

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government, which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country, support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

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## What is Wrong with Market-Oriented Policies?

Over the last few years, market-based economic policies implemented by developing countries have often been criticized. Many critics have argued that these market-based policies have been responsible for the financial crises faced by several developing countries over the last few years. As a result of these criticisms, questions have been raised about the rationale for developing countries to follow these market-based policies. In fact, a number of developing countries have recently elected governments that promised "alternative" policies to improve the well-being of the population.

The Bleyzer Foundation has reviewed whether these criticisms are valid. It reviewed the causes of recent financial crises experienced by a number of developing countries to examine whether in fact market-based policies could be blamed for them. A recent note issued by The Bleyzer Foundation reviewed the causes of the 2001 Argentinean crisis and concluded that it was the failure of the government to deal with its fiscal deficits, its large public debt and the overvaluation of the peso that was responsible for the crisis. The earlier market-based policies followed by the Argentinean government could not be made responsible this crisis. This note reviews other recent crises, including the Mexico crisis of 1994–95, the East Asian crisis of 1997, and the Russian crisis of 1998.

### Empirical Evidence

#### *Mexico in 1994*

Mexico faced a major financial crisis in December 1994. This happened despite the fact that during the 10 years before 1994, Mexico had made major progress in economic reforms: the fiscal budget was balanced, inflation was reduced to 10%, the public sector debt in terms of GDP was reduced over half, a large number of state enterprises and banks were privatized, the domestic economy was de-regulated and liberalized, and international trade was liberalized.

The strength of the program and low interest rates in the US encouraged capital inflows, which reached US\$30 billion in 1993 (about 6–7% of GDP.) These inflows of funds permitted a large increase in international reserves, which reached US\$30 billion by February 1994.

But due to the excessive eagerness of the government to bring inflation down to US levels, it limited the movements of the foreign exchange rate between the peso and the dollar. The foreign exchange rate was used as an anchor to control inflation. With a relatively fixed foreign exchange rate, high capital inflows led to an appreciation of about 20% in the foreign exchange rate. In turn, this overvaluation of the peso encouraged significant increases in imports, principally for current consumption. Although exports were still growing, it was at a lower pace than imports. As a result, the current account of the balance-of-payments ran high deficits that averaged about US\$25 billion per year in 1991–93, or about 6% of GDP. This was clearly an unsustainable level. But the government was hopeful that the forthcoming entry of Mexico into the NAFTA trade agreement with the US and Canada would gradually improve exports and bring equilibrium over time. Mainly for political reasons, the government continued to fix the exchange rate, and failed to carry out the 20% devaluation that was needed to reduce the current account deficit to sustainable levels.

In early 1994, these external imbalances began to worry foreign investors. As a result, during 1994, the level of capital inflows dropped from US\$30 billion in 1993 to US\$15 billion. This was still a significant amount, but not enough to cover imports. With decreasing international reserves and declining confidence from foreign investors, around March 1994, the government could have devalued the currency. At that time, the level of international reserves was sufficiently high compared to its small foreign short term. Therefore, a relatively minor devaluation of 20% could have succeeded in stabilizing the situation. But instead of devaluing the currency, the government opted for financing the current account deficit by issuing short term notes indexed to the US dollar (Tesobonos) that could be bought by foreigners. The level of Tesobonos increased from about \$4 billion in March 1994 to \$30 billion by November 1994. This was the second major mistake of the government, because despite the Tesobono financing, the level of international reserves continued to decline from US\$30 billion in March 1994 to US\$10 billion in November 1994. By November 1994, Tesobonos and other foreign short term obligations represented three times international reserves. This was clearly an unsustainable situation.

As the country became unable to place more debt obligations in late 1994, it was forced to devalue and then allow the peso to float freely. The peso suffered a large devaluation of 145% by March 1995. This precipitated a major financial crisis for the country, with negative rates of economic growth and significant hardship and losses for the population.

This review shows that it was the failure of the government to address a major disequilibrium in its balance of payment with proper exchange rates and monetary policy — and its fruitless attempt to finance it with foreign short term borrowings — that produced the crises. In fact, after Mexico introduced a more flexible foreign exchange rate and deepened economic reforms, the country was able to swiftly recover from the crisis.

### *East Asia in 1997*

In mid-1997, several East Asian countries faced financial crises, precipitated by devaluations in Thailand, Malaysia, South Korea, the Philippines, and Indonesia.

