Financial Markets and Globalisation

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Introduction

‘My sense is that one consequence of this Asian crisis is an increasing awareness in the region that market capitalism, as practised in the west, especially in the US, is the superior model’. This was the opinion expressed in March of 1998, by the US Federal Reserve Board Chairman Alan Greenspan. ‘That is, it provides greater promise of producing rising standards of living and continuous growth’, he continued. And by pointing out that many Asian leaders were ‘endeavouring to move their economies much more rapidly toward the type of economic system that we have in the US’, the chairman sounded assured that the US system was the superior one, to which all others will aspire to converge.

Is this true? Or, closer to the hearts of many Asians, is this inevitable? In trying to answer this question, it would be helpful to reconsider what had led to the East Asian financial crisis. Many have pointed to the peg with the US dollar, the heavy short-term foreign borrowing and the weakness in the East Asian financial sectors and industrial bases. But macroeconomic variables such as growth, government budget balances and inflation rates were not at dangerous levels before the crisis. On the other hand, some have blamed ‘crony capitalism’. This paper is an attempt to clarify the relationships

1 The author gratefully acknowledges helpful comments from Eiji Ogawa, Michihiro Ohyama, Hiroaki Fukami, Naoyuki Yoshino, Mitsuhiro Fukao and participants of the 57th Annual Congress of The Japan Society of International Economics, but takes full responsibility for all remaining errors.

between all these factors, by finding the fundamental ingredients of a financial crisis.

The analysis in this paper will show that yes, systems\textsuperscript{3} will converge to one closer to the US-type system, but not because the latter is superior in ‘producing rising standards of living and continuous growth’. It is because of three reasons.

One, as a result of the fundamental nature of financial markets and exchange rates, an open economy cannot ignore the evaluations and expectations of financial markets. Countries actually risk economic devastation if they fail to meet standards that are endorsed by international financial markets. Two, as it has become more apparent from the recent Asian financial crisis, financial markets endorse market-oriented capitalism, and are suspicious of (what they think as) ‘crony capitalism’. The third reason why systems will converge to the one similar to the US is because market-oriented capitalism encourages transparency and disclosure, which are essential in avoiding a financial crisis in a globalised environment.

The financial sector of an open economy should adopt the ‘global standard’, defined as the internationally common standard that enforces disclosure and transparency. Such a standard is also the one endorsed by, and maintains stability in, world financial markets. In a global environment, agents who engage in borrowing and lending do not share an implicit understanding about how business is done, or about unwritten rules. Information can become much more asymmetric than between agents who share the same nationality, culture, history, tradition and customs etc. In such a globalised setting, risk cannot be managed properly without disclosure and transparent rules.

The financial problems in Japan as well as the Asian nations hit by the recent crisis

\textsuperscript{3} We use ‘systems’ and ‘structures’ interchangeably to indicate customs on commercial relationships, written or unwritten rules on disclosure and accounting, corporate governance, hiring and firing practices etc. All these are aspects of economic and social life that are seen by foreigners as ‘structural impediments’ to entry, and more recently as reasons to cast doubt upon a country’s economic viability.
have a common and fundamental feature. That is the fact that their financial sector operated under standards that may have been suitable in a closed environment, but were certainly not so in a global environment.

Adopting a US-style system does not assure ‘rising standards of living and continuous growth’. All it does is it gives countries a better chance of pleasuring the markets and avoiding a financial crisis⁴. If some Asian leaders are fervently adopting a US-style system today, it is not because they are suddenly convinced of its absolute superiority. It is because they realise that adopting a system that meets the ‘global standard’ as defined above is the quickest way to recover confidence in global financial markets, and to avoid recurrence of crises. Their aim is to stabilise the markets with increased transparency, better disclosure rules and improved risk management. Financial globalisation⁵ without structural convergence in the financial sector invites financial crises. In other words, capital account liberalisation without financial deregulation is a fertile ground for disaster to occur. We can rephrase the ‘global standard’ as the standard that minimises the risk of financial crises.

