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Editor's Introduction

In this issue, *Ekonomi-tek* presents two articles.

In the first one, Yılmaz Akyüz, of the South Center and UNCTAD, takes up the Asian crisis on its 20th anniversary. As he explains it, this financial crisis was a liquidity crisis brought about by a confluence of factors, such as speculative investments in property, excessive short-term borrowing in foreign currencies, domestic financial de-regulation, and capital-account liberalization. Following the crisis, Asian countries put in place measures to forestall new surges in capital inflows, including the adoption of flexible exchange rates, accumulation of substantial foreign reserves, moving from debt finance to equity finance, shifting from foreign borrowing to local borrowing, the opening of domestic asset and credit markets to non-residents, and extensive liberalization of the capital account for residents. Akyüz states that Asian economies are much more open today and that the foreign presence in the region's credit, equity, and debt markets has reached record levels, strongly affecting their liquidity and financing. As a result, these economies have now become susceptible to global financial cycles and shocks, irrespective of their low external debt, high net foreign assets, and high international reserves.

In the second piece, Cecilia Rumi, from the Universidad Nacional de La Plata, in Argentina, lays out the instability and uncertainty in the Argentine economy in the last century. As proxy measures of uncertainty, the author lists i) high and volatile inflation rates, with periods of hyperinflation, ii) large and volatile black-market premiums in exchange rates, and iii) high country-risk premiums in international capital markets. We learn from the paper that, since independence, Argentina has defaulted on its sovereign debt eight times. In 2001, for instance, the Argentine government became the world's biggest defaulter by refusing to honor some $100 billion foreign debt. Citing other studies, the author reveals that, in addition to wrong-headed economic policies, institutional weaknesses, including political entities that do not constrain politicians and pervasive corruption create an atmosphere of uncertainty. The author also reports that over the last century, Argentina has revamped its currency four times, and, on each occasion, zeroes had to be taken off the predecessor. On at least five occasions over the last 55 years, citizens' deposits in the country's banks were confiscated by the Argentine government of the day.

We look forward to presenting you with interesting articles in the coming issues of *Ekonomi-tek*.

Ercan Uygur
Editor
Ekonomi-tek

Editörün Sunuşu

Ekonomi-tek'in bu sayısı iki makale sunmaktadır.

Birinci makalede, South Centre ve UNCTAD baş ekonomisti Yılmaz Akyüz, 20. yıldönümünde Asya bunalımını ele almaktadır. Akyüz, bu finansal bunalımın bir likidite bunalımı olduğunu ve spekülatif gayri menkul yatırımları, aşırı kısa vadeli döviz borçlanması, iç finansmanda ve sermaye hesabında serbestleşme gibi unsurların bileşimi ile ortaya çıktığını açıklamaktadır. Bunalımdan sonra Asya ülkeleri hızlı sermaye girişlerine karşı; esnek döviz kuru sisteminin kabulü, büyük döviz rezervleri birikimi, borçlanma yerine iç kaynaklarla finansman, dış borçlanma yerine içerideki yabancı uluslararası bankalardan borçlanma, iç varlık ve kredi piyasalarının yabancılara açılması ve yerleşiklere sermaye hesabının serbestleşmesi gibi önlemler aldılar. Yazar, şimdilerde Asya ekonomilerinin çok daha açık ekonomiler olduğunu, yabancı varlığının sermaye, kredi ve borçlanma piyasalarında rekor düzeylere ulaştığını ve bunların ülkelerin likidite ve finansman koşullarını etkilediğini belirtmektedir. Bu ülkeler, düşük dış borçlarına, yüksek net dış varlıklarına ve döviz rezervlerine bakılmaksızın, şimdilerde küresel finansal devrelere ve şoklara daha açık hale gelmişlerdir.

