



Current Issues in Emerging Market Economies

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**Capital Flows in Emerging Asia:
Should External Borrowing be Restrained?**

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CAPITAL FLOWS IN EMERGING ASIA; SHOULD EXTERNAL BORROWING BE RESTRAINED?
Presentation at the 7th Dubrovnik Economic Conference

by
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I. INTRODUCTION

1. **Before I begin, let me first thank you for the opportunity to speak to you today.** The organizers have been very successful in bringing together an impressive group of practitioners and academics to address very topical issues related to emerging market economies. I observe that most speakers are focusing their remarks on Latin America and European emerging markets, which perhaps reflects a vote of confidence in Asia's prospects after the 1997–98 crisis. This said, the experience of the Asian emerging markets still can provide useful lessons, so my remarks today will take a distinctly Asian perspective.

2. **There is little doubt that the Asian financial crisis was one of the most dramatic economic events in Asia's recent history.** The financial turbulence that originated in Thailand in the summer of 1997 spread quickly to virtually all emerging markets in the region, and helped wipe out years of economic growth. Real GDP of Korea and Thailand fell by 7 and 10 percent, respectively, in real terms between 1997 and 1998, and Indonesia's GDP still remains nearly 10 percent below its 1997 level in real terms. The spillovers to the rest of the world were also significant, especially to other emerging markets.

3. **Although many lessons have been drawn from the experience, it seems to me that one of the most salient is that excessively high external indebtedness² helped precipitate the crisis and greatly complicated its resolution** (see Figure 1).³ In the period leading up to 1997, borrowers **and** international creditors both severely underestimated the costs and risks associated with this type of funding, contributing to over-investment and excessive leverage. With the increase in external indebtedness, monetary and exchange rate policies had limited room to maneuver in response to macroeconomic shocks—including the weakening of the electronics market and the yen's depreciation from the mid-1990s. The fact that many, if not all, emerging markets were similarly exposed meant that conditions were ripe for a shift in sentiment, contagion, and system-wide financial and balance-of-payments crises.

4. **Today, I want to discuss this experience and ask two key questions:**

¹Director, Asia and Pacific Department, International Monetary Fund. The views expressed here are my own and do not necessarily represent those of the IMF. However, they reflect useful comments of my colleagues, which I gratefully acknowledge.

² As discussed in paragraph 13, the external debt of emerging markets is almost always in foreign currency.

³ The figures referred to are found at the end of the note.

- **First**, for emerging markets, do the benefits of allowing residents complete freedom to issue external debt outweigh the costs?
- **Second**, if the costs of this type of borrowing are higher than commonly assumed, is there then a case for policies that would limit this form of capital inflow?

II. CAPITAL ACCOUNT LIBERALIZATION AND CONTROLS

5. **Before addressing these specific issues, I would like to outline briefly my views on the broader issues of capital account liberalization and controls** in order to avoid the risk that what I will say today about these specific issues will give you the wrong impression of my view about the broader issues.

6. **Let me begin by emphasizing the general benefits of international capital mobility.** It allows countries with limited savings to attract financing for productive domestic investment projects, it spreads investment risk more broadly, promotes international trade, and contributes to the efficiency of the financial system and the development of financial markets. Capital mobility allows households, firms, or sovereign borrowers to use international capital markets to facilitate inter-temporal consumption smoothing, which helps dampen business cycles. It also allows investors to diversify their portfolios internationally, reducing their vulnerability to domestic economic disturbances and enabling investors to achieve higher risk-adjusted rates of return. Thus, in sum, international capital mobility promotes saving and investment and can deliver faster economic growth.

7. **At the same time, however, there may be valid arguments for capital controls as a means to address market failures.** For example, financial markets are subject to information asymmetries that can lead, among other things, to herd behavior that is not fully consistent with underlying economic fundamentals. As a result, instability, panic, and financial crisis can be triggered, with significant macroeconomic costs. This suggests a case for restrictions on capital inflows and, in exceptional circumstances, even measures to directly limit capital outflows.