Once the financial sector decides to do business according to the ‘global standard’, the rest of the economy must follow. The reason is because borrowers will have to

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⁴ The demise of Long Term Capital Management and other hedge funds made it abundantly clear that disclosure and transparency can be insufficient even at the heart of the Anglo-American financial markets. But this fact only reinforces the argument here that transparency and disclosure are essential to a stable financial system.

⁵ Financial globalisation’ is used here to mean integration of world financial markets and the resulting competition in the financial sector on a global scale. This progresses with the progress in financial liberalisation, which allows free movement of financial resources across borders in the form of direct and indirect investment. Financial globalisation may not be necessary for structural convergence. This paper argues that it is sufficient, under the condition that countries wish to avoid a crisis.
meet standards set by lenders.

If transparency spreads to other parts of the structure of an economy, that as benefits. Those who used to be constrained by the old system will be able to realise their economic potential in a more transparent system. At the same time, convergence of systems can have effects that are unwelcome. For instance, a gap will emerge during the process of convergence, between sections of the country which will adopt ‘global standards’ and sections that do not. Where such a gap already exists, it will be widened. This could lead to social instability, as already seen in some Asian countries.

Those who choose not to conform to the standards acceptable to global financial markets may introduce capital controls. Before the East Asian crisis, such a move would have been dismissed categorically as unproductive. However, since the crisis, many have come to see that in markets as volatile as the financial markets, market forces can turn into something beyond the intention and control of even the purest of the market-believers. Some are suggesting measures to rein in the destructive forces of short-term international financial flows. Since markets with controls are second-best, it is not possible to define the best system of capital controls. The search for an appropriate solution will continue on a case-by-case basis. In this environment, the ‘global standard’ may change in the longer term, especially with the added element of the new European single currency.

In the first section of this paper, we try to identify two basic ingredients of a financial crisis by looking at the recent East Asian experience. The two ingredients are (1) the distinguishing characteristics of financial markets and (2) the ‘inconsistent triangle’. In the second section we discuss the implications of these ingredients. We argue that all who expose themselves to the international financial markets and wish to avoid financial crises will be obliged to adopt structures that insure transparency. Then we look at capital controls as a way to avoid conforming to the ‘global standard’, at the same time as averting financial crises. We conclude by discussing some future
prospects including the implications of Emu.

I. The makings of a financial crisis

The Asian Experience

During the latter half of 1997, something totally unexpected took place in East Asia. Nobody had expected this to happen, not with that much speed and magnitude. East Asia was supposed to be the region of the next century. This was where income was to be created and money was to be made. But within a period of six months, stock markets, currencies and economies of the nations considered most promising collapsed.

Detailed studies of each country would be necessary to thoroughly understand how this happened. These already exist, and are increasing in number. Many have pointed to the peg with the US dollar, the heavy short-term foreign borrowing and the weakness in the East Asian financial sectors and industrial bases. But macroeconomic variables such as growth, government budget balances and inflation rates were not at crisis levels before the crisis. On the other hand, some have blamed 'crony capitalism'. Here we would like to try to pick out the elements that were common to all East Asian countries affected. We abstract as much as possible in order to identify the basic ingredients of a financial crisis. This abstraction will make it clear that the fundamental sources of financial crises are universal. It will also be helpful in discussing the possibilities of recurrence, how best to avoid a crisis, and the implications to the global financial system.

