OF MAGIC DRAGONS AND OTHER
STRANGE BEASTS:
A REASSESSMENT OF THE LATIN
AMERICAN AND ASIAN CRISSES

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You never know what is enough
unless you know what is more than enough.
(William Blake, The Marriage of Heaven and Hell)

THE EAST ASIAN CRISIS WHOSE BEGINNING is usually dated back
to the suspension of the Thai bath peg to the US dollar in
July 1997 and whose final end no one can foresee at the
moment may already be legitimately called the economic
event of the closing 20th century. Its course holds a similar
relevance for development theory and policy to that of the
Latin American debt crisis which kept countless numbers
of economists busy during the 1980s. But this is not the
only parallel. The contention of the present paper is that in
spite of all the apparent differences in the appearance and
run of the two crises, their development strategies have
been characterised by a build-up of foreign debt which
constantly creates depreciation expectations and

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culminates in a balance of payments crisis. The present focus on Latin America and Asia serves to highlight deficiencies in the growth-cum-debt strategy and does not claim to give a detailed analysis of all the countries affected by the crisis. Hence, in the first instance a short overview on the evolution of the Latin American crisis will be given. This will be followed by a general review of how the Asian crisis has been received in academe, in which we elaborate on differences and common features. Finally in a conclusion the main findings will be summed up.

1. LATIN LOSERS

The international debt crisis attracted world-wide attention with the default of one of Latin America’s biggest debtors in late summer 1982. Actually, however, things had gone wrong long before as is shown by the numerous reschedulings of external debt undertaken by countries as different as Poland, Uganda, Madagascar and Bolivia. But since Mexico was the first two-digit billion dollar debtor unable to pay its debt, and since Latin America owed almost half of the outstanding debt stock of the developing world, the academic and international community overwhelmingly focused on the debt crisis as a specific Latin American problem, although in terms of its substance and consequences it was very similar to that of all developing countries, albeit on a different level.

Since the breakdown of the Bretton Woods System accumulation of external debt has accelerated sharply. While the developing countries (excluding the former Soviet Union) hoarded up close to $60 billion in the period between World War II and 1970, the debt stock rose 10-fold in the 1970s. At least three circumstances deserve mention here: (a) the proportionately higher growth rates of
developing countries in comparison to those of industrialised countries (World Bank 1978: Appendix Table 2), stimulated the discussion on so-called ‘emerging markets’ like Argentina, Brazil, Mexico or Venezuela; (b) the flood of Petro-Dollars in the wake of the oil price increase provided internationally active commercial banks with a considerable range of liquidity; and (c) a wave of capital account liberalisation in industrialised countries in the 1960s and 1970s resulted in the rise of cross border capital transactions. These factors enabled commercial banks to extend their credit volume, denominated in US dollars with flexible - and at that time still relatively low - (real) interest rates **vis-à-vis** Latin America which was crying out for extra financial resources to oil its ongoing growth process.

According to then prevalent post-Keynesian and structuralist paradigms, Latin America did not hold sufficient domestic savings to finance the investment projects that would spark off the catching-up process and ultimately close the gap **vis-à-vis** high income countries.\(^2\) Furthermore, Latin American countries were thought of as economies with historically deformed markets in which either the price mechanism did not work at all or private economic actors were, for one reason or another, incapable of responding adequately to scarcity-expressing price signals. Consequently, goaded on by a lively debate led by the United Nations Economic Commission for Latin America and the Caribbean (CEPAL), governments came to the conclusion that strong public intervention in the market process was not only desirable but indispensable if the goals of broadening domestic

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\(^2\) See as the most cited Nurkse (1966) as well as Chenerey and Strout (1966).
production capacity and breaking up the dualistic structure that impeded the development process were to be reached within an acceptable time horizon. This intervention assumed a variety of shapes, all embedded in an Import-Substituting-Investment (ISI) Strategy that primarily focused on the administrative allocation of resources and price setting that would later come in for a good deal of adverse publicity as ‘financial repression’. As far as their insertion in world markets was concerned, the Latin American position was characterised by a current account deficit which was assumed to be transitory insofar as the build-up of manufacturing industries was meant to replace raw material exports and render net current imports superfluous in the long run. The strategy was financed through a monetization of budget deficits by national central banks on the one hand and - an increasingly relevant factor - by the accumulation of external debt on the other.