8. **Even in these circumstances, however, capital controls should be viewed as temporary mechanisms to address these concerns.** Ultimately capital controls lose their effectiveness, since market participants are adept at evading restrictions on specific transactions such as short-term external borrowing. As a result, countries are often forced to broaden controls progressively to longer-term transactions, increasing the efficiency losses and the other costs associated with capital controls.

9. Since capital controls should be viewed as temporary mechanisms, they should ideally be coupled with **a well-defined timetable for establishing appropriate prudential regulations and strong supervisory systems** in the context of which market-based risk management systems can operate effectively.

10. **Capital controls should not be used to delay macroeconomic policy and exchange rate adjustments.** While recognizing that there may be a case for capital controls when

capital flows are clearly inconsistent with long-term fundamentals, it needs to be emphasized that capital controls should not be viewed as substitutes for appropriate macro and exchange rate policies.

11. In a nutshell, my view then is that, although there may be possible justification for temporary use of capital controls, **in the long run the benefits of a liberal capital account regime outweigh the costs**. This is not different from the broad thrust of the Fund's general advice to its members, namely, **to move over time and in an orderly manner toward a liberal capital account**.

III. FOREIGN CURRENCY BORROWING—THE “ORIGINAL SIN”

12. With the foregoing as general background, I would like now to focus on more specific issues relating to external borrowing by emerging market countries. Let me reiterate here that the views to be expressed are my own and do not necessarily represent those of the Fund.

13. **As I indicated at the outset, I am extremely uneasy about the risks posed by unrestricted external borrowing by emerging markets.** In my view, and in the view of a growing number of commentators, the potential costs of debt-creating capital inflows for emerging markets and for the broader global financial system have been significantly understated. I base this view on several observations:

- **First, the external debt of emerging markets is almost always in foreign currency, with the consequence that borrowers assume the entire foreign exchange risk.** Some analysts have observed that the share of securities issued by developing countries in foreign currency approaches nearly 100 percent (while the figure is close to zero for most industrial countries).⁴ This phenomenon—which has become known as the “original sin”—has a number of unfortunate effects, including uncertainties attaching to the local currency value of contractual obligations, exposure of the country to balance sheet mismatches, and pressures on the monetary authorities to maintain exchange rate stability. As we have seen in many countries in South East Asia—including Korea, Thailand, and Indonesia before the crisis—exchange rate stability (maintained through a peg or a heavily managed float) in turn encourages market participants to mis-price risk and ramp up foreign currency debt, thus further constraining the monetary authorities and exchange rate policies. As the experience of

⁴ For example, see the estimates in R. Hausman, U. Panizza, and E. Stein, “Why do Countries Float the Way They Float?” IADB Working Paper No. 418 (May 2000), presented at this conference last year. Other literature quotes different specific figures for industrial countries but in qualitative terms, the implication is the same.

the past decade and much empirical work have illustrated, high levels of external debt, particularly short-term debt, are clear leading indicators of instability and crisis.⁵

- **To mitigate these risks associated with external debt, countries are advised to maintain sufficiently large foreign exchange reserves, but this entails costs.** For example, it is now widely agreed that emerging markets should maintain—for macro-prudential reasons—at least 100 percent reserve cover for all external debt with a residual term to maturity of less than one year. However, as borrowing costs typically exceed the rate of return on reserve assets, the question arises whether there exists any net benefit to external short-term borrowing.
- **I am even doubtful about the benefits of foreign currency borrowing with longer maturity.** Generally, forward and swap transactions beyond one year are rare if they exist at all, and in the case of those involving emerging market currencies they simply do not exist. Indeed, it is difficult to envisage that the market for such transactions will ever develop because it seems unlikely that there would ever be sufficient interest in taking the other side of the transaction.⁶ This lack of market development, and exchange rate uncertainties, mean that borrowers are not able to adequately compare, until after the fact, the cost of foreign currency borrowing against the internal rate of return of the projects they may be financing. Accordingly, the risk of unsound business decisions is compounded if projects are financed with external borrowing.⁷
- **Still, many argue that external borrowing allows a country to finance extra investment, thereby enhancing growth.** However, this view is less persuasive when it comes to emerging market countries in Asia. Since most Asian emerging market countries already have very high domestic saving and investment rates—often exceeding 30 percent of GDP—the benefits of capital inflows in terms of additional growth are likely to be lower than in countries that suffer from a domestic saving shortage (Figure 2). To be sure, even for Asian emerging countries, FDI is likely to enhance growth because it brings to them not only financing but also advanced technology and up-to-date management techniques.⁸ However, the benefit of

