives were put in place. We will also see, however, that the international official community was not entirely blameless in this process. Pressure from the IMF and national governments in the industrial countries for the Asian countries to open to their financial markets often gave insufficient attention to issues of sequencing and the existence of perverse incentives. And the Basle Accord designed to strengthen financial standards had the unanticipated consequence of contributing to excessive capital inflows into several emerging market countries including Korea.

Section I: Perverse Financial Liberalization

The basic link between financial liberalization and crisis in Asia centers around two undesired outcomes: a weakening banking sector crippled by a high percentage of non-performing loans; and the rapid increase in short-term foreign debt. This section focuses on explaining the mechanisms by which liberalization resulted in such perverse outcomes. For a variety of reasons, liberalization seems to have generated perverse incentives both for excessive risk-taking and over-borrowing.

Explaining bad loans:

²¹ The extent of direct financial contagion to Indonesia remains in more dispute than for Korea. It is often overlooked that while there were some immediate effects, heavy pressure on the did not begin until roughly a month after the baht's depreciation.

One way to explain the high percentage of non-performing loans among banks in crisis countries is to focus on market failure in the form of moral hazard. Moral hazard affects every domestic banking system to some extent even in the most open financial markets because even without capture by special interests, the crucial role played by the banking sector would lead almost any government to take steps to avoid the failure of large banks. This is the too big to fail form of moral hazard. Because this is the case, free market reforms in the banking sector will lead to perversities like excessive risk-taking due to moral hazard unless offset by government regulation. However, the weakening of the banking sector is not inevitable and can be mitigated or exacerbated through public policy. Note that the nature of banking systems is such that complete laissez faire is unlikely to be optimal. Because of maturity transformation, i.e. banks borrow short term and lend long term, there is a need for lender of last resort type provisions that will inevitably create moral hazard problems, and hence will require some prudential regulations. But while some moral hazard in the banking sector is inevitable, in the Asian crisis countries, there was much more than necessary. In fact, there does seem to be some strong empirical evidence that moral hazard played a significant role in the Asian currency and financial crises.²² In several of the crisis countries, explicit government guarantees served to exacerbate excessive risk-taking on the part of domestic banks and foreign investors. In Malaysia, as of 1999 public funds such as the Employees Provident Fund were still being used to prop up the stock market and rescue privatized public enterprises, creating a situation whereby profits are privatized, but losses are virtually socialized.²³ As late as August 1997, the Korean Ministry of Finance announced that it would guarantee all foreign debt, not only creating a huge moral hazard

²² Sarno and Taylor (1999), 655.

²³ Ariff and Abubakar (1999), 435.

problem, but also sending a signal that the corporate and banking sectors were facing serious difficulties.²⁴ Moreover, not one *chaebol* had been allowed to fail for the entire decade before Hanbo Steel collapsed in 1997.²⁵

Yet another problem is that sound private management of banks cannot be relied upon during financial reform to mitigate some of the other problems associated with excessive risk-taking. According to one observer, the combination of speculative domestic borrowers and abundant, but mostly short-term capital overwhelmed these Asian countries understaffed, inexperienced and immature financial institutions.²⁶ Sound management is, in fact, unlikely at least immediately following a period of state interventionist financial policy. State-led finance and finance allocation can leave a deficit of risk-management knowledge and experience within the private sector. Under these conditions, market reform can lead to poor decisions and a heavy short-term debt burden. Insufficient evaluation of monetary investments may lead to a misallocation of finance and non-performing loans over and above those resulting just from excessive risk taking. The lack of risk management skills in Korea is of course a by-product of the long-time state-bank-*chaebol* relationship where the banking system served as a conduit for policy loans. By most accounts, that relationship has yet to be fully severed, and it should come as no surprise that the banking industry, throughout Asia, currently suffers from a paucity of risk-management skills.²⁷

Another contributor to the financial weakness of the private banking sector has to do with the incentives behind bank ownership. Privatization of state-owned banks constitutes an important component of the financial reform process. Yet the privatization process itself can fall

²⁴ Demetriades and Fattouh (1999), 790.

²⁵ Radelet and Sachs (1998), 14.

²⁶ Katz (1999), 428.

prey to perverse incentives. This can be viewed as an incompatibility between political motivations and economic incentives, or as political capture of the reform process. For example, privatization in principle should lead to greater overall efficiency as the private sector possesses some comparative advantage over government in making profit-maximizing economic decisions. However, the privatization process is particularly susceptible to political capture/rent-seeking given the stakes involved, as with the charter of new merchant banks in Korea. The government converted twenty-four financially weak short-term financing companies into merchant banks in two separate rounds: nine in 1994 and fifteen in 1996. They proceeded to engage in risky foreign exchange transactions. Among the banks whose licenses were revoked in 1998, five were new entrants from 1994, and ten were from 1996. Thus, government reforms encouraged greater debt exposure in an already overexposed financial system.²⁸ Moreover, in Korea as part of financial reform banks were allowed to open and expand operations overseas. As a result, banks expanded their foreign currency denominated business as aggressively as they did their domestic loan portfolios. The net result was an increase in foreign currency liabilities of overseas branches that was almost as large as the external debts of domestic branches.²⁹ Nor did this happen only in Korea. The number of nonbank financial institutions expanded dramatically in Thailand as well prior to the crisis.³⁰ In fact, throughout East Asia in the 1980s and 1990s, there had been a proliferation of new banking and quasi-banking institutions with little equity capital and less experience, nearly all engaged directly or indirectly in intermediating foreign capital.³¹

Build-up of short-term debt:

²⁷ Ariff and Abubakar (1999), 434.

²⁸ Auerbach (2001), 208.

²⁹ Dooley and Shin (1998), 4.

³⁰ Furman and Stiglitz (1998), 7.

³¹ Katz (1999), 428.