By 1996, in a number of economic areas, East Asian countries were doing well: their fiscal budgets were balanced (in fact, most countries had small fiscal budget surpluses of 1% of GDP), inflation was also under control (for all countries inflation rates ranged from 5% to 10% pa), domestic savings rates were quite high, and GDP growth was high for all countries in the region.

On the strength of these economic results, and low interest rates in Japan, significant capital inflows came into the region, growing from US\$10 billion per year in 1984–89, to US\$108 billion in 1996, of which US\$30 billion was in the form of bank loans. This led to the accumulation of large external debt. For the five most affected countries, short-term bank foreign debt increased from US\$93 billion in 1993 to US\$152 billion in 1996. Although the ratios of external debt to exports and GDP were reasonable, the debt was short-term and by mid-1997, the ratio of short-term external debt to international reserves was above 1.0: Thailand — 1.5, Indonesia — 1.7, and Korea — 2.1.

Capital inflows also led to the appreciation of local currencies during the 1990s. This appreciation took place because many countries (Thailand, Malaysia, the Philippines) tacitly pegged their currencies to the US dollar to facilitate borrowings and reduce borrowing costs. From 1990 to 1997, real exchange rates appreciated by 19% in Malaysia, 23% in the Philippines, 12% in Thailand, 8% in Indonesia, and 30% in Hong Kong. Fixing the exchange rate proved to be a major mistake.

The appreciation of the domestic currencies and the easy availability of foreign short term loans led to significant current account deficits, which in 1996 had reached 9.2% of GDP in Thailand, 6% in Malaysia, 6% in the Philippines, and 4.9% Korea. These current account deficits were not sustainable. Although several factors contributed to these current account imbalances, in the end it was the desire of the East Asian governments to peg the exchange rate that was one of the causes of the crises.

The East Asian governments attempted to guide foreign borrowings by commercial banks to the governments' preferred sectors. Based on implicit government guarantees and government pressures, commercial banks undertook many investments that were uneconomic. In fact, poor investments led to a high level of non-performing loans in commercial banks, which reached more than 15% in Thailand, Indonesia, Malaysia and Korea. A substantial portion of new investments (30% to 40% of bank loans in Thailand and Malaysia) went to real estate, leading to over-investment and excess building capacity, which led to price declines. The

profitability of other new investments was also low. The incremental capital output ratios increased sharply during 1993–1996. In fact, during 1993–96, most public Asian companies in the crises countries were value-destroyers, not value-creators (returns on investment capital were lower than interest rates.) Over time, commercial banks became insolvent and incapable of servicing their foreign debt.

The main reason for over-investment in poor projects by the banking system was political pressure, favoritism, and patronage coupled with poor banking practices. Poor banking practices were widespread and were induced by moral hazards: the understanding that their investments were "insured" by the government, which was encouraging them. Bad banking practices were also facilitated by lack of transparency, poor banking regulations and supervision, inadequate bank capital requirements, and inadequate bankruptcy procedures.

The widespread perception of a real misalignment and unsustainable external imbalances undermined the credibility of the governments' commitment to fixed exchange rates in many countries in the region. This led to a change in lending sentiments. Without the possibility of roll-over, many firms with large short-term foreign debt could not easily repay it. More defaults followed and several major firms went bankrupt. These events brought on currency devaluations and the financial crises that followed them.

The Asian crises can be summarized as being caused by large external imbalances resulting from poor economic policies, particularly pegged exchange rates and excessive bank foreign borrowings due to implicit government guarantees. Bad banking practices and undue political patronage led to excessive and low-profitability investments that defaulted.

In fact, before the 1997 crises, the East Asian countries were performing satisfactorily thanks to a number of market-based economic reforms. But it was the interference of the governments in the markets that caused the crises.

### ***Russia in 1998***

On August 17, 1998, Russia simultaneously devalued its currency, defaulted on much of its domestic government debt, and declared a moratorium on debt principal payments to foreigners by Russian companies and banks. These moves prompted a run on the banks, a sharper fall in the exchange rate (from 6 roubles/dollar in mid-1998 to 22 roubles/dollar in March 1999) and an acceleration of inflation. Within a week, the government fell.