In the meanwhile average annual Latin American inflation rates, though relatively moderate compared to those which were to come in the 1980s, began to rise; by the 1970s they had already reached two digit rates, an indication of a principal defect in this type of economic policy. The increase in foreign debt was not considered a major problem either by national governments or by international organisations. Under the heading ‘What would be required for even faster growth?’ the World Bank (1980:12) still noted only two years before the outbreak of the debt crisis as the last of its recommendations that

‘Finally, capital flows to developing countries would need to

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3 This applies to all Latin American countries except Honduras, Paraguay and Panama which realise inflation rates of less than 10 per cent whilst Argentina and Chile already produced three digit numbers. See World Bank (1981: Appendix Table 1).
increase substantially. Given increases in developing-country exports (and thus in debt-servicing capacity) and in the efficiency with which the capital is used, developing countries would become increasingly attractive customers to commercial lenders.

However, by the latter half of the 1970s the international economic environment had changed completely to the severe disadvantage of developing countries. First of all, the international level of both nominal and real interest rates climbed steadily, reaching its peak in 1981 when US prime rate stood at 21.5 per cent due to the so-called “Volcker shock” by which the US administration tried to restore international credibility to the US dollar as a store of value and a unit of account. Moreover, the second oil crisis arrived, caused by another oil price increase and the US-Iran conflict. This scenario provoked a world-wide recession with a slow down of the investment dynamic resulting in stagnating, sometimes even negative, real growth rates to which industrialised countries could adjust faster by cutting imports and trying to raise export revenues. Thus developing countries were confronted with a situation in which the debt service for already disbursed credits with flexible interest rates multiplied continuously, opportunities to roll over their credits on the international credit market decreased sharply, and their ability to serve the debt by raising exports deteriorated substantially. Hence the gap between the amount of foreign exchange required to serve the debt and the actual receipts of foreign exchange was dramatically widened. When international capital markets refused to provide Latin America with sufficient capital to finance its current account deficits and the rescheduling of its external debt, the debt crisis broke

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4 At that time OPEC members were discussing whether to conduct the oil trade in a currency other than the US dollar.
From its onset up to 1988 the debt crisis was unanimously assumed to be a serious, but nevertheless temporary, liquidity problem: Serious because the failure of various big debtors threatened the solvency of a few highly engaged private creditors, especially commercial banks in the US, which were lacking enough reserves for non-performing loans; temporary because the range of measures implemented consisted of rescheduling the debt stock and providing fresh money in combination with adjustment programs worked out under the leadership of Bretton Woods institutions. The aim of the adjustment programs was to re-establish the ability to pay by prolonging the redemption time and by cuts in the interest rate for which special instruments had to be introduced like the Sector Adjustment Loans (SECAL) and Structural Adjustment Loans (SAL) of the World Bank or the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) of the IMF.

Although Latin America succeeded in turning around the current account from a deficit into a surplus by severely restricting internal demand and thus suppressing the income generating process, the debt stock rose continuously. By the end of the 1980s doubts about the character of the crisis were growing. The Brady Plan (1989), in opposition to the failed Baker Plan (1985), considered partial debt relief and thus acknowledged shortcomings in previous dealings, though not in the theoretical construct which still relied on a ‘growth-cum-debt’ concept. As the IMF (1987:42) noted,

“In the context of an adjustment program, guidelines on external debt management basically describe policies that would provide the country with the maximum sustainable net resource transfer over the
Almost from the outset of the debt crisis, Bretton Woods Institutions required an extensive range of measures including the implementation of economic conditionality in the form of freeing prices, with particular emphasis on freeing both interest rates and the exchange rate, liberalising markets for capital and labour, cutting back on public spending and in general reducing the role of the state in the market process.\textsuperscript{5} As the 1980s drew to a close there was a general consensus that not enough progress had been made and that the economic conditionality package should be supplemented by a political dimension which included anti-corruption measures, the broadened participation of so-called civil society in the design of national economic policy, and the regular holding of elections (World Bank 1991: Chapter 7).