Obviously the build-up of short-term debt severely weakened the domestic banking sectors of crisis countries in Asia. And clearly the governments had a lot to do with encouraging short-term debt build-up.³² One way to understand why short-term debt skyrocketed with financial deregulation is to look at the incentive structures created by state regulation of the financial sector before liberalization and to understand that pre-liberalization those perverse incentives might have been held in check by government oversight. For example, continued government control over the long-term capital market, in the form of window guidance or direct controls over interest rates, created a shortage of long-term capital during the earlier rapid growth period in most Asian countries. This shortage encouraged the use of short-term credit to finance long-term investments. This perverse incentive ultimately led to a perverse outcome in the form of a mismatch of borrowing and lending terms which is widely acknowledged to be one of the main ingredients of the Asian financial crisis.³³ Under these conditions, reform may encourage market actors to take advantage of pre-existing incentives because oversight has diminished.

The starkest example of this kind of perverse incentive is the liberalization of the short-term loan market in the context of an already weakened banking sector.³⁴ When governments in East Asia liberalized their banking sectors and capital markets, they began by opening up only the short-term maturity end of these markets. Unfortunately, this segment of the market tends to be characterized not only by short-term horizons on the part of investors, but also by short-term rent-seeking for quick profits by banks taking advantage of close ties with government.³⁵ Some Korean banks actually had a negative net worth when the loan market was liberalized. The fact

³² Fischer (1998)

³³ Katz (1999), 429.

³⁴ Demetriades and Fattouh (1999), 788.

that banks with negative net worth could continue to operate obviously is more a function of inadequate prudential regulation in the pre-liberalization period than of liberalization per se. However, in this context of insolvency, liberalization may have actually exacerbated the problem because banks with negative net worth do face strong (perverse) incentives to load up on short-term debt as a means of gambling for redemption in a liberalized short-term loan market. That is, if the banking system is unsound due to a large debt overhang or a large percentage of non-performing loans that have not yet been written off, these banks have very little to lose by loading up on more risky but potentially highly profitable new loans made accessible as a result of liberalization. This is especially true when viewed in conjunction with the too big to fail form of moral hazard. In both cases, the down-side risks of taking on more short-term loan risk is considerably discounted in comparison with the upside of redeeming a failing business enterprise with the infusion of fresh capital.

Governments further encouraged the build-up of short-term debt by liberalizing the loan market while implicitly lowering the perceived costs of foreign borrowing through the pegged exchange rate.³⁶ Most of the crisis country governments sharply limited the size of exchange rate fluctuations and fostered the impression that the private sector need not worry about the possibility of large depreciation. Thus the substantial differential between high domestic interest rates in the crisis countries and low rates in Europe, Japan and the U.S was seen as a source of arbitrage profits or low borrowing costs rather than as an indicator of differentials in risk. As a consequence, much of the crisis country foreign borrowing went unhedged. Thus, financial sector liberalization and exchange rate policies interacted perversely. In many countries, often

³⁵ Katz (1999), 429.

³⁶ Demetriades and Fattouh (1999), 788, and Dooley and Shin (1999), 2.

with explicit government encouragement, the private sector came to believe that large exchange rate depreciations would not be allowed, or if such changes did occur nationals would be compensated by the government. This both encouraged foreign borrowing and discouraged the purchase of forward cover as an insurance against the risk of major exchange rate changes.

Not only was short-term borrowing frequently given an indirect subsidy through exchange rate pegging, in some cases governments even gave tax incentives that encouraged short-term borrowing. A prime example of the encouragement of such borrowing is given by Thailand's creation of the Bangkok International Banking Facility (BIBF). While originally designed only to give encouragement to the creation of Bangkok as an international financial center by giving a tax break to foreign borrowings which were then re-lent abroad. By the time the BIBF had traveled from the Finance Ministry through the Thai political process, the requirement that the borrowed capital be re-exported had been effectively dropped, leaving a net subsidy to foreign borrowing.

As all of these examples suggest, one of the most powerful variables in explaining the incidence of recent international currency crisis is a high ratio of short-term foreign debt to a country's international reserves.³⁷ Private actors of course have incentives to worry about their liquidity situation within the context of the normal operation of the economy. They typically do not have incentives, however, to worry sufficiently about so-called systemic risk because of the externalities generated by financial interdependence during crisis. Many economists, such as Eichengreen and Stiglitz, argue that because unhedged short term foreign borrowing in emerging markets carries these negative risk externalities, they should be subject to a corrective tax, or regulation. The so-called Chile tax is an example of this approach. Additional foreign currency

³⁷ Velasco et al. (1996), 265-83; Furman & Stiglitz (1998); and Radelet & Sachs, (1998).

borrowing by one firm or bank increases not only its own risk but also the risk of other borrowers who would also be hurt if a crisis occurred. This externality presents a case for government oversight or regulation of some types of banking and financial market activities to avoid excessively risky positions. Such interdependence externalities also provide a powerful argument for the government to play the role of a lender of last resort. The classic example is the bank, which has made sound long-term loans but could be forced into bankruptcy by a run on its deposits. This provides a widely accepted rationale for government policies to deal with such panic or crisis. The problem is that by doing so, the government lessens the incentives for the bank to worry sufficiently about the quality of the loans and investments it makes. In other words, the prospect of bailouts creates moral hazard. This in turn provides a need for some form of government oversight to help reduce the likelihood of bad loans. That's supposed to be how it works. And like the industrial countries, all of the major emerging markets had systems of oversight in place. The problem was that they were not very effective.

But excessive risk and short-term borrowing is not just an oversight issue. The sequencing of reform itself can also create perverse incentives. For example, the Koreans liberalized short-term bank lending while maintaining restrictions on the long-term loan market. This is just the reverse of the normally recommended sequence of liberalization. This partial nature of liberalization led to perverse incentives for short-term borrowing over and above international financial market trends. Taken together with Korea's status as a successful export-led economy with a balance of payments surplus, the accelerating rate of liberalization attracted a substantial amount of short-term bank credit from abroad (supply-side). The liberalization of short-term finance in contrast with the continued regulation of the long-term capital market and portfolio investment encouraged businesses to borrow short-term (demand- side). This

sequencing of short-term before long-term financial liberalization also encouraged vigorous competition in the short-term loan market by chartering new merchant banks that had an advantage in international borrowing before implementing a prudential regulation system with sufficient oversight capacity and without insuring that new banks (or any banks) possessed adequate risk management skills.