⁵ It needs to be emphasized that the problem is **not** external debt per se, but external debt in **foreign currency**. For emerging market countries, however, they are one and the same in reality.

⁶ Such interest would emerge only if residents of advanced countries, for whatever reasons, choose to borrow long term in the currency of emerging market countries.

⁷ The current plight of many Indonesian companies saddled with foreign debt and the present dispute between Enron and the state government of Maharashtra in India—where the return on the project was guaranteed in dollar terms—provide vivid examples of this point.

⁸ Indeed, empirical research suggests that compared to FDI, bank lending and portfolio inflows tend to simply substitute for domestic saving rather than finance additional investment. See B. Bosworth and S. Collins, “Capital Flows to Developing Economies: Implications for Saving and Investment,” *BPEA* (1999).

additional investment in high-saving Asian emerging countries financed by external borrowing is questionable given that such borrowing is always in foreign currency and thus has ramifications for systemic risks. As a final point on the issue of external borrowing, investment, and growth, let me note that many now view the so-called “investment-led growth strategy” which over time led to untenable bank and corporate balance sheets, including excessive external indebtedness in foreign currency, as the root cause of the Asian crisis.

14. **To sum up, I question the view that it is a sound policy to let residents of emerging market economies to borrow abroad freely (in foreign-currency terms), especially in the case of high saving Asian emerging market economies.** While there may be legitimate reasons to import capital that serve both the national and the global good, there seem persuasive reasons to suggest that as far as possible this should be in the form of nondebt-creating inflows.

IV. THE ROLE FOR PUBLIC POLICY

15. **The key question, then, is whether there is a case for public policies to discourage foreign borrowing.** In my view the answer is yes, since we can identify market failures or other distortions that have caused incentives to be inappropriately skewed toward external borrowing.

16. **The first is the market failure resulting from what I would call a “fallacy of composition.”** By this I mean that market participants do not fully recognize the fact that their foreign currency borrowing exposes not just themselves to risk, but also imposes economy-wide risks. In other words, foreign currency borrowing by the private sector imposes a cost on society—an externality—that is not adequately priced by the market. One business borrowing abroad exposes itself alone to a shift in market sentiment. However, if many businesses borrow abroad, collectively they expose the economy to systemic risks.

17. **In addition there are policy-related factors that have helped skew emerging markets toward external debt.**

- **For example, fixed or heavily managed exchange rates create conditions that encourage excessive external borrowing.** There are clear indications that potential domestic borrowers and foreign investors tend to regard fixed exchange rates as a given aspect of the environment without questioning whether such a regime is in fact sustainable. As experience shows, market participants tend to be highly myopic about exchange rate risks, and the demand for external borrowing tends to increase sharply when interest rate differentials favor borrowing in foreign currency terms, exposing themselves, the economy as a whole, and the international system to adverse shocks.
- **Moral hazard compounds the problem.** Borrowers in emerging markets are often large, systemically important, and politically well connected. In the absence of credible signals from governments that they will not intervene, market participants

may count on bailouts and underweight the risks that might be associated with external borrowing. In Asia, the concept of “too big to fail” was prevalent, and will linger unless governments credibly demonstrate their willingness to let large borrowers go under. Moral hazard also affects the behavior of lenders if they perceive that there is a good chance of their being spared from taking full consequences of their risk taking.