And indeed, in the first half of the 1990s an overwhelming majority of then democratic governments in Latin America had adopted such a ‘market-friendly strategy’. The annual inflation rate was brought down to under the 10 per cent mark, exchange rates proved unusually stable and, not the least of their achievements, large-scale privatisation programmes were introduced. Furthermore, a change of a number of external factors such as relatively low real interest rates at an international level and higher access to international capital markets, especially bond markets, resulted in a better debt-servicing performance and allowed Latin American economic actors to change the composition of the debt stock, transforming

\textsuperscript{5} See also for recent reference Caiola (1995:9-13).
\textsuperscript{6} For an excellent overview and assessment of early Latin American liberalisation attempts and their failures see Díaz-Alejandro (1985).
it from loans by commercial banks and official creditors to liabilities made up of portfolio and foreign direct investment. Consequently, the Latin American debt crisis ceased to be the order of the day, either because it was assumed to be under control due to good crisis management or because it was supposed to have been solved and done away with. But the 1994/1995 Mexican crisis which sent shock waves through the whole region, underlined once more the fragility of Latin American economies and gave rise to that cynical bit of advice to investors ‘enjoy the party but dance near the door’. It also served as a stark reminder to Latin America of just who would be the definite loser when everything else was lost.

2. AND ASIAN FLU

The East Asian tigers - Hongkong, Singapore, South Korea, Taiwan, and more recently the newly industrialising economies (NIEs) of Indonesia, Malaysia and Thailand – were considered the success stories, as beacons among the numerous miscarried development efforts littering recent decades. They seemingly represented the ideal development model which all theoretical schools claimed as their own. Mainstream economics, for instance, staked its claim because in its view the Asian countries had got their fundamentals right with their ‘pragmatic orthodoxy in macroeconomic management’ capped by privately induced net capital inflows which helped then to finance a growing current account deficit (e.g. World Bank Policy Research Project: Chapters 2, 3). Structuralists and post-Keynesians too saw in them a reflection of their own economic thinking because, as they said, only the comprehensive production capacities built up during the phase of ISI-strategy could have allowed them later to realise the huge
expansion in GDP and exports without inflationary pressures whilst government intervention distorted prices and set incentives which were not in step with market rules, thereby boosting investment and dynamising comparative advantages. But then, to everybody’s general surprise, on the very eve of the year of the tiger, the tigers and little dragons themselves not only lost most of their fire but seemed threatened by dire extinction.

At first sight the Asian crisis seems to have been provoked by a relatively moderate slowdown of growth prospects, especially export prospects, in the second half of the 1990s when the US dollar recuperated against other key currencies including the German mark and Japanese yen. Since Asian currencies were loosely or even tightly linked to the dollar, its nominal appreciation resulted in a drop in Asian competitiveness on world export markets. Prompted by an interest rate increase in the bond market and ambitious privatisation projects (for example in South Korea), share prices began to fall, and as early as August 1996 the Thai bath suffered its first attack. With deteriorating actual profits and profit expectations, more and more companies had difficulties in meeting their credit obligations. Hence, commercial banks were hit by a devaluation of their two distinct financial claims: The assets held by the banking system greatly decreased in value, a slump which was further aggravated by sales of some cliff-hanging institutional investors, whilst at the same time the share of non-performing loans steadily increased. Although Asian companies and banks were still

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8 See The Financial Times 27 September 1996. A short description of the South Korean situation can be found in The Economist, 2
able to raise sufficient liquidity on international capital markets in 1996,\(^9\) this could not prevent the bankruptcy of large Asian conglomerates in 1997. And it set a downward spiral in motion at the end of which the liquidity squeeze merged into a wide default of the Asian commercial banking system with the share of non-performing loans to bank capital reaching at least 100 per cent in the Philippines and over 600 per cent in Malaysia (Fig. 1).

\[\text{Figure 1. Non-performing Loans (percentage of Bank Capital)}\]
\[\text{Source: Deutsche Bank Research 1998, p 53}\]

With regard to the East Asian crisis there is general consensus on three arguments. First, the crisis is said to have revealed inherent weaknesses in Asian banking systems which remained concealed as long as the growth process was steady and uninterrupted. And indeed, for the five most affected countries, the average total domestic debt to GDP ratio rose to 125 per cent with domestic debt servicing costs riding at an average of roughly 27 per cent

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\(^9\) The international claims (credits and bonds) held by foreign banks vis-à-vis the five most affected countries (Indonesia, Malaysia, Philippines, South Korea and Thailand) rose by a remarkable 25 per cent in 1996. See Radelet, Sachs (1998:Table 3).
of GDP and displaying what some have termed an excessive credit expansion by domestic commercial banks to parastatals and private companies (Fig. 2). Secondly, the weakness of the banking system is not to be considered the sole factor in explaining the speed and intensity of the crisis. And thirdly, the profound economic and social setback manifested during the adjustment process is not to be explained on economic grounds alone. Even so, there seems to be deep disagreement in the academic community about who is to blame for the woes of the financial systems and - even more to the point - about whether the state of financial systems has been if not the sole, then at least the key, factor in causing the crisis.