There were two common elements in the crisis: rapid and massive outflow of capital and the futile defense of the exchange rate. The first element, the rapid and massive outflow, was mostly of private short-term capital. That is one reason why the outflow after the crisis was so rapid. According to the IMF, annual average net private capital inflows into East Asian economies were 5 to 10% of GDP during 1992 to 96. The combined net private inflows to Indonesia, Malaysia, South Korea, Thailand and the
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Philippines was US$ 40.5 billion in 1994. In 1995, this figure was US$ 77.4 billion, in 1996 it was US$ 93 billion. After the 1997 crash, it is estimated that there was a net outflow of private capital by US$ 12 billion. This means that in just one year, there was a swing in the net supply of private capital to these five countries by US$ 105 billion, 10% of the five nations’ pre-crisis GDP.\(^6\)

When capital was flowing in, not much attention was being paid to the systems of the economies on the receiving end.\(^7\) But in fact, ways of doing business, especially in the banking sector, were different in Asia from those in the West. Risk management, disclosure and transparency were all insufficient. Funds were being supplied to East Asian businesses that tended to be concentrated in the hands of the few well-connected.

The important point is that these structural differences did not emerge immediately before the crisis; they existed all through the years when foreign money was flowing into the region. In other words, financial integration proceeded, without much thought given to the lack of structural integration. Perhaps it was because forcing convergence in business practices meant interference into domestic affairs, which the lenders did not wish to be accused of doing. Even ASEAN itself held non-interference as one of its core principles. There was also the tendency to praise certain aspects of the difference. Asians and non-Asians alike argued that the Asian work-ethic and family structure

\(^6\) The figures including the estimated outflow are from the Institute of International Finance, quoted in Martin Wolf's article 'Flows and blows' in Financial Times, 3rd March 1998.

\(^7\) It must be noted that structural differences exist also among the lender nations. Recently, the peculiarity of the Japanese system (that used to be seen as related to the Japanese miracle) has come to be seen as the source of Japan’s economic troubles by Europe and the USA. But Europe is different from the USA, and within Europe there are also differences. This point is in fact relevant to the conclusion of this paper.
were superior, that Asian growth would continue because of this, that there indeed was ‘a third way’ (neither capitalism or communism).

For whatever reason, the gap between the financial and real aspects of the economies was ignored by both lenders and borrowers, so long as it did not interfere with raising profits. It was only when market participants began to doubt the prospects of securing profits that they focused on the structural differences. Once the spotlight was on it, it triggered a quick and enormous destruction of confidence. The 97 crisis was a rude awakening to all who never bothered to pay attention to the potential problems due to structural differences.

Structural differences were ignored while funds kept flowing into the region because financial markets are different from other markets. This difference, or the peculiarities of financial markets is one of the two main ingredients of a financial crisis. The other ingredient is the so-called ‘inconsistent triangle’. We discuss each of these in the next two sections.

**Peculiarities of Financial Markets**

World financial markets become integrated much more quickly than other markets because the speed of adjustment is higher (or the cost of transactions is lower) in financial markets, compared to other markets. Another peculiarity of financial markets is the importance of market expectations and credibility of authorities. These two features

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8 In the mid-70s economists trying to explain massive and rapid exchange rate fluctuations became aware of the difference between the real and financial sectors of the economy. Specifically, they began to see the difference in the speed of adjustment in the goods and services market and the financial market. The stock equilibrium approach to exchange rate determination was born. This took us a long way in explaining day-to-day and sometimes second-to-second changes in exchange rates, a distinguishing feature of the post-Bretton-Woods world economy.
particularly increase price volatility in financial markets. They also lead easily to panic and contagion of panic.

Another characteristic is asymmetric information. A textbook example is when the borrower has more information than the lender on the likelihood of repaying his debts. In a broader context, there is also asymmetry in information held by those who engage in financial transactions and those who try to supervise them. Financial dealings are much less visible than transactions in goods and services. The difficulty of supervision is even greater for international borrowing and lending. A related and important problem is that of moral hazard, those engaged in financial intermediation know that their survival is vital to the economy. There is also an element of monopoly on the part of the lenders, in so far as funds are indispensable for the survival and/or growth of the borrowers.