18. **International efforts have focused on addressing these latter policy-related factors:**

- **First**, we are encouraging countries to move toward greater exchange rate flexibility, and this, aside from many other effects, should help ensure that markets pay more attention to currency risk.
- **Second**, we are seeking to attenuate moral hazard by emphasizing the importance of less-interventionist policy, better governance, and greater transparency in our dialogue with the authorities. Also, we are moving toward greater private sector involvement (PSI) in crises, for example through collective action clauses in loan agreements and other means.

19. **Nonetheless, we must be humble about the extent to which these efforts can produce quick results in addressing the policy distortions. Also, we must be clear that the problems arising from the market failure associated with a fallacy of composition do not go away easily.**

20. **There then may be a role for additional policies to discourage external debt.** Let me offer a tentative list of policies that might serve this objective:

- **As regards the banking sector**, existing prudential requirements already typically limit open foreign currency positions to some share of capital. In my view, there would be considerable merit in tightening these requirements such that banks will not be allowed to maintain **any** net open foreign exchange position; banks’ foreign currency claims on residents should not be counted as eligible assets in this specific context. While this limitation would eliminate any currency exposure, it would still be important to ensure that asset-liability management guidelines were sufficient to ensure that market and credit risks associated with banks’ foreign currency positions were contained.
- Foreign-currency borrowing by **the nonfinancial corporate sector** should also be limited. Here the key issue concerns possible policy measures to restrain **medium- and long-term foreign borrowing**.⁹ One possible approach would be to impose a tax

⁹ Nonfinancial companies in Asian emerging market countries undertake little short-term external borrowing outside suppliers’ credit (accounts payable). They typically rely on domestic financial institutions for intermediation.

on foreign borrowing through bonds and syndicated bank loans. Key parameters in deciding an appropriate tax rate presumably include the volume of annual external borrowing (on average) in relation to the size of the economy, the frequency with which the country concerned is hit by an external crisis, and the severity of a (potential) crisis measured by output foregone. Obviously, it would not be an easy task to determine the tax rate. As an alternative, a market-based mechanism could be considered that would allocate access to this type of debt, subject to economy-wide limits set by the authorities. These limits could be established on the basis of estimates of the sustainable level of debt (presumably rather small) and access to this window could be determined through auctions. This would be equivalent to placing a tax on foreign debt, where the market endogenously established the tax rate subject to an exogenously determined ceiling.

21. **It needs to be emphasized that these proposals are for limiting external borrowing by [Asian] emerging markets countries and have nothing to do with foreign direct investment and portfolio flows into equity markets.** In fact, emerging market countries should be **encouraged to phase out existing impediments to these flows expeditiously**, and develop market and regulatory structures to promote such flows. This would be a part and parcel of a general strategy to make their economies more open and market based, a strategy that those countries should be, and many are indeed, pursuing.

22. **Neither do I make similar proposals (for limiting external borrowing) with respect to the advanced economies**, for the following reasons.

- **First**, the fact that domestic bond markets in the advanced economies are well developed enables much easier access to external financing in local currency terms and, reflecting this, most advanced economies do not have large foreign currency debt exposures. Since my conjecture is that the systemic risks associated with foreign currency debt tend to rise more than proportionately with the increase in foreign currency exposure, a small amount of external debt in relation to the size of the economy means that the risks are much more manageable.
- **Second**, these economies are typically more robust and resilient than the emerging market economies, with stronger risk management and prudential systems in both the corporate and the banking sectors. Thus, even if they were to take on the same level of external debt as an emerging market economy, their vulnerability to shocks is considerably less.

23. **For these reasons, the measures I have suggested to curtail external borrowing by Asian emerging countries should be seen as transitional, rather than permanent policy prescriptions.** As these economies develop further and grow in size, their capital markets strengthen, and their vulnerability to shocks also tends to decline, the need for measures to limit external borrowing will decline. During this transition period, the priority for these economies, however, must remain on the structural reforms that would increase their resilience. These reforms include:

- **Developing domestic bond markets (as well as equity markets).** A strong domestic capital market will enhance the efficiency and stability of the financial sector as a whole. Moreover, a vibrant domestic market will ultimately facilitate external demand for local currency assets, thereby enabling emerging markets to borrow from abroad in local currency.
- **Strengthening the prudential/supervisory framework.** Emerging markets should upgrade their prudential/supervisory framework, to keep pace with developments in international financial markets. For emerging markets to be able to participate in and reap the benefit of international capital markets, the prudential/supervisory framework should address financial vulnerability arising from both the domestic and international markets.
- **Improving transparency and the flow of information, e.g., by disclosure.** The efficiency of financial intermediation depends on the flow of accurate information. Improved accounting and disclosure standards, requiring corporations to provide accurate information to the public, which will be better equipped to exercise market discipline.