One part of the academic community singles out the (informal) mix of public and private entities in the Asian economies as the pivot of the crisis. This blend is seen in public guarantees for private banks’ liabilities giving rise to a full-blown bubble and a moral hazard problem. As Krugman (1998a:1) writes,

“The first act was the story of the bubble. It began, we now think, with bad banking. In all of the countries that are currently in
crisis, there was a fuzzy line at best between what was public and what was private; (...) All those irresponsible loans created a boom in real estate and stock markets, which made the balance sheets of banks and their clients look much healthier than they were.

As commercial banks, like all financial intermediaries, simultaneously fulfil the function of debtors and creditors, irrespective of the personal relationship of some of the owners to the political network, their economic interest consists both in maintaining their ability to pay and in securing their pure economic survival. Their ability to pay is mainly conditioned by their maturity structure and their reserve management whilst their economic survival depends in general on the quality and security of their financial claims. If it is correct that Asian governments gave implicit or even explicit public guarantees for total cover of the banking systems ability to pay, then we need to investigate whether such credit extension under aspects of liquidity really is “bad banking” or rather not simply a manifestation of highly efficient economic behaviour under a given set of incentives and conditions. Restricting credit volume which is no threat to liquidity and holding interest-free reserves when the government has in any case given concrete guarantees in case of an emergency would normally be construed as a waste of resources and an indication of grave resource misallocation. The only lesson to be learnt here is that what proves to be efficient for one sole economic agent does not necessarily provide guarantees for macroeconomic stability and a steady increase of income levels for a whole economy. In other words, analyses based on allocation are not capable of grasping the Asian crisis in its entirety.

Even so, the outstanding financial claims of the banking system are highly relevant with regard to solvency which requires that the value of financial claims together
with equity capital must at least be equal to the value of liabilities, irrespective of who is going to take them over in case of an emergency - be it a deposit insurance or the central budget. And, as we have seen, financial claims consisting of tradable, not nominal fixed assets and loans collapsed so dismally that existing liabilities exceeded the value of equity or banking capital - which by the way is always low in comparison to liabilities in every banking system of the world. Asian commercial banks, however, found themselves in the strange situation of being insolvent but still liquid due to public guarantees whereby their insolvency was by no means backed by the above mentioned government guarantees. Hence we should question from a solvency standpoint whether public guarantees did in fact induce credit extension because at the most they were only valid for the passive side of the balance sheet whilst financial claims belong squarely on the active one. Leaving aside for the moment the question of guarantees, the key to the vexed issue of whether the comportment displayed by financial institutions really deserves to be dismissed as “bad banking“ lies in ascertaining whether the value of financial claims was already lower than liabilities previous to the crisis or only became so after its outbreak. If the latter is true - which is our contention considering that it was a whole region and not just a few banks that had slid into bankruptcy - then the collapse of commercial banks is not a cause but rather a result of the crisis.\(^{10}\)

Furthermore, Krugman acknowledges that private investor panic triggered off a large-scale withdrawal of

\(^{10}\) A more systematic analysis of the relevance of micro- and macroeconomic factors to banking crises in the 1970s and 1980s can be found in Caprio and Klingebiel (1997).
foreign capital and made the situation even worse but he also adds that the panic itself was underscored in principle by bad banking: „The crisis, in short, was a punishment for Asian sins, even if the punishment was disproportionate to the crime“ (Krugman 1998b:3).

Although it acknowledges weaknesses of domestic banking systems, the other part of the academic community strongly rejects any notion of public responsibility for the unsustainable build-up of domestic and foreign debt. As Sachs (1997:3) notes, „The currency crisis is not the result of Asian government profligacy. This is a crisis made mainly in the private, albeit under-regulated, financial markets.“ The argument goes that the majority of international lending had been aimed at the non-banking sector for which there had been no explicit public guarantees and where none of the international investors could have entertained realistic expectations of implicit ones (Radelet and Sachs 1998:6 and 31).