All these characteristics are particular to the financial markets. Alone or together, they compose an important ingredient of a financial crisis. Because transactions are virtually costless and market expectations matter much, price volatility is high. Once credibility is lost, expectations become self-fulfilling, further encouraging buying or selling in the same direction. Aided by advancement in technology, masses of funds can be withdrawn in a matter of days if not hours. And because there is asymmetry of information, credibility can be lost on a rumour, without major incidents such as wars or changes in government. Panic easily spreads from one financial market to another. Lenders often do not have the time, will or resources to find out everything about borrowers operating under different rules. Demanding more transparency and disclosure may be politically inadvisable. Besides, why ‘meddle in domestic affairs’ and risk losing potential profits to competitors. In any case should something go seriously wrong, the authorities will always choose bailing them out over risking a contagious financial meltdown.

Borrowers, on their part, are encouraged to open financial markets and to increase
inflow of foreign capital. They are not shy to do so because funds are welcome, especially those that become available without the need of painful structural adjustments.

As a result of all this, financial integration proceeds on a global scale, leaving the structural differences untouched. All is well as long as the economies are performing well. But sooner or later, perhaps due to changes in the macroeconomic environment, the macroeconomic balance of the borrowing economies can be tipped. Doubt enters the minds of the lenders and is easily spread and multiplied. Capital flights and exchange rate depreciations are triggered, after which borrowers will be even more in need of borrowing but to no avail. Economic crises ensue. The unfilled gap between the integrated financial sector and the still divergent systems is exposed.

The Inconsistent Triangle

The other common element of the Asian financial crisis is exchange rate devaluation, in spite of official intervention. The relationship between a country’s exchange rate, capital flows and monetary policy can be explained using the idea of the ‘inconsistent triangle’. The ‘inconsistent triangle’ means that in general, out of the three goals of (1) exchange rate stability, (2) monetary policy autonomy and (3) free movement of capital, only two can be attained at the same time. For instance, when a county chooses to remove capital controls but still wants exchange rate stability, it gives up its monetary autonomy.

There can be special cases in which some of the three goals are not independent form each other. In such a case this triangle deteriorates into a line or a point. An example is when the monetary policy that is good for the domestic economy also hap-

9 Giving up monetary policy autonomy is not sufficient for exchange rate stability. Exchange market intervention must be possible, for instance by having sufficient foreign exchange reserves.
pens to be consistent with a stable exchange rate under free capital mobility. But in general the three goals are independent from each other, and this leaves us with a dilemma. Monetary policy affects both the exchange rate and the domestic economy. If monetary policy must be changed to stabilise the domestic economy, the exchange rate will change, unless capital controls can stop that. In other words, as Timmergen’s theorem tells us, in general two policy-goals cannot be reached at the same time with one policy-tool.

The dilemma can easily turn into a crisis if the world markets begin to buy or sell a currency heavily. For instance if world financial markets decide to sell a currency (for any reason), either the currency must be allowed to depreciate or monetary policy must be devoted to intervention to support the currency. If the intervention lacks credibility, then markets will keep selling. In fact, interventions are effective only if they succeed in changing market sentiments. The amount of money changing hands in the world foreign exchange market each day exceeds the foreign exchange reserves for all IMF member countries combined 10.

Once monetary authorities find themselves in this situation, they cannot give up easily. The vicious cycle of exchange market intervention and loss of foreign reserves starts. Precisely because market sentiments are everything in the short run, authorities must keep a brave face and declare that they will continue to successfully support their currency. This provides market participants with the assurance that all they sell will be

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10 Mitsuhiro Fukao points out that because most buying and selling in the foreign exchange market are accompanied by transactions in the opposite direction within the same day, the argument that intervention is ineffective due to the relative size of funds is dubious. However, even if his observation is correct under normal circumstances, it is difficult to believe that market participants in panic will engage voluntarily in transactions in the opposite direction. Otherwise, intervention would indeed have been effective and the Asian currency crisis would not have happened.
bought up by authorities. The more the authority intervenes, the more foreign exchange reserves are depleted, leading to further loss of credibility and need for intervention.