24. **Given that restraining external borrowing by Asian emerging market countries may give rise to efficiency losses, it is essential that these countries carry out the reforms just mentioned as promptly as they can reasonably do so as to minimize the period of their transition to an advanced economy.** Many of the general benefits of international capital mobility discussed earlier (in paragraph 6) apply to both debt and equity flows. In some cases, the benefits are reinforced when both debt and equity capital can flow unconstrained in line with market forces. Accordingly, restraining external borrowing by Asian emerging market countries is unlikely to provide a free lunch. Speedy implementation of an ambitious reform agenda is thus essential.

25. As the discussion in the preceding two paragraphs indicate, it might be more appropriate to view my presentation today as one on **sequencing issues involved in the process of capital account liberalization rather than on a case for restraining external borrowing by Asian emerging market countries.** Perhaps I should have chosen a title in line with that. Should I have done so, however, you would not have understood why, until this point of my presentation!

26. **Before closing, I feel I should mention that many others have written on possible policy approaches to external debt/borrowing. Some of their main points are as follows:**

- In order to curb the exposure of the public sector, the “Guidotti rule” has been proposed that would require countries to ensure that their liquid foreign currency reserves be sufficient to match their entire foreign currency debt service requirements for one year.

- Chairman Greenspan of the U.S. Federal Reserve has suggested measures to correct the incentive structure for cross-border bank lending, including assigning higher risk weights to interbank lines under the Basle Accord.
- Some others have argued in favor of heavily restricting or banning foreign currency denominated liabilities, for example, as a way to delink financial and balance of payments crises.

V. CONCLUDING REMARKS

27. **To conclude, my reading of the experience of the past several years leads me to suggest that policy makers look closely at measures that would discourage external borrowing in foreign currency.** In my view, there are significant market failures and policy distortions that lead the private sector to take on excessive levels of this kind of debt, and strong prudential rules and market-based measures that limit this type of borrowing are in the best interest of individual emerging markets and the broader financial system.