After the bubble burst in 1997 sparking off the crisis, events were propelled by a number of factors, namely: the refusal of panicking foreign private creditors to roll over short-term credits, the failure of governments to detect the gravity of the problems involved from the outset and provide appropriate measures to deal with them, and the harsh conditions Asian governments were compelled to enter into with the IMF which fuelled the panic even more (Radelet and Sachs 1998:2 and 7). From these factors Radelet and Sachs single out financial panic and the „disorderly work-out“ of governments and the international community headed by the IMF as the key points. „Since we view the crisis as a case of multiple equilibrium, our hypothesis is that the worst of the crisis could have been largely avoided with relatively moderate adjustments and appropriate policy changes“ (Radelet and
In other words, in their view Asian economic fundamentals and the underlying weaknesses of financial systems are not sufficient to explain the depth and intensity of the economic and social upheaval. The panic itself is mainly attributed to the build-up of short-term debt denominated in US dollar causing a temporary liquidity problem which proved unsolvable due to the lack of an international lender of last resort and which therefore resulted in a large-scale credit crunch. However, reducing the Asian crisis to a maturity problem of borrowing short and lending long is to gravely underestimate the Asian development process which relied essentially on foreign indebtedness. Thus the increase of the share of short-term debt in relation to long-term debt should be viewed only as an indicator of the system’s vulnerability but cannot be interpreted as the cause of the crisis.

This brings us the question of unregulated financial markets. Radelet and Sachs (1998: 31-32) do indeed raise the question of whether it is now time to apply controls on short-term capital flows. But it should be obvious that capital controls – no matter how efficiently they might be implemented - by no means prevent domestic and international investors from springing off a currency when their financial claims and their nominal wealth are threatened by devaluation between almost 50 per cent and over 200 per cent - the very extent to which Asian currencies declined in the eight months directly following the outbreak of the crisis (Fig. 3).

In short, both sides of the academic community base their main arguments on two main factors: the failure of governments or international organisations and panic by international investors. While Krugman pinpoints governmental failure as laying the grounds for the crisis
which was only aggravated in the aftermath by sudden large capital outflows, Sachs and Radelet focus on the financial panic which in their view resulted in an abrupt cut off of capital, intensified by the failure of governments and international institutions to react adequately.

![Figure 3. Exchange rate Changes. (July 1997 – Feb. 1998)](source: Bank for International Settlements 1998, p 47)

3. DIFFERENCES AND COMMON FEATURES

The 1980s Latin American crisis and the 1990s Asian crisis differ in at least three significant respects: (a) the international economic environment; (b) debtors; and (c) exchange rate regimes. With regard to exchange rate regimes, Latin America installed a real anchor system expressed in a crawling peg, often with dual or multiple exchange rates graduated according to their priority frames for imports, from preferential treatment for so-called capital goods to discrimination against luxury items. Asia, on the other hand, favoured a unified or sole exchange rate tied in a nominal anchor system either officially or implicitly through a very narrow band in which the exchange rate could float. In Latin America the main debtors were central and regional governments together
with public enterprises, whereas in Asia the overwhelming majority of debtors stemmed from the private sector. Although it has become somewhat of a truism that capital flows to Asia were essentially in the form of direct or portfolio investments and not in the form of credits as was the case for Latin America, with the notable exception of Malaysia, this is just not true. The fact is that in the last few years more than 50 per cent (in 1996 as much as 70 per cent) of all net private capital inflows to Asian economies under review here were in the form of loans from commercial banks or non-bank private creditors (Table 1). Moreover, at the outbreak of the Latin American crisis the world economy was already in deep recession with tremendously high international interest rates and dramatically low growth rates, whereas Asia went out of step at a time when the economic world climate was highly favourable.