İkinci makalenin yazarı, Arjantin'den Universidad Nacional de La Plata'dan Cecilia Rumi'dir ve son bir asırda Arjantin'deki istikrarsızlığı ve belirsizliği irdelemektedir. Rumi, belirsizliğin yaklaşık ölçütleri olarak; i) Hiperenflasyonların da yer aldığı yüksek ve dalgalı enflasyon oranlarını, ii) döviz kuru piyasalarında büyük ve dalgalı kara borsa farklarını, iii) uluslararası sermaye piyasalarında yüksek ülke risk primlerini listelemektedir. Makaleden öğreniyoruz ki, bağımsızlığından bu yana Arjantin sekiz kez dış borç yükümlülüğünü yerine getiremeyeceğini ilan etmiştir. Örneğin, 2001'de Arjantin hükümeti 100 milyar $ olan dış borcunu ödeyemeyeceğini açıklamıştır; bu, dünyada o zamana kadar ödenmemiş en yüksek borç miktarıdır. Diğer çalışmaları da kaynak gösteren yazar, belirsizliklerin kaynağı olarak yanlış politikalar yanında, kurumsal zayıflıkları vurgulamakta ve bu bağlamda politikacıları denetleyemeyen politik yapıyı ve yaygın yolsuzluğu öne çıkarmaktadır. Yazar ayrıca Arjantin'in geçen bir asırda parasını dört kez değiştirdiğini ve her değişiklikte bir önceki paradan sıfırlar attığını bildirmektedir. Son 55 yılda, Arjantin hükümetleri en az beş kez bankalardaki mevduatlara el koymuşlardır.

Ekonomi-tek'in gelecek sayılarında da sizlere aydınlatıcı makaleler sunmayı umut ediyoruz.

Ercan Uygur
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Ekonomi-tek

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THE ASIAN FINANCIAL CRISIS: LESSONS LEARNED AND UNLEARNED

Yılmaz Akyüz[*]

Abstract

Much of what has recently been written about the Asian crisis on the occasion of its 20th anniversary praises the lessons drawn from the crisis and the measures implemented thereupon. But they often fail to appreciate that while these might have been effective in preventing the crisis in 1997, they may be inadequate and even counter-productive today because they entail deeper integration into global finance.

JEL Codes: E32, E44, FH1231, F62, G01

Keywords: Financial crisis, Asian economies

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1. The Crisis Revisited

Governments in both mature and emerging economies no doubt draw lessons from financial crises in order to adopt measures to prevent their recurrence. However, it is often the case that such measures are designed to address the root causes of the last crisis but not the next one. More importantly, they can actually become the new sources of instability and crisis. This is indeed the case in emerging economies that experienced recurrent bouts of instability and crises in the second half of the 1990s and early 2000s, including several East Asian economies hit by a virulent crisis in 1997.

The Asian crisis was caused by a combination of misguided financial policies with overreaction of foreign lenders to temporary shortfalls in international liquidity rather than structural imbalances and excessive indebtedness. It was basically a liquidity crisis but it led to insolvencies because of misguided interventions, notably by the IMF. Like crises almost everywhere else it was preceded by a sharp increase in capital inflows, notably short-term lending by international commercial banks to both banks and firms in the region. Most such lending was directed to non-financial private firms, but in Korea, and to a lesser extent elsewhere, the financial sector was also an important recipient of funds.

An important reason for the surge in international lending to East Asia was the "yield famine" in advanced economies due to low interest rates resulting from monetary policy response to economic slowdown in the early 1990s. Higher returns in high-growth, low-risk Asian economies with a record of relatively stable exchange rates made them attractive locations for international lenders. Moral hazard also played a role. The Mexican bailout encouraged imprudent lending and governments in East Asia looked ready to bail out private debtors.

An important part of capital inflows consisted of short-term arbitrage funds seeking to profit from interest rate differentials. Further, borrowing from cheaper foreign markets allowed local firms to reduce their financing costs. Firms were also driven by eroding competitiveness and reduced export earnings resulting from the entry of low-cost producers, particularly in Korea. They reacted by augmenting investment to increase productivity and market shares. In doing so they also added to global excess supply in several manufacturing products exported from East Asia. As in Japan in the second half of the 1980s, the rapid expansion of production capacity was a key factor in the subsequent financial difficulties. However, not all international borrowers

were engaged in export activity. There was a speculative surge in the property market supported by funds borrowed abroad, notably in Thailand. Similarly, some private firms in the region invested heavily in other non-traded activities, including infrastructure.

Both borrowers and lenders underestimated the exchange rate risk because of the history of