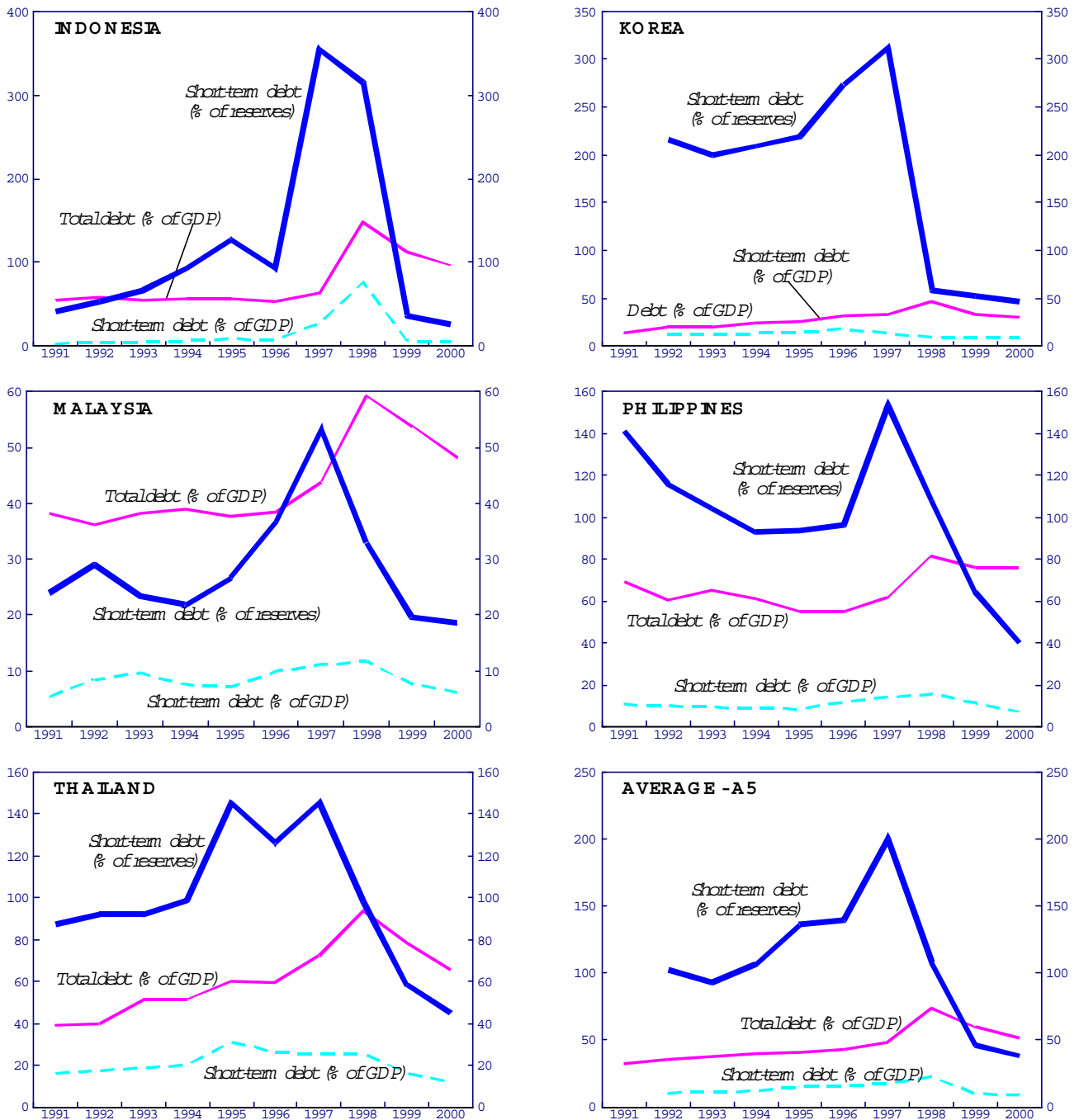
28. **Let me stress, however, that I am not in favor of capital controls that restrict capital inflows more generally.** In my view, countries **should encourage** nondebt creating capital flows such as FDI and portfolio investment in stock markets. I am not against external debt per se, but see a case for restraints because, for emerging market countries, it is almost always in foreign currency.

29. **Also, once an emerging market country achieves a status of a fully advanced country, with strong risk management systems in place, these strictures relating to external debt should be phased out.** To this end, emerging market countries should pursue vigorously structural reforms aimed at making their economies (and the financial sector in particular) more robust and resilient.

30. **Undoubtedly, efficiency losses may arise from limits on external borrowing by Asian emerging market countries.** Debt and equity flows are not perfectly substitutable, and there are instances—including large infrastructure projects—when foreign currency debt may be the most efficient means of financing. Exporters too have a natural exchange rate hedge, and for them, it would seem reasonable to borrow at least part of their funds in foreign currency to finance capital investment.