Table 1. External Financing of Asian Economies #

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<tr>
<td>Current account balance</td>
<td>-24,6</td>
<td>-41,3</td>
<td>-54,9</td>
<td>-26</td>
</tr>
<tr>
<td>External financing, net of which</td>
<td>47,4</td>
<td>80,9</td>
<td>92,8</td>
<td>15,2</td>
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<tr>
<td>Private equity investment</td>
<td>12,2</td>
<td>15,5</td>
<td>19,1</td>
<td>4,5</td>
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<tr>
<td>Private creditors</td>
<td>26,2</td>
<td>61,8</td>
<td>74</td>
<td>-7,0</td>
</tr>
<tr>
<td>Official flows</td>
<td>7</td>
<td>3,6</td>
<td>-0,2</td>
<td>27,2</td>
</tr>
<tr>
<td>Resident lending/other net*</td>
<td>-17,5</td>
<td>-25,9</td>
<td>-19,6</td>
<td>-11,9</td>
</tr>
<tr>
<td>Reserves, excl gold</td>
<td>-5,4</td>
<td>-13,7</td>
<td>-18,3</td>
<td>22,7</td>
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# Indonesia, Malaysia, Philippines, South Korea, Thailand. e estimate.
* including gold, and errors and omissions.

Source: Radelet, Sachs, 1998, Table 2.

But both Latin America and East Asia realised net capital inflows and current account deficits (South Korea, Philippines and Thailand even realised trade deficits) with the whole array of negative consequences. Both net capital inflows and current account deficits are an expression of the overvaluation of the exchange rate. This process begins
with overvaluation and unfolds in a loss of international competitiveness and a current account deficit, which as a precondition requires net capital inflows re-cementing or even worsening the status quo. Continuous net capital inflows result in an accumulation of foreign debt stock which has to be serviced and thus an extra burden is laid on subsequent current accounts. The longer this process continues the more unrealistic it seems that the country can service - let alone pay back - foreign debt under its own steam. It usually ends up in the paradoxical situation of having to raise new foreign debt to service the old. Furthermore, overvaluation and international net debtor positions fuel growing depreciation expectations for the domestic currency. In order to compensate the decrease of the local currency liquidity premium, an increase in domestic interest rates is required. But higher interest rates not only tend to slow down national growth, they also make local credits dearer and - ceteris paribus - induce domestic economic agents to pile up even more debt at the international level. This process shows cumulative characteristics and may result in an extreme case either in a complete erosion of the domestic monetary system with hyperinflation and dollarization as was the case in Latin America, or in international bankruptcy with a seemingly unfounded sudden U-turn in capital flows and a bottomless deterioration of exchange rates as was the case in Asia. In both cases, however, so-called panicking domestic and international investors do not necessarily tread some secret psychological path which we economists are unable to grasp - they are merely ordinary actors in a market process from which they are unable to escape on their own.

Overvaluation itself can be a result either of the administrative fixing of the nominal exchange rate under
conditions of a positive inflation differential or of domestic interest rates which are too high in comparison to international interest rates and which thus induce private net capital inflows. If private net capital inflows are not counterbalanced by official net capital outflows, the basis of overvaluation is laid. There is a lasting debate on how long current account deficits may be sustained (e.g. Milesi-Ferreti and Razin 1996), but, from our point of view, they are not sustainable at all for developing countries. Unlike the US, these countries cannot indebt themselves in their own currency and therefore, should currency depreciation occur, they are not able to depreciate their debt. A country’s current account deficit can stretch over several decades but sooner or later the time comes when international investors are no longer prepared to finance it. Then the country will be precipitated into an ordinary balance of payments crisis and forced to turn the current account around. However, we cannot assume that this will be achieved „smoothly and without disruptions“ since it necessarily involves putting a squeeze on the domestic economy.\textsuperscript{11}

\textsuperscript{11} In periods of liquidity crisis fresh money can indeed smooth the process of readjustment to a changing national and international economic environment as it allows a prolongation of the adjustment period. In contrast to a debt-cum-growth strategy, one has to bear in mind: (a) that this is a situation of crisis in which an economy exceptionally falls back on capital imports to prevent default and is not aimed at encouraging a catching-up process; (b) that these net capital imports consist mainly of public or publicly guaranteed credits to bridge a temporary liquidity problem and are not intended as permanent filling for an assumed savings-gap; and (c) that this fresh money does not suspend the necessity of adjustment and the need to turn around the current account in the middle term. Economies which postpone or neglect an adjustment for political or economic reasons cannot rely in the long term on net capital imports. Unlike official
At this juncture we may well inquire why the overwhelming majority of observers did not realise that the ongoing Asian development process was flawed with instability? The answer is as stark as it is tragic: Even today mainstream economics sticks to the mystery of a savings-gap in which current account deficits and net capital inflows still serve as indicators for a viable catching-up process.