In the meantime, the domestic economy is damaged by the shortfall in funds and drop in purchasing power. What is needed for economic recovery is lower interest rates. But interest rates must be kept high or even raised to keep money flowing in (or to stop money from flowing out). In other words, monetary policy is now devoted to supporting the exchange rate. Sterilisation is not a choice because it will further deplete the effectiveness of intervention. Hence, intervention (in the form of purchase of the domestic currency) reduces money supply. The higher interest rates, lower money supply and the halt in the inflow of foreign funds further hurt domestic economic activities. Before the resulting economic downturn, and the depreciation itself have time to improve the current account and the stock of foreign reserves, the currency is forced into further depreciation\(^\text{11}\).

Until July of 1997, currencies of most East Asian nations were fixed, practically to the US dollar. After the attacks on their currencies started, the monetary authorities must have become aware at one point that they will have to float their currencies. But had they floated the currencies, authorities would have been blamed for having invited further selling and willingly started a currency crisis. In order to avoid devaluation, authorities had to keep repeating that there was absolutely no plan for one.

The inconsistent triangle is not an Asian phenomenon, but a universal fact. An exchange rate is a relative price of two monies. It is determined by the relative supply (or demand) of the two currencies. Anytime the relative quantity of money changes, the exchange rate also changes, ceteris paribus. By using a simple two-country macroe-

\(^{11}\) Again, this is because money changes hands much more quickly than goods and services. The fact that asset prices such as exchange rates change much more quickly than activities in the current account is well-recognised as the source of the J-curve effect.
conomic model, it can be shown that an exchange rate moves when changes in the money supply and/or other exogenous variables are asymmetric between the two countries. In other words, if everything between the two countries is symmetric, the exchange rate does not change. The inconsistent triangle is just another way to say this. If a country chooses to stabilise its exchange rate, it cannot change its money supply according to its domestic needs, unless foreign money supply can be changed symmetrically. No country can evade this fact. Once a country decides to loosen its capital controls, it can use its monetary policy either for domestic stabilisation or exchange rate stabilisation, but in general not both. This difficult choice is faced by every country that is sufficiently exposed to the world financial markets.

The fundamental difference between financial markets and other markets discussed earlier is also not a uniquely Asian characteristic. Everywhere, money simply changes hands more quickly than other goods and services. The inconsistent triangle and the particularities of financial markets are the omnipresent and basic ingredients of a financial crisis. Thus we can conclude that at least potentially, the risk of financial crises lies everywhere. All we need in addition to these two ingredients is a trigger for finan-

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12 In East Asia, the crisis was triggered by macroeconomic difficulties. During the period up to July 1997, the macroeconomic environment for the East Asian countries had changed. First, there was the Mexican crisis of 1994 to 95, which led authorities in East Asia to raise interest rates to preempt attack on their currencies. This encouraged further capital inflows from abroad. China emerged as a competitor, especially after the devaluation of the yuan in 1994. The US dollar appreciated against the Japanese yen, and took along most East Asian currencies with it. Japan went into a recession and turned to investing abroad, which fueled the real-estate bubble in East Asia. Eventually, confidence returned to Europe in anticipation of a successful introduction of the new single currency. In North America, people became convinced that the upturn in the economy and Wall Street was not temporary. These factors led capital to flow away from East Asia into Europe and North America.
II. The implications of financial globalisation

Convergence --- Competition or crisis

Because the two ingredients we discussed above are fundamental, it is not possible to eliminate financial crises altogether from this world. In the extreme case of absolutely no trade or capital flows, with complete autarky for all nations, there will be no exchange rates and no international financial markets. The speed of adjustment in domestic financial markets will still differ from those in other domestic markets, but at least there will be no economic fluctuations due to changes in expectations in international financial markets. Another extreme theoretical case is a steady state in which all open economies adopt one single system and one single currency. Again there will no longer be exchange rates to devalue or revalue. And if all nominal variables change proportionately and all adopt one ‘global standard’ in everything, there will be no reason to prefer one economy over another.