III. The political economy of perverse liberalization

If liberalization as implemented by Korea and many others led to so many perversities and ultimately economic hardship, why did they liberalize in the way that they did? There are two important reasons to take a political economy perspective here. The first is that if even some of the reform perversities were foreseeable, then the only way to explain these policies without assuming irrational policymakers is to look at political influences. The other reason is that sometimes what appears to be a bad economic decision may actually be a best alternative within a political economy context. For example, it could make sense to implement reforms that make economic crisis more likely if one's goal is to further the reform process. As discussed earlier, crises are not always bad. Sometimes the costs may be fairly low and they generate further reforms so that the net effects can be positive in a dynamic sense. Thus, from a political economy perspective, one can argue for initial reforms that will create problems, which will stimulate further reforms. Deregulation of only some interest rates is an example. This will distort financial flows and can create a support base for further reforms. Thus optimal sequencing from a political economy perspective can sometimes look quite different than it would from a purely economic or state efficiency perspective.³⁸ If the crisis generated is too

³⁸ Wihlborg and Willett, (1997)

costly, however, then the whole liberalization process can be set back.³⁹ The recent crises in Mexico and Asia were ones where the costs were enormous. Even if they have not set back the general process of liberalization, the costs have been so high that it would be extremely difficult to argue that these episodes reflected points on an efficient path towards liberalization.

What follows is an attempt to explain various influences over the formation of reform policy. We argue that perverse liberalization results from a combination of political pressure from both domestic and international actors as well as the interplay between policymaking officials and domestic elites and the mental models which actors adopt. The relative strength of these variable influences is likely to vary from one case to another.

a. Interest groups

We start by looking at politically entrenched domestic interest groups and rent-seeking behavior. The most common way that Asian governments have benefited these groups is through restrictions on foreign competition in the banking sector. For example, the Malaysian government throughout the 1990s restricted the amount of public-sector business that could go to foreign banks, froze new bank licenses just as foreign banks sought entry, and imposed strict limits on branch expansion for existing banks.⁴⁰ But this form of financial sector protectionism prevailed in most Asian countries even while financial liberalization proceeded in other areas. Even in Hong Kong, arguably the most laissez-faire of the Asian emerging markets, the domestic banking sector enjoyed protection from foreign competition.⁴¹

Big business and banks in Asia also influenced the sequencing of reform in the loan market. A detailed look at the reform process in Korea will help to illustrate how financial-

³⁹ Haggard and Maxfield, (1996)

⁴⁰ The Economist (1997), 26.

⁴¹ Auerbach (2001), 125-127.

industrial conglomerates influenced the liberalization process despite the government's apparent desire to avoid such outcomes. Needless to say, in countries where crony capitalism was the norm, such influence could play out even more explicitly.⁴² Korean state managers came under significant pressure by 1993 from the *chaebol* to liberalize short-term finance.⁴³ There is no question the move toward liberalized financial markets fit in with the Kim Young Sam governments Ase-gye-wha globalization priority, and therefore served a political function. But this does not explain why both short-term and long-term credit markets were not liberalized. Ironically, policymakers suggested that one of the strongest reasons for introducing competition in the market for bank loans was to mitigate the considerable economic power and influence of the *chaebol*. Indeed, controlling the excesses of big business throughout the liberalization process was an explicit goal for Korean policymakers.⁴⁴ The state first embarked upon financial liberalization in 1980 not with the idea of letting market forces reign freely, but rather with the idea of building new institutions between the state and big business that would serve to ensure economic control over big business irregularities and to prevent its dominance in the market. Korean officials saw liberalization as redefining the rules in order to continue meeting prudential objectives and prevented the exercise of cartel-like private market power.⁴⁵ Part of the long-term liberalization plan was to restrict big business privileged access to policy loans and their oligopolized production in the market.⁴⁶ The reform-oriented officials firmly believed that economic liberalization would not be successful without preventing further business concentration. State control over big business served not only the states economic goals but also its political goals. The Chun regime (1981-88) put an emphasis on the political goal of the

⁴² For example in Indonesia where friends and family relations of Suharto enjoyed special influence.

⁴³ Lee et. al. (2000), 1.

⁴⁴ Auerbach (2001), 85-87.

⁴⁵ Hughes (1988), 341.

welfare and justice society against the previous regimes collusive state-big business ruling coalition, thus pinning the new regimes legitimacy on its ability to control big business.⁴⁷

But despite rather explicit state goals to avoid such outcomes, there is considerable evidence that the content and sequence of Korean liberalization ultimately allowed the *chaebol* to take advantage of perverse incentives. That is, the rather unbalanced form that financial opening took was partially a result of the unyielding pressure from the *chaebol*, who saw short-term borrowing as a way to get around government restrictions on borrowing and investment decisions as well as the capitalization restrictions. Some observers have described the government strategy of liberalizing short-term borrowing while leaving long-term borrowing regulated as government officials giving in where pressures were strong and holding back where it was not.⁴⁸ Given the short-term nature of NBF (non-bank financial institution) borrowing, the liberalization of the short-term market prior to the long-term market was an understandable outcome of interest politics. During the 1994-1996 investment boom, large enterprises accounted for 45.7% of debt, while small and medium-sized enterprises accounted for only 17.7%.⁴⁹ The financial sector also showed signs of increasing concentration with the top eight nationwide banks together accounting for two-thirds of the entire commercial banking sector, and three-quarters of total commercial bank assets.⁵⁰ Between 1994 and 1996, foreign bank lending to Korea went from \$52 to \$108 billion. About \$60 billion of debt outstanding in 1997 was used by the *chaebol* to finance direct investments abroad. Korean banks invested in foreign assets with

⁴⁶ Rhee (1994), 154.

⁴⁷ Rhee (1994), 193.

⁴⁸ Cho (2000)

⁴⁹ Haggard and Mo (1999), 4.