“But large-scale borrowing by itself need not to lead to a crisis. Statistical evidence suggests that a large current account deficit or high level of debt are not highly significant predictors of crisis. More important than the magnitude of the current account deficit is how it is financed, and how the funds are used” (Frankel 1998:1).

Regrettably this is not the case. Asian countries had been lavishly praised for their ability to attract private capital inflows, in contrast to Latin America which up to the 1990s always had difficulties in moving private international investors to enthusiasm. Capital inflows to Asia were widely interpreted as a sign of the sustainability and stability of the economic process, precisely because they came mainly from the private hand. But it has now become apparent that for prices like the exchange rate it is completely irrelevant which economic sector performs the activities that finally lead to an overvaluation. It is the development assistance, market-induced capital flows require adjustment, at least with regard to internal (political and economic) stability - an aspect what is impressively clear in the case of Mozambique. For the function of net capital imports within the debt-cum-growth strategy and adjustment strategies in crisis situations, see World Development Report 1985, especially Chapter 4.

12 From my point of view this question lies at the core of the debate on the failure of the economic community to predict the crisis. Sensu stricto of course nobody could seriously expect this as economists are not some pepped up version of the oracle of Delphi.
economic activity itself - here net capital inflows and an accumulation of external debt - which is the decisive factor. What is of prime importance here is that the administrative fixing of prices – whether as exchange rates in the form of explicit or implicit nominal pegs as in Asia or in accordance with ad hoc rules for day-to-day government business as in Latin America – will not provide automatic long-term guarantees for their acceptance by economic agents.

The ‘State versus Market’ dichotomy is another popular but nevertheless inappropriate debate. The nation state like private economic agents, is a market actor with an own internal and external budget constraint. The former consists in a stable low inflation rate and the latter in a stable exchange rate, so that all national money functions can be assumed by the local currency. Up to the 1990s Latin America continually violated both internal and external budget constraints by printing money and accumulating foreign debt, whilst Asia was celebrated for its strict adherence to very low inflation rates. Yet internal stability is merely a necessary, but by no means sufficient, condition for external stability. The systematic creation of depreciation expectations through foreign indebtedness damages external stability and will inevitably lead to depreciation. Herein lies the failure of the Asian state which, apart from its belief in the growth-cum-debt strategy, added extra vulnerability to financial markets by an insufficient surveillance of domestic credit institutions. Asian supervisory authorities were especially negligent with regard to commercial banks’ exposure to a shift in international portfolio flows by tolerating a build-up of an open foreign currency position up to over twenty per cent of all claims by commercial banks (Horn and Schrooten (1999:17).
The nation state too is subject to failure and elimination just as are other market actors. The difference is that whereas bankrupt private companies are dissolved economically and physically, the nation state is gradually divested of its economic functions whilst its physical survival is ensured. Bankruptcy affecting an entire country means a debt overhang irrespective of which criteria are used to define it.\textsuperscript{13} A debt overhang can only be reduced by debt relief which can be arranged through bilateral - or in the case of private creditors – multilateral negotiations. If parties cannot agree upon individual conditions, the market itself will develop its own instruments. Since the mid 1980s there has been a secondary market for the debt developing countries owe to foreign private creditors in which bonds are bought and sold far below their nominal value, on average with a discount of 50 per cent.\textsuperscript{14} Hence, debt relief is completely consistent with market rules - in the one case carried out by national or international institutions, in the other directly executed by private economic actors. In both cases losses are socialised whilst in the case of private market agents the potential gains are privatised. Accordingly, we may assume that in a negotiated process scope for smoother adjustment exists and should be given preference.

In principle, the economic solution to state level bankruptcies can only consist in debt relief in conjunction with a development strategy which does not re-establish

\textsuperscript{13} Usually a debt overhang is defined by an excess of actual debt stock over the expected discounted debt service. This definition is problematic insofar as every country can be forced to squeeze its economy to such a degree that expected flows are at least equal to actual stock.