Needless to say, both of these extreme cases are totally unrealistic. In the world we live in, the best we can do is to take measures to reduce the possibility and/or magnitude of financial crises. This is easier said than done. One obvious way is macroeconomic stability. If macroeconomic variables such as inflation, unemployment, current account, government budget balances and debts are all stable, markets will find little reason to attack a currency. A strong industrial base, a well-educated workforce and technological advancement would also help. But even if all this could be attained, countries do not exist in a vacuum and external shocks can easily change the macroeconomic balance. And political and other events easily affect market expectations and destabilise exchange rates because of the nature of financial markets discussed earlier. Another way to proceed is to directly control some parts of the movement of capital around the world. In this context, we discuss capital controls further below.
Here we consider another way in which financial crises can be made less frequent, or at least less painful. This is structural convergence to the global standard, particularly in the financial sector. Out of the several peculiarities of financial markets pointed out in the first section, information asymmetry is just about the only aspect which we can change. Doing so has three benefits. First, a strong and stable financial sector always contributes to economic health. Second, it decreases information asymmetry and prepares market participants so that they may panic less in the event of a sell-off. Third, markets will not have the “failure to meet the global standard” as a reason to attack the currency.

For a system to converge to one that meets the global standard, it must be exposed to forces that make such a convergence inevitable. One such force is competition through deregulation. Sectors that are opened to foreign competition will adopt a system that is viable under global competition, because only agents who adopt such a system will survive. In contrast, in sectors that are protected by government regulations, standards will be established separately from the standard in the unprotected outside world. The standard that emerges under protection may work well within the closeted environment. But once the sector starts to do business in a different environment, the established system will have to be abandoned, if not, lead to failure.

This was precisely what happened in the financial sectors of Japan and East Asia. It is one thing to achieve capital account liberalisation, quite another to allow competition in the financial sector. During the 1990’s, the East Asian countries removed capi-

13 Thailand created an offshore financial market (BIBF) where residents can freely engage in foreign exchange trading. Foreign residents can obtain Thai-baht credit from domestic banks and spot and forward exchange markets are both well-developed. In Indonesia, residents can also freely trade in foreign exchange. South Korea achieved capital account convertibility in preparation for joining the OECD, though won credit to foreign residents are still restricted and the forward exchange market is undeveloped (IMF, International Capital Markets, Annex I, page 70).
tal controls, some more boldly and quickly than Japan\textsuperscript{13}. But even when capital is allowed to flow freely in and out of the country, domestic financial institutions can remain protected from competition with foreigners, or with each other. Deregulation is needed to change this\textsuperscript{14}. Standards in Asian financial sectors differed from the global standard because the sector had been protected for decades. This meant that when international capital flows were liberalised, Asian financial institutions went out into the global financial markets, without changing their old ways of doing business that were good only inside their protected homes.

It should also be noted that introducing competition in the domestic financial sector is more difficult than introducing competition in other sectors. Due to the characteristics of financial markets discussed already, liberalising this sector can be destabilising. Thus, countries have a dilemma. Too much competition in the financial sector can hinder economic stability and/or development. That is why some regulation and fixed exchange rates are recommended especially for a developing country. However, protection of the financial sector engenders customs of financial transactions which lack transparency and disclosure. This can lead to disaster, when later the financial sector is opened.

Which bring us to the other force that makes convergence inevitable; a crisis. This is most likely when capital account liberalisation proceeds without opening the domestic financial sector to competition. To have stability under the former, we need the latter.

\textsuperscript{14} Even countries in the West have laws that forbid foreign ownership of certain strategic industries. There may also be firewalls between banks, securities firms and insurers, such as the Glass-Steagall Law in the USA. A bill to scrap this law was approved in the US House in May 1998, by a one vote margin. The banking sector is opposed to this bill and apparently one of the reasons is that it shifts authority to oversee the banking sector from the Treasury to the Federal Reserve. The Senate has yet to vote on this bill. Yet, the Glass-Steagall Law is increasingly toothless and there is cut-throat competition in the US financial sector.
If a country chooses not to take the path of deregulation, business practices in the domestic financial sector will not conform to the global standard. Sooner or later, some economic difficulty will lead investors and lenders to focus on the structural difference. A financial crisis will be triggered. Under strain and in need of money, the domestic economy will have no choice but to adopt systems endorsed by the markets.15