Since the early 1990s, the government had implemented a number of economic reforms. But the fiscal deficit was never brought under real control, reaching 8% of GDP in 1996, 7% in 1997, and 5% in the first half

of 1998. These high fiscal deficits were due to the inability of the government to raise fiscal revenues (due to widespread exemptions for vested interests, excessive transfers to states, and poor collection capacity), and the inability of the government to control expenditures (excessive subsidies and failure to impose hard budgets on public enterprises and agencies.)

In spite of the large fiscal deficits, the re-election of President Yeltsin in July 1996 brought the expectation of future progress. This led to huge increases in foreign loans and portfolio investments into the domestic equity and T-bill markets. These capital inflows led to a large asset price bubble, with the stock market rising by 150% in real terms in 1996 and a further 180% in the first 8 months of 1997, according to the stock index produced by Morgan Stanley Capital International (MSCI).

In this new environment, regional governments, commercial banks, and exporters were able to borrow in dollars. The federal government was also able to finance much of its fiscal deficits by issuing short-term T-bills. The stock of T-bills increased from US\$35 billion equivalent in July 1996 to US\$70 billion equivalent in June 1998. One-third of this stock was held by foreigners. In November 1996, the government issued its first US\$1 billion Eurobond, and over the next two years, it borrowed a further US\$15 billion in the international markets.

As the level of debt increased, foreign investors hedged themselves against the risk of devaluation by buying forward contracts with Russian banks. These contracts apparently assured them a fixed rate of return in dollars by guaranteeing a predetermined exchange rate. But this increased the exposure and vulnerability of local banks to declines in the rouble. In the second half of 1997, foreign banks grew increasingly concerned and became unwilling to roll-over maturing loans to Russian banks, due to political difficulties of the government with the Duma and the realization of large economic disequilibrium in the country.

Some large Russian banks were forced to make margin calls and had to liquidate shares to make payments, depressing stock prices from October 1997 on. Stock prices collapsed from 500 in October 1997 to 30 in September 1998, according to the MSCI index.

Initially, the government provided banks with large liquidity support. But the government itself had financing problems. Throughout the summer of 1998, the government could not place the US\$1 billion of T-bills maturing every week. During the summer, capital flight accelerated: international reserves dropped from US\$11 billion to US\$8 billion in July. In July 1998, the IMF agreed to provide emergency financing, which would bring US\$22 billion in resources, of which US\$4.8 billion was disbursed immediately in the first tranche. But this IMF financing supported the rouble just for a few weeks and was not sufficient to calm the financial markets down.

By early August 1998, several banks were at the verge of collapse and began to default on their international obligations. On August 17th, the government gave up its defense of the rouble, announcing its own debt default and moratorium. The Russian domestic banks suffered significantly: out of the 1,473 banks in Russia on the eve of the crisis, 440 are no longer functioning.

The main cause of the Russian crisis was an unsustainable fiscal budget deficit, as was the case in the crises of Latin America in the 1980s, coupled by excessive foreign borrowings by the government and commercial banks.

## Conclusions

The crises suffered by the countries reviewed above were caused by the incomplete and inadequate implementation by governments of consistent and comprehensive free-market policies. They were caused by the failures of these governments to address key fundamental issues, such as fiscal deficits, currency overvaluation, poor banking supervision and inadequate government interventions. In many cases, these failures were encouraged by political and vested interest groups. In other cases, the central government just did not have the commitment to influence other parts of the government to implement needed reforms.

The crises were not caused by the competitive free market-based policies followed by these countries. In fact, these countries suffered from too little reform, rather than too much reform. The countries just failed to adopt free-market reforms with sufficient rigor.

Another set of problems in the implementation of policies was the failure to carry out adequate sequencing of their execution. In particular, some countries opened up their capital accounts too early, before they had developed appropriate banking supervision and regulations to avoid moral hazards and stabilized their economies. With liberalized capital flows, domestic banks and governments borrowed too much, bringing foreign debt to unsustainable levels. The risk of reversals in capital flows was underestimated.

International experience shows that countries that have consistently applied sound and comprehensive free market policies (such as Chile, Hungary, the Czech Republic, Slovenia, China) have done much better than those countries that have applied alternative economic models. In fact, as demonstrated by countries such as Belarus, North Korea, and Cuba, alternative economic models have little or nothing to offer to sustain economic growth and improve the quality of life of their citizens.