overvaluation and is not reliant on net capital inflows. In order for development to occur, a country must be in a position to realise a current account surplus. And, as we all live in one world, a surplus for one country necessarily implies a deficit for another. In the 1980s the US bore the main burden of the debt crisis in industrialised countries, expressed in a soaring trade and current account deficit. In 1980 it started out with a surplus as high as $3.4 billion, but quit the decade with a deficit of over $90 billion, whilst its junior partners, Germany and Japan, had not only succeeded in turning round their current accounts but had heavily boosted their surpluses from $3.5 billion and $7 billion in 1982 to $46.8 billion and $35.8 billion in 1990 respectively (World Development Report: various editions). The worldwide adjustment on the side of the industrialised countries to the Asian Crisis takes a similar course to the adjustment in the 1980s. The US reacted by cutting interest rates and tolerating a strong appreciation of the US dollar which brought in its wake a current account deficit growing by the year and destined to hit an all-time high of 4.5 per cent of GDP (forecast IMF) in the near future. Pressures on Asian borrowers were thus reduced by lowering credit costs and improving their export expectations. In contrast to the US, both Japan and Euroland are trying to maintain or even expand their shares in world markets in an attempt to overcome their internal economic problems. Although in the year 2000 many observers have already noted a remarkable Asian recovery which could signal an end to the downturn in East Asia, whether or not this process is sustainale will depend decisively on the ability of the US to achieve a ‘soft landing’ but also on China, the most serious competitor among Asian countries. Not without good reason did China – which is otherwise grouped in the low-income
country bracket – join the international industrialised community to finance a rescue package for South East Asian countries both in 1997 and 1998. If the Chinese government decides to devalue its currency to protect its own position in the world market, this will in all probability spark off a new wave of devaluations by East Asian countries which will severely hit the already battered economies of South Africa and Latin America. What will happen then only the future will show although sometimes a closer look at history does prove salutary.

4. CONCLUSION

The evolution of the Latin American crisis in the 1980s and the East-Asian crisis in the 1990s exhibits at least two common features. In both cases depreciation expectations were generated: in Latin America by administrated capital inflows, in East Asia by private net capital inflows. Obviously neither states nor private agents are endowed with omnipotent powers, nor should they be understood in general as distorting subjects. Both public and private sectors are economic actors with a distinct range of action limited by respective budgetary constraints. Moreover, the way the international community handled the problems was similar. Under the threat of a regional default, fresh money was pumped into crisis-ridden countries in an attempt to limit repercussions and to gain time for reflection. The volume of money provided marked a new era in crisis management and was combined in a second

15 China’s export surplus deteriorated sharply. On a one-year-basis export surplus fell by 48 per cent considering the first 5 months 1999 alone. At the same time deepening inflation results in a profit squeeze of local companies which is more and more destabilising the domestic financial system. See The Financial Times 16 June 1999.
phase with the introduction of new instruments.

The outbreak of the debt crisis in 1982 wrought a definite switch of paradigm in development theory from a post-Keynesian to a neo-liberal approach, necessitating the re-establishment of so-called correct relative prices and the liberalisation of markets. With Asia already serving as the metaphor for widely liberalised markets, there is obviously no call that can be seriously considered for even tougher liberalisation policies. Instead the old debate about capital controls and the world-wide application of the Tobin tax is re-emerging.\textsuperscript{16} What has not altered with the paradigm switch is adhesion to the idea of a savings-gap. Thus both the Latin American crisis and the Asian crisis are indicative not so much of governmental or market failures as of the failure to unveil the growth-cum-debt strategy and of the then mainstream economic thinking. Considering the extent of the social, political and economic setback it has undergone, Asia merits inducing a profound change in

\textsuperscript{16} Any assessment of the re-regulation of capital market flows and capital market actors, including national and international financial institutions, depends decisively on the question whether financial crises as discussed above are due to internal, so-called home-made factors or are rather a product of inherent instability in the current world monetary system. The first variation implies at least a (theoretical) possibility of preventing financial crises by improving financial surveillance mechanisms and bringing about a stronger government adherence to fundamentals. The second variant, on the other hand, implies that not only shall we have to accommodate ourselves to financial crises in the immediate future, but also, more tellingly, that in general such crises cannot be prevented. Thus the requirements of the pre- and post-crisis-management are significantly higher. Such a backdrop places a thorough discussion of issues such as necessity or efficiency of capital controls, a reform of international financial institutions or even a nominal peg between Euro, Dollar and Yen aimed at mitigating the occurrence of financial crises beyond the scope of the present paper.
development economics whose most famous success story in 50 years has just faded away. But current debates raise little hope of this happening.

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