Capital controls

Capital controls may be another way to minimise the risk of a financial crisis. However, it remains true that strengthening of the financial sector is important, and this is achieved through deregulation and competition. Some advocate capital controls, while opening the financial sector to foreign competition. An example of capital controls combined with an open financial sector is Chile. Proposals by the IMF and BIS have the same philosophy.

Others want to control the flow of capital without removing restrictions on entry into the domestic financial sector. This latter case is dangerous because the domestic financial sector could then become inefficient and cause an economic crisis of its own making. There is risk that Malaysia may turn out to be the case.

On 1st September, Malaysia announced introduction of capital controls. This was a huge turnaround from the pre-crisis policy to make Kuala Lumpur Asia’s financial centre. The central bank governor and his deputy resigned just before this introduction of controls. Trading in ringgit instruments among offshore banks was banned. Malaysian institutions could no longer offer domestic credit facilities to non-resident

15 The letters of intent from Indonesia, South Korea and Thailand (which can be found at www.imf.org) show their commitment to market opening and their resolve to restructure their financial markets. As for Japan, the financial difficulties from the bad debt and the Big Bang are both forcing the adoption of the global standard. Of course, a country can impose capital controls and avoid having to meet the global standard. This is discussed below.
banks and stockbrokers. Ringgits held outside Malaysia had to be repatriated before October, or lose their value. The maximum amount of foreign currency which residents could take out of the country was set at the equivalent of M$10,000. For non-residents, if they wanted to invest abroad more than the same amount in foreign currency, they had to seek prior approval. Travelers could no longer bring in or take out more than M$1,000 in cash. Selling of shares by foreigners at the Kuala Lumpur stock exchange was effectively banned for a year, because foreigners who sold shares could no longer repatriate earnings for a year. Payment for all exports and imports had to be made in foreign currency. In addition to these measures to control capital flows, on 2nd September the ringgit was fixed at 3.8 ringgit to the US dollar.

By introducing these controls, Malaysia aimed at lowering interest rates and boosting the economy by fiscal stimulus, without risking exchange rate depreciation. The required reserve ratio has been cut in stages from 13.5% in March to 4% on 16th September. Banks are under heavy pressure from the Malaysian central bank to lend. The maximum permitted interest margins on loans was cut to 2.5 percentage points from 4, and reserve requirements were lowered to encourage banks.

Theoretically, there is a possibility this would work. But there are many conditions which must be met. Loopholes must be closed if the controls are to work their purpose of maintaining exchange rate stability. The current account surplus must increase despite the increase in domestic demand, and the restricted supply of investment funds must be just enough to satisfy the demand for investment to sustain growth. Imports and exports should develop in such a way that they are not hindered by the limited availability of foreign exchange. But most importantly, some form of incentive must be created to restructure the domestic financial industry. Policies made possible by these controls may improve the economic situation. But at the same time, they risk taking off the pressure for the kinds of reforms seen in Thailand, Indonesia and South Korea.
Whether or not they will bring about stability, measures taken by Malaysia would have been dismissed as anti-market and inefficient before the crisis. The Asian crisis has changed the minds of many, and has led prominent economists (such as Paul Krugman and Joseph Stiglitz) and market participants (such as George Soros) to advocate some form of control. In its 1998 report on international capital markets, the IMF said controls on inward capital flows could be useful for some countries. Earlier, the Fund floated the idea of devising a way to legally stop creditors from repatriating their money, when such repatriation destabilises the world financial system. The BIS, which houses the Basle committee of bank supervisors, has come up with its ‘core principles’ as a check-list for bank supervision. The general manager of BIS suggested some prudential restraints on capital inflows, for instance a deposit requirement of the kind seen in Chile.

By nature, no regime of capital controls and/or interventions can be first-best. So the debate is likely to be inconclusive, and different forms of controls and interventions will be tried, where they will be tried. Evaluation of the outcomes will be done on a case-by-case basis. Two things seem to be clear, though. One, that intervention and control without the adoption of global standards by the financial sector is dangerous. And two, that the global financial system no longer has as much confidence in the

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16 A dollar shortage in Kuala Lumpur exchange booths was reported on 12th September, but as of 10th October, foreign firms are not finding difficulty in settlements of export and import payments (Nihon Keizai Shimbun). At the same time, the central bank reports that of the M$ 32 billion held overseas, M$ 12.7 billion had returned to Malaysia by September 22nd. M$ 1.7 billion of privately held cash had been put back into bank deposits. Malaysia’s foreign reserves increased by more than US$ 1 billion in the first two weeks of September to US$ 21.25 billion (Financial Times, 7th October 1998).

17 The reference cites articles written by Messrs. Krugman, Stiglitz and Soros in the Financial Times on this subject.
virtues of the free flow of capital.

IV. Concluding remarks

Where there will be exchange rates, there will be possibilities of currency crises. Some have commented that the Emu is unlikely to work with diverse fiscal authorities and inflexible labour markets. They may be right. One thing that is certain, however, is that given the ingredients of a crisis pointed out in the first section of this paper, the only certain way to eliminate currency market turmoil is to eliminate exchange rates by introducing a unified currency. A single currency for the entire world is not expected in the near future. This means that some measures must be taken to minimise the risk of financial crises.

We have seen that convergence of standards in the financial sectors to one that ensures transparency would contribute to the stability of the global economy. For this, protection in financial sectors need to be removed, but in an orderly manner. Many Asian nations are moving in this direction. Some form of control on short-term capital flows may be advisable, but there is no formula that would fit all. In the interest of efficient global allocation of savings, controls are also unlikely to be permanent. Policy authorities face the increasingly difficult task of striking a balance between too much and too little competition in the financial sector.

Convergence of standards in the financial sector will lead to convergence of standards in other aspects of the systems, as borrowers try to conform to the standards set by lenders. In that sense, the financial sector sets the standards for the rest of the economy and society. Firms wishing to raise capital, whether by direct or indirect financing, may have to change their labour-relations and corporate governance accordingly. Since the ultimate way of stabilising the exchange rate is to eliminate asymmetry between the relevant countries, convergence in all aspects is desirable in terms of exchange rate stability. And unless nations are ready to introduce a single currency,
exchange rate stability will remain an issue.

Then, the question is the nature of the system to which countries converge. The Asian experience taught us that the global standard in the financial sector must be one that ensures transparency and minimises information asymmetry, similar to the one set in the USA. But other aspects of economic and social life do not necessarily have to become as free-market-oriented. If disclosure is sufficient to avoid a sudden and massive run on the currency, the global standard in corporate governance for instance may still emphasise good management-worker relationships, stakeholding, and smaller income disparities.

The successful system gets to set the global standard. Back in the 1980s, Western firms eagerly adopted systems such as Quality Circles and Just-In-Time inventories. Success speaks for itself. The system or the structure that leads to economic success will be adopted as the global standard. This is where Europe becomes especially important. If the new single currency euro becomes a rival to the US dollar as an international currency, it would change the way the world economy functions. The balance of economic power in the world will become potentially less stable. But the emergence of Europe with a strong financial sector and a key currency can be helpful to countries other than the USA, especially those that are less enthusiastic about convergence towards structures that are engraved with free-market-values. Europe can be a more moderate voice in the global financial arena.

Needless to say, Europe itself will come under the forces of global competition. As European bond and securities markets expand, more financing may come from the markets instead of banks. However, if Emu is successful and the European economies grow stronger, European corporate governance, employee-employer relations, commercial customs etc. do not have to converge to a new standard. Global standards in such aspects of economic and social life will converge towards the European standard instead.
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