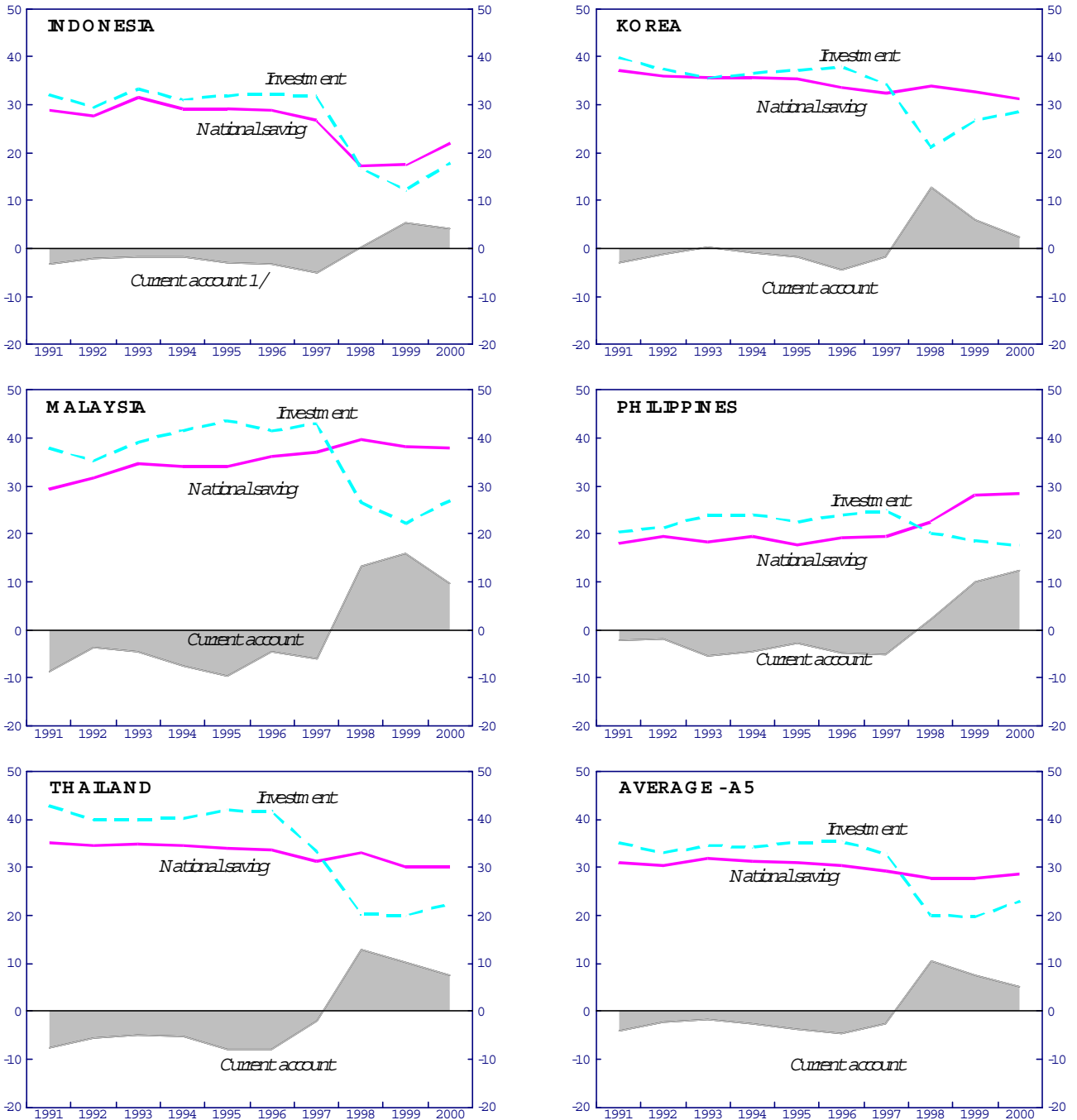
31. **However, as I hope I have made clear, we do not operate in a first-best world.** The experience of the last five years has clearly illustrated the costs of allowing unfettered borrowing in foreign currencies by emerging market residents. While restricting this access could have adverse effects on some emerging economies in Asia, I expect these will be modest, especially when weighed against the benefits of reduced risk of major systemic crises.

**FIGURE 1. SELECTED ASIAN COUNTRIES
EXTERNAL DEBT
(in percent)**



Sources: IMF, World Economic Outlook May 2001.

**FIGURE 2. SELECTED ASIAN COUNTRIES
SAVING AND INVESTMENT
(in percent of GDP)**



Sources: IMF, World Economic Outlook, May 2001.

1/ Saving minus investment.

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