IMF and the east-Asian debacle

That Taiwan, the east Asian economy in best shape is not an IMF member has a lesson to offer on the moral hazard of Fund activity, says **Vivek Moorthy**

THE GLOBAL financial and economic system, based on unfettered private capital flows, has come in for a great deal of criticism after the east-Asian debacle. The critics usually lump together the two undesirable pillars of Western capitalism as being unstable financial markets (hot money), and the IMF. What they do not realise, or deliberately choose to ignore, is that the IMF is not a manifestation of the free market. Instead, it is a tax supported bureaucracy that influences, and alters private capital flows — for better or for worse; and it does that in a manner that would not have otherwise occurred under a genuinely free market system.

The well-known economist Milton Friedman, a long-standing critic of the IMF, has argued that the current global crisis has been due to the IMF's meddling. That is what he recently wrote in the Asian Wall Street Journal. The Mexican crisis in 1994-95 also produced a quantum jump in the scale of the IMF's activity. Mexico, it is said, was bailed out by a $50 billion financial aid package from a consortium including the US, the IMF. But in reality it was not Mexico, the country, that was bailed out. Instead of that the ones that were truly bailed out were foreign entities — like banks and other financial institutions which had made dollar loans to Mexico.

The Mexican bailout also helped fuel the east-Asian crisis. It encouraged individuals and financial institutions to lend to and invest in the east-Asian countries, drawn by high domestic interest rates and returns on investment. They felt insulated against currency risk, believing that the IMF would bail them out if the exchange pegs broke down. Russia is the latest example. The end result has been more, rather than less, financial instability.

Perverse incentives created by official guarantees for private lending is a major instance of moral hazard. Friedman's conclusion, that the global economic crisis is the result of the IMF's interference, that gave rise to moral hazard, is clearly overstated. After all there were large and volatile capital flows even during the nineteenth century and first quarter of this century, well before the IMF was formed. Financial bubbles and panics, and associated cycles in real activity, are endemic to the market system. Such crises have repeatedly occurred during the gold standard era, when private individuals ended up bearing and, more crucially, were expected to bear, most of the risk from their investments. Market economies are inherently volatile.

CAPITAL INFLOWS OF ASEAN ECONOMIES

	Average 1989-95	Average 1991-94	1995	1996	1997
Indonesia					
Net private capital flows	4.2	3.5	6.2	6.3	1.6
*Other net investments	2.6	1.9	3.1	2.7	0.1
Malaysia					
Net private capital flows	8.8	11.3	8.8	9.6	4.7
*Other net investments	2.3	3.7	4.1	4.5	-0.6
Thailand					
Net private capital flows	10.2	9.1	12.7	9.3	-10.9
*Other net investments	7.4	6.8	10.0	7.7	-12.6
Taiwan					
Net private capital flows	-4.0	-1.8	-3.6	-3.2	-3.8
*Other net investments	-2.8	-1.6	-3.3	-2.1	-2.6

Because of data limitations, other net investment may include some official flows. Data for 1997 are projections
* denotes of which

The above consideration notwithstanding, there is evidence that lends credence to the view that moral hazard has contributed to the destabilising capital flows to east Asia.

The accompanying Table presents data on net aggregate private capital flows, and also for the relevant sub-category of other net investment (mostly bank lending) for select east-Asian countries. The other major components of private capital flows, not reported here, are portfolio investment and direct investment.

It will be seen that Indonesia, Malaysia and Thailand have undergone proportionately large net private capital inflows during the entire decade, until the crisis erupted in 1997. For Korea and the Philippines, two other major east-Asian countries not included in the Table, the pattern is similar to that seen here: large net private inflows this decade up to 1996.

Taiwan, however, sticks out like a sore thumb. It has undergone net capital outflows, both aggregate and also for other net investment, for this entire decade.

In the years preceding the crisis, Taiwan's booming economy should have been attracting capital like the others in the region, based on the euphoric, contagious mood among investors about Asia's prospects. That it did not do so is a noteworthy.

What could be the reason for this anomalous outcome? It is the moral hazard effect. Taiwan is not a member of the IMF. Officially designated as a province of China, it is expected to join the mainland some day. Thus, it cannot expect to rely on any IMF assistance in case of external financing difficulties. That implies a disincentive for foreign investors to invest there. To firmly conclude along these lines requires data on both inflows and outflows of capital, as well as detailed background knowledge about Taiwan's economy and the regulations its government imposes on capital flows of different kinds. But, as a first approximation, the moral hazard view seems vindicated.

Apart from the direct moral hazard effect, there are other channels of influence, probably more important, through which official agencies played a role in inducing capital to flow to emerging markets. Paul Krugman has attributed much of the capital flow to emerging markets in the early 1990s to the synergy of views and activities of private investors and government officials. The Washington Consensus, is how he described it, meaning that not only the US Government but also the network of institutions and leaders centred in Washington

Indeed, the five-year reign of the Washington consensus may be usefully thought of a speculative bubble. It involved the usual economic process by which excessive market optimism can work out temporarily as a self-fulfilling prophecy; it also included a more subtle political process through which the common beliefs of policy-makers and investors proved mutually reinforcing.

Its political status excludes Taiwan from this circuit, although it has been an integral part of what the World Bank study in 1993 termed the east-Asian miracle.

Taiwan, as it stands among the eastAsian countries, is in the best shape despite its heavy export and foreign trade orientation. Its inflation rate is close to zero, while its real GDP growth in the four quarters ending June 1998 has been a bit over 5 per cent, the highest of the Asian countries, except for China (whose data is of extremely dubious quality). So one cannot but raise the following question: Is it just a coincidence that the best performing east-Asian economy has been outside the realm of the IMF and the Washington consensus?

From a wider perspective, the east-Asian crisis calls for a reassessment of the role of the state in the economy. The failure of comprehensive planning led to a drastic reduction in foreign aid and direct state intervention in many developing economies by the 70s and 80s. However, that has been replaced by indirect state intervention, with governments promoting private capital inflows actively to boost growth. They provide exchange rate cover and other kinds of project specific guarantees. It is time to reconsider whether the government should engage in such indirect intervention, instead of sticking to its classical role of fostering a sound legal infrastructure — the sine qua non for sustainable, welfare-enhancing economic activity.

The author is with IIM, Bangalore