⁵⁰ Dekle and Ubide (1999), 7.

funds borrowed from foreign banks in the range of \$23 billion.⁵¹ The reliance of the *chaebol* on bank borrowing--as opposed to equity or bond financing-- increased leverage ratios and made the *chaebol* highly susceptible to bankruptcies when hit with shocks. In turn, the health of the banking sector became heavily dependent on the viability of the *chaebol*, since such a high fraction of bank assets are in the form of lending to these enterprises.⁵² Korean financial institutions were over-exposed to foreign-exchange risk and a high proportion of foreign liabilities had relatively short maturities. So at the very least, deregulation of the financial sector in the early 1990s, together with ongoing features of the government-banking-*chaebol* relationship, increased Korea's vulnerability to outside capital flows by creating the incentive for short-term indebtedness.⁵³

Finally, large business groups throughout Asia benefitted from the process of bank privatization. As many scholars have pointed out, privatization because of the large stakes involved is particularly prone to rent-seeking and capture. In countries like Korea, and even now Taiwan, government relaxation of controls over entry and ownership has led to the largest business groups dominating both the ownership of commercial banks and non-bank financial institutions.⁵⁴ One result in Korea was that credit became concentrated with the largest thirty business groups receiving over 70% of total short-term credit.⁵⁵ One potential sticking point for Korean officials was that in order to strengthen banks, it was necessary to end the ban on *chaebol* ownership of them. But bank privatization only strengthened the already powerful *chaebol*.⁵⁶

⁵¹ Haggard and Mo (1999), 7.

⁵² Dekle and Ubide (1999), 18.

⁵³ Haggard and Mo (1999), 22.

⁵⁴ Tan (2003).

⁵⁵ Rhee (1994), 203.

⁵⁶ Pollack (1997)

b. Foreign pressure

Foreign international pressures for financial liberalization can come through several channels. One is through impersonal market forces. That is, the degree of international capital mobility can influence the costs and benefits of a wide array of financial strategies. Actions by other emerging market governments may also have important effects through this channel. Liberalization of competitors raises the costs of continued restrictions in the home country.

A second is through influence on actors' mental models. While the extent of influence is open to debate, there can be little question that attitudes toward financial liberalization had become much more favorable in the 1990s than in the 1970s, and that the international transmission of ideas has a good deal to do with these changed attitudes.

A third channel is through direct pressure. This can come via direct lobbying on emerging market governments by international financial interests, but such pressures are perhaps more commonly intermediated by national governments in the industrialized countries (Bhagwati's Wall Street-Treasury complex). Of course lobbying, persuasion, arm-twisting, etc from industrial country governments and the international financial institutions can come from sincere beliefs that liberalization is in the best interests of the emerging market countries. The relative influence of interests and ideas or ideology in this context will often be difficult if not impossible to tease out. Assuming that bureaucrats throughout Asia have been reluctant to cede discretionary power to the private sector, one could interpret the decision to liberalize short-term finance as the result of market pressure. That is, international finance brought the most market pressure to bear in the short-term credit market in part because the volume of short-term financial flows was so much greater. In other words, bureaucrats failed to liberalize long-term finance because they possessed the capability to resist, whereas they could not resist the tide of

market forces in the short-term financial market. Also long-term lending by its very nature can tolerate deviations away from market prices because of non-monetary criteria such as recurrent contracting which may lower transactions costs.⁵⁷

External pressure for financial markets opening can be extremely powerful. This is an area in which unintended consequences are of major importance. Sometimes the effects on emerging markets are the result of industrial country policies. Fluctuations in credit conditions in the rich countries have been shown to have strong effects on the size of international financial flows to emerging markets. Less inevitably, the efforts of the industrial countries to develop better standards for risk management by the major international banks resulted in incentives for the banks to shift from longer term to short term lending.⁵⁸ The so called Basle Accord on capital adequacy standards for banks reflected a substantial achievement of international cooperation, but few noticed at the time that this was followed quickly by a dramatic increase in the ratio of short term to long term bank loans going to emerging markets. This was the result of the much higher ratios of capital required to back bank loans of over one year.

The Czech Republic, Mexico, and Korea were hit by a double whammy. By achieving sufficient economic and political success to be allowed to join the industrial countries as members of the OECD they automatically qualified under the Basle rules for a lower risk category with lower capital requirements on loans. And sure enough, their admissions were followed by surges of capital inflows (concentrated of course on the short-term end). This problem has at last become well recognized. Indeed, it was rumored that at one point the U.S.

⁵⁷ Williamson (1975)

⁵⁸ Goodman and Pauly (1993); Cohen, (1996)

government argued against the admission of Slovakia to the OECD on the grounds that there was a danger this would lead to a financial crisis.

These industrial country institutional innovations had little influence on the portfolio managers that are so often blamed for international financial crisis; but perceptions of their influence are often highly exaggerated. When one looks at the statistics on the composition of the capital outflows from Asia during the crisis, the effects of the actions of the staid old international bankers were far larger than those of the portfolio managers. Indeed, while it is hard to get data, many observers argue that so called capital flight by domestic nationals was much larger than for international portfolio investors. It is well documented that the run on the peso in 1994 was initiated by Mexican nationals, not international investors.

But we cannot totally discount the more formal external pressures to liberalize. In Korea, President Kim's desire to join the OECD, combined with pressure from the IMF and the US government may have led to the liberalization of domestic financial markets before existing weaknesses in the banking system, including poor regulatory and supervisory framework, could be addressed.⁵⁹ So while liberalization may have taken place in the absence of foreign pressure, the nature and timing of liberalization may have been acutely affected.

c. Populism

In the case of Korea, as with economic policymaking in many countries, it is difficult to separate the concept of populism from nationalism. The long history of discouraging foreign direct investment in Korea underscores the effect of populism on foreign economic policy. Because foreign direct investment happens to be one of the more stable forms of capital flow, especially when compared with portfolio capital, these restrictions take on added importance

⁵⁹ Demetriades and Fattouh (1999), 791.

given the role of excessive short-term capital flows in exacerbating if not causing crises. Why was the Korean government so reluctant to allow foreign direct investment? It is difficult to explain this on the basis of nationalism alone if one considers that Mexico has historically been extremely nationalistic, but has now welcomed foreign direct investment. Moreover, one might have expected a strong demonstration effect given the timing of Mexico's success in allowing FDI, and the Korean financial crisis. Yet if we consider the economic and political costs and benefits, the Korean reluctance to allow FDI does make political sense. The NAFTA package required Mexican officials to abandon or at least step back from the nationalistic banner, but it also offered something in return, access to the vast U.S. market. For Korea, the prospect of allowing FDI was more of a unilateral political cost up front for the promise of greater economic performance later. But even the long-term benefits of FDI were not uniformly accepted by Korean policymakers because Korea could point to a long record of economic growth and development in the absence of FDI. Popularism may also play a pervasive role in blocking the reform process in general, insofar as there are considerable short-term costs associated with financial liberalization. Government officials may find it difficult to dismantle a system of policy loans if the recipients of those loans have played an important welfare function, as the *chaebol* did in Korea.⁶⁰ In Mexico, financial-industrial conglomerates similarly served the function of dispersing government credit, especially to the rural sector, in the days of heavy government intervention in the financial sector.⁶¹ One clear indication that Korean officials have especially resisted reforms that were likely to be unpopular is that only with the IMF providing a shield for the regime post-crisis, has there been any attempt to implement unpopular

⁶⁰ Pempel (1999), 124.

⁶¹ Auerbach (2001), 31.

reforms like legalizing layoffs and allowing corporate bankruptcy. But it may not just be the IMF shield that has made structural reforms more palatable.⁶² It may also be the case that market reform is more likely to be taken up as a populist cause in a post-crisis environment. This has certainly been the case in Latin America as well as Eastern Europe.⁶³

d. Policymaking mistakes and bad mental models

In addition to the political influences of outside forces on government policy, we must look at the interests and perspectives of state policymakers themselves, some of which has already been discussed in the form of incentives created by government policy. But in addition to creating unintended perverse incentives or falling prey to political influences (both domestic and international), there is considerable evidence that in countries like most of the countries in question, policymakers possessed some policymaking autonomy or insulation from constituent pressures.

One particularly troubling aspect of perverse liberalization shared by most of the crisis countries is the lack of prudential regulation. The poor quality of bank supervision--lax prudential rules and financial oversight-- led to a sharp deterioration in the quality of banks' loan portfolios in countries like Korea and Mexico.⁶⁴ While most economists agree on the need for capital-account liberalization, they have also come to believe that banks should first upgrade their risk-management practices and supervisors should strengthen oversight of financial institutions.⁶⁵ There is quite a bit of consensus among experts that prudential regulation is a key ingredient in any successful liberalization effort. This makes the lack of such safeguards even more puzzling. But this too can be explained as rational actors, in this case policymakers, facing

⁶² Woo-Cumings (1999), 130-131.

⁶³ Horowitz and Petras (2002); Demmers, Fernandez Jilberto, and Hogenboom (2001)

⁶⁴ McLeod and Garnaut (1998), 270.

perverse incentives. By definition, prudential regulation must be initialized and carried out by government officials. Yet, this process involves a high degree of incentive incompatibility because state bureaucrats are enmeshed in a patronage system that they themselves are supposed to be charged with cleaning up. Even if that system is now proving to be increasingly inefficient, the direct participants in the system may still be benefiting in some way while the costs are dispersed among the broader population.

In Korea for example, lax prudential regulation allowed heavy concentration of lending and the disproportionate growth between Korean banks and non-bank industries. In a three-year period alone leading up to the crisis, merchant banks acquired \$20 Billion in foreign debt.⁶⁶ Regulation was especially lax for newly licensed merchant banks whose capital requirements in proportion to loans were woefully inadequate. The same can be said for Thailand. This fact alone significantly further increased the vulnerability of the banks to business failure. But the lack of prudential regulation, an act of omission, also interacted with the removal of various government restrictions on foreign borrowing, an act of commission, to exacerbate banking sector weaknesses. Financial liberalization and tight money kept domestic interest rates above world rates, which encouraged domestic banks to rely on foreign credit. The pegged exchange rate also encouraged the perception that foreign capital was relatively cheap, contributing to the wave of excessive short-term foreign borrowing that was intensified by ineffective prudential supervision. And because private actors considered the pegged exchange rate system quite credible, they made borrowing decisions under a false sense of security.⁶⁷

⁶⁵ Eichengreen (1999), 2.

⁶⁶ Chang, Park, and Yoo (1998), 738.

⁶⁷ Demetriades and Fattouh (1999), 788.

This paints a rather pessimistic picture of governments' ability to improve prudential regulation because despite a growing consensus that strong oversight and the enforcement of sound banking practices are necessary, a lack of risk management skills and perverse incentives facing financial decision-makers in the liberalization process make it unlikely. Nevertheless, there are positive examples of how prudential regulation can be enforced by relying on sound incentives and avoiding perverse ones. In Malaysia, for example, officials have insisted on best banking practices as a condition for debt-restructuring and recapitalization. The Securities Commission has also attempted to encourage greater corporate disclosure, codes of conduct, and business ethics by making it compulsory for listed companies to release their financial results on a quarterly basis.⁶⁸ It is interesting to note that Malaysia is considered by most observers to have been the least market friendly in its response to the crisis in Asia. It does, however, appear that public-sector macroeconomic governance has been comparatively good in Malaysia by regional and global standards.⁶⁹

Perverse liberalization may also result from policymakers with good intentions getting it wrong in one of two ways: either by focusing on the wrong issue or employing a flawed economic model. An example of the former is that Korean policymakers were overly concerned with current account balance rather than debt structure. In practice, this meant that policymakers were unwilling to allow substantial exchange rate flexibility for fear of losing control over an important trade policy tool. Political incentives to give too much weight to short-run exchange rate stability led these countries to practice insufficient flexibility. Why did the external balance loom so large as to overshadow concern with the rapidly growing short-term debt structure of many domestic enterprises in Asia? One reason could be that exchange rate changes can affect

⁶⁸ Ariff and Abubakar (1999), 434-435.

government finance itself aside from its effect on private markets. Devaluation would tend to contract imports which would in turn sharply reduce customs collections and overall government revenue. This was in fact the case in the Philippines in the aftermath of the crisis.⁷⁰ Another reason might have been that these countries, especially Korea, tended to attract foreign capital in part based on their reputation for export competitiveness. Losing control over trade policy meant not only losing control over the trade balance but financial flows as well. There is some evidence that the balance of payments turning to deficit prior to the crisis did in fact affect Korea's credit worthiness, which suggests that the linking of trade with loan availability in the minds of policymakers was not completely unfounded.

Also, from a domestic political perspective, the Kim Young Sam government's mandate depended upon continued international competitiveness. His administration had declared globalization as its top priority.⁷¹ In Mexico, on the other hand, where the norm was a balance of payments deficit prior to 1994, policymakers were not expected to deliver international competitiveness, but rather domestic stability. This explains in part the resistance to devaluation in Mexico. What policymakers did bank on was the idea of delivering NAFTA.

With respect to economic theories, one could argue that policymakers in countries like Korea and especially Japan never really bought into the benefits of financial liberalization. That is, no paradigm shift has taken place from an interventionist developmental state model to a free market liberalization model. Here it is instructive to compare Korean with Mexican liberalization with respect to world-view and the belief in models alternative to the Western Free Market model among policymakers. Mexico had to abandon the state-led model in the early

⁶⁹ Ariff and Abubakar (1999), 434.

⁷⁰ Alburo (1999), 455.

⁷¹ Dooley and Shin (1998), 3.

1980s (debt crisis), but Korea hung on to it. This even though both come under international pressure to liberalize from IMF/US. Also, the economic success experienced by Korea in the 1980s and early 1990s reinforced the interventionist model in the minds of policymakers while simultaneously encouraging excessive and speculative short-term capital flows that helped destabilize the Korean economy, especially in the context of perverse liberalization. In Mexico, success did the same thing in the early 1990s, which contributed to the 1994 crisis, but the 1980s had seen a more thorough dismantling of the state-led financial system than in Korea.

Directions for Future Research

We hope that the preceding has been sufficient to convince the reader that the causes of perverse financial liberalization, both domestic and international, should be an important topic for political economy research. A major part of this will involve continuing the recent research on the political economy causes of financial liberalization in general. Especially important here we believe are more detailed delineation and investigation of the various channels through which market pressures generate incentives for liberalization. Much of the recent literature takes it as axiomatic that increasing globalization generates strong pressures for liberalization. This is undoubtedly true, but just as with financial crisis, governments can respond to these pressures in many ways including imposing more barriers. We also know relatively little about the relative influence on liberalization of different types of capital flows and financial actors and about the relative importance of government perceptions of anticipated market reactions to policies and developments versus direct lobbying by market actors and indirect lobbying via institutions such as the IMF and US Treasury.

Turning to perverse liberalization, we need to develop a more comprehensive analytical taxonomy of the major types of perverse liberalization and begin to investigate more systematically their incidence under different types of circumstances. For example, are some types of political systems more subject to perverse liberalization than others? We would expect governments that are strongly beholden to concentrated financial interests to be more susceptible to perverse liberalization. The influence of populism seems less clear. One can easily conjecture scenarios where this could go in either direction. We would expect elite bureaucracies to reduce the incidence of perverse liberalization, but the case of Japan illustrates that an elite bureaucracy is not sufficient protection against severe bad loans problems. And both China and Japan illustrate that the maintenance of heavy government direction and regulations is also no guarantee against the development of major bad loan problems in the financial sector.

Another important issue for investigation is whether patterns of perverse liberalization vary across countries with different economic ideologies and developmental strategies. Are there correlations between the incidence of perverse liberalization and countries levels of development, legal traditions, degree of political freedom, and numerous other factors being identified in the rapidly expanding literature on institutions and economic performance? How has the degree of IMF and World Bank involvement influenced the success record of liberalization? How the track record of crisis induced liberalizations compared with liberalizations emanating from other sources? And what can we learn from the limited number of successful financial liberalizations that have taken place?

A Concluding Comment

We may hope that such positive political economy research will give us insights into normative policy issues and that by taking political economy considerations into account

countries will be able to find greater scope for liberalization that avoid the types of perversities highlighted in this paper. While there is much analysis and research to be done, one conclusion of which we are confident is that the development of good policy will not be aided by continued ideological debate at the level of states versus markets. The theory of second best indeed tells us that a move away from state intervention and toward market allocation will not necessarily result in a pareto improvement within the context of other state and/or market failures. We have witnessed many times over now both liberalization efforts prior to crises and policy responses to crises, that might have been individually appropriate in the context of otherwise “perfect markets” according to economic theory, but lacked synchronization, sequencing, and, more importantly, coordination.⁷²

For markets to operate well they need considerable infrastructure that must be provided by the state, but state involvement has often been perverse. The issue is how states and markets can best complement. Market critics need to recognize that most of the recent currency and financial instability has been caused less by any inherent instability of financial markets than by financial markets reacting to perverse economic incentives generated by governments. Likewise market enthusiasts need to recognize that in the absence of an appropriate infrastructure of law and institutions, markets are unlikely to work well and where perverse economic incentives are in place that liberalization can sometimes do more harm than good.

Slogans about government versus the market miss the point. The question is their appropriate relationships. Financial liberalization is an important requirement for economies to reach their long run growth potential. But liberalization is a process that must be managed carefully and requires as much attention to patterns of political influence as to technical

⁷² Albuero (1999), 456.

economic issues. This will not be an easy task, but looking at the right questions can be a big help.

References

- Andrews, David. and Thomas Willett. Financial Interdependence and the State: International Monetary Relations at the Centurys End, *International Organization*, 51:3, 479-511, 1997.
- Agénor, Pierre-Richard, M. Miller, D. Vines and A. Weber eds., *The Asian Financial Crisis*. Cambridge: Cambridge University Press, 2001.
- Ariff, Mohamed. and Syarisa Yanti Abubakar. The Malaysian Financial Crisis: Economic Impact and Recovery Prospects, *The Developing Economies*, Vol. 37, 1999, 417-38.
- Bascom, Wilbert. *The Economics of Financial Reform in Developing Countries*. New York: St. Martin's Press, 1994.
- Bayoumi, Tamim. The Morning After: Explaining the Slowdown in Japanese Growth in the 1990s, *IMF Working Paper* #13, 1999.
- Bhagwati, Jagdish. The Capital Myth. *Foreign Affairs*, May-June 1998.
- Caprio, Gerard Jr., Izak Atiyas, and James Hanson. *Financial Reform: Theory and Practice*. Cambridge: Cambridge University Press, 1994.
- Caprio, Honohan, and Stiglitz eds. *Financial Liberalization: How Far? How Fast?* Cambridge: Cambridge University Press, 2001.
- Chang, Park and Yoo. Interpreting the Korean Crisis: Financial Liberalization, Industrial Policy, and Corporate Governance, *Cambridge Journal of Economics*, 1998.
- Classens, Stijn and Kristin Forbes eds., *International Financial Contagion*. Kluwer, 2001.
- Cohen, Benjamin. Phoenix Risen: The Resurrection of Global Finance, *World Politics* 48, 268-96, 1996.
- Cole, David. and Betty Slade. A Reform of Financial Systems, @ in Perkins and Roemer eds., *Reforming Economic Systems in Developing Countries*, Cambridge: Harvard University Press, 1991.
- Corsetti, Giancarlo, Nouriel Roubini, and Paolo Pesenti. Paper Tigers? A Model of the Asian Crisis, Cambridge: *NBER Working Paper Series* 6783, 1998.

- Dean, James. Which Failed: Asian Capitalism, or International Capital Markets? in Jay Choi, ed., *Asian Financial Crisis*, vol.1 of International Financial Review, JAI Press/Elsevier, 2000.
- Dean, James. East Asia Through a Glass Darkly: Disparate Lenses on the Road to Damascus, in Harcourt, Lim, and Park, eds., *Editing Economics: Essays in Honour of Mark Perlman*. Routledge, 2001.
- Dekle, Robert. and Angel Ubide. *Korea: Financial Sector Development and Reform*, unpublished manuscript, 1999.
- Demetriades, Panicos. and Bassam Fattouh. The South Korean Financial Crisis: Competing Explanations and Policy Lessons for Financial Liberalization, *International Affairs* 75:4 (1999), 779-792.
- Demmers, J., Fernandez Jilberto, A.E. and B. Hogenboom eds. *Miraculous Metamorphoses: The Neoliberalization of Latin American Populism*, New York: Zed Books, 2001.
- Dooley, Michael. and Inseok Shin. A Private Inflows when Crises are Anticipated: A Case Study of Korea. @ Unpublished manuscript.
- Dornbusch, Rudiger. and Alejandro Reynoso. The Financial Factors in Economic Development. *American Economic Review*, 79:204-209, 1989.
- Economist*, A Survey of Banking in Emerging Markets, April 12, 1997, 5-40.
- Eichengreen, Barry. *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*. Washington, D.C.: Institute for International Economics, 1999.
- Eichengreen, Barry et al. Capital Account Liberalization: Theoretical and Practical Aspects, *IMF Occasional Paper* 172, 1998.
- Eichengreen, Barry, and Donald Mathieson. Hedge Funds and Financial Market Dynamics. *IMF Occasional Paper* 166. Washington D.C.: International Monetary Fund, 1998.
- Fischer, Stanley. The Financial Crisis in Emerging Markets: Some Lessons, speech as First Deputy Managing Director of the International Monetary Fund, April 28, 1999.
- Fischer, Stanley. Address at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, D.C., January 22, 1998
- Furman, Jason and Joseph Stiglitz Economic Crises: Evidence and Insights from East Asia *Brooking Papers*, 1998.
- Glick, Reuven, R. Moreno and Mark Spiegel eds, *Financial Crisis in Emerging Markets* Cambridge: Cambridge University Press, 2001.

- Goldstein, Morris. *The Asian Financial Crisis: Causes, Cures, and Systemic Implications*. Washington, D.C.: Institute for International Economics, 1998.
- Goodman, John. and Louis Pauly. The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets, *World Politics*, 46:1, 50-82, 1993.
- Haggard, Stephan. The Political Economy of Financial Market Reform, in Harwood and Smith eds., *Sequencing: Financial Strategies for Developing Countries*. Washington, D.C.: Brookings Institution Press, 1997.
- Haggard, Stephan, *The Political Economy of the Asian Financial Crisis*, Institute for International Economics, 2000.
- Horowitz, Shale and Uk Heo, eds., *The Political Economy of International Financial Crisis*. Rowman & Littlefield Publishers. 2001.
- Horowitz, Shale. and Martin Petras Pride and Prejudice in Prague: Banking Sector Policy, Corporate Governance, and the Czech Transition paper presented at the International Studies Association meetings, March 2002.
- Johnston, Barry. The Speed of Financial Sector Reform: Risks and Strategies, in Harwood, Alison and Bruce L.R. Smith, eds., *Sequencing: Financial Strategies for Developing Countries*. Washington, D.C.: Brookings Institution Press, 1997.
- Haggard, Stephan. and Sylvia Maxfield, The Political Economy of Financial Internationalization in the Developing World, in Robert Keohane and Helen Milner eds, *Internationalization and Domestic Politics*, Cambridge: Cambridge University Press, 1996.
- Haggard, Stephan. Chung Lee, and Sylvia Maxfield, eds, *The Politics of Finance in Developing Countries*, Cornell, 1993.
- Haggard, Stephan. and Jongryn Mo. The Political Economy of the Korean Financial Crisis, unpublished manuscript, 1999.
- Harwood, Alison. and Bruce Smith eds., *Sequencing: Financial Strategies for Developing Countries*. Washington, D.C.: Brookings Institution Press, 1997.
- Katz, Stanley. The Asian Crisis, the IMF and the Critics, *Eastern Economic Journal*, Vol. 25, No. 4, Fall 1999, 421-439.
- Krause, Lawrence. The Economics and Politics of the Asian Financial Crisis of 1997-98, Washington D.C.: Council on Foreign Relations, 1998.
- Krueger, Anne and T. Ito eds., *Financial Deregulation and Integration in Asia*, Chicago: Chicago University Press, 1996.

- Lee, Chung H. The Visible Hand and Economic Development: The Case of South Korea. in Roumasset and Barr eds., *The Economics of Cooperation: East Asian Development and the Case for Pro-Market Intervention*. Boulder: Westview Press, 1992.
- Lee, Chung. Kuen Lee and Kangkook Lee. Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea, unpublished manuscript, 2000.
- Loriaux, Michael...et al. *Capital Ungoverned: Liberalizing Finance in Interventionist States*, Ithaca: Cornell University Press, 1997.
- McKinnon, Ronald and H. Pill. Credit Liberalizations and International Capital Flows: The Overborrowing Syndrome, in Krueger and Ito eds., *Financial Deregulation and Integration in Asia*, Chicago: Chicago University Press, 1996.
- McKinnon, Ronald. *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, Baltimore: Johns Hopkins University Press, 1991.
- McLeod, Ross. and Ross Garnaut. Eds., *East Asia in Crisis: From Being a Miracle to Needing One*, New York: Routledge, 1998.
- Montes-Negret, Fernando. and Luis Landa, Interest Rate Spreads in Mexico during Liberalization, in Caprio, Honohan, and Stiglitz eds. *Financial Liberalization: How Far? How Fast?* Cambridge: Cambridge University Press, 2001.
- Nam, Sang-Woo. Korea's Financial Reform Since the Early 1980s, in Caprio, Atiyas, and Hanson eds. *Financial Reform: Theory and Experience*. Cambridge: Cambridge University Press, 1994.
- Patrick, Hugh. Comparisons, Contrasts, and Implications, in Patrick and Park. eds., *The Financial Development of Japan, Korea, and Taiwan: Growth, Repression, and Liberalization*. New York: Oxford University Press, 1994.
- Pempel, T.J. ed., *The Politics of the Asian Economic Crisis*. Ithaca: Cornell University Press, 1999.
- Perkins, Dwight. and Michael Roemer eds., *Reforming Economic Systems in Developing Countries*, Cambridge: Harvard University Press, 1991.
- Pyo, Hak. The Financial Crisis in South Korea: Anatomy and Policy Imperatives, in Jackson ed. *Asian Contagion*. Boulder: Westview Press, 1999.
- Quinn Dennis. The Correlates of Change in International Financial Regulation *American Political Science Review*, September 1997.

- Radelet, Steven, and Jeffrey Sachs. The onset of the East Asian Financial Crisis, *NBER Working Paper #6680*, Cambridge: National Bureau of Economic Research, 1998.
- Radelet Steven and Jeffrey Sachs, 1998. The East Asian Financial Crisis. *Brookings Paper on Economic Activity, No 1*. pp 1-98.
- Ries Christine and Richard J. Sweeney eds. *Capital Controls in Emerging Economies*. Boulder: Westview Press, 1997.
- Rhee, Jong-Chan. *The State and Industry in South Korea: The Limits of the Authoritarian State*. New York: Routledge, 1994.
- Rodrik, Dani. Understanding Economic Policy Reform, *Journal of Economic Literature*, 34, 9-41, 1996.
- Rodrik, Dani. Who Needs Capital Account Convertibility? *Essays in International Finance*, No. 218. Princeton: Princeton University Press, 1998.
- Shefrin, Hersh. *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*. Boston: Harvard Business School Press, 2000.
- Shleifer, Andrei. *Inefficient Markets: An Introduction to Behavioral Finance*. Oxford University Press (2000).
- Soros, George. *The Crisis of Global Capitalism*. New York: Public Affairs, 1998.
- Strange, Susan. *Mad Money*. Manchester: Manchester University Press, 1988.
- Tan, Alex. Pluralization of Politics, Win Sets, and Perverse Financial Liberalization: The Case of Taiwan's Experience, @ unpublished manuscript, 2003.
- Tseng, Wanda. And Robert Cooker. *Financial Liberalization: Money Demand, and Monetary Policy in Asian Countries*. Washington, D.C.: International Monetary Fund, 1991.
- Wihlborg, Clas. and Kalman Dezséri. Preconditions for Liberalization of Capital Flows: A Review and Interpretation, in Ries and Sweeney eds., *Capital Controls in Emerging Economies*, Boulder: Westview Press, 1997.
- Wihlborg, Clas. and Thomas Willett. Capital Account Liberalization and Policy Incentives, in Ries and Sweeney eds., *Capital Controls in Emerging Economies*, Boulder: Westview Press, 1997.
- Willett, Thomas. Did the Mexican Bailout Really Cause the Asian Crisis? *Claremont Policy Briefs*, March, 1999.
- _____. International Financial Markets as Sources of Crisis of Discipline. *Princeton Essays in*

- International Finance*, No. 218. Princeton: Princeton University Press, May 2000.
- Willett, Thomas and Arthur Denzau. A Chile Plus Approach to Managing International Financial Flows *Claremont Policy Briefs*, October 1999.
- Willett, Thomas, Aida Budiman, Arthur Denzau, Gab-Je Jo, Cesar Ramos and John Thomas. The Falsification of Four Popular Hypotheses about International Financial Behavior during the Asian Crisis *Claremont Working Paper*, 2001.
- Williamson, Oliver. *Markets and Hierarchies: Analysis and Antitrust Implications*. New York: The Free Press, 1975.
- Woo, Jung-en. ed., *Race to the Swift: State and Finance in Korean Industrialization*. New York: Columbia University Press, 1991.
- Woo-Cumings, Meredith. The State, Democracy, and the Reform of the Corporate Sector in Korea, in Pempel, T.J. ed., *The Politics of the Asian Economic Crisis*. Ithaca: Cornell University Press 1999.
- Zank, Neal. et.al. *Reforming Financial Systems: Policy Change and Privatization*. New York: Greenwood Press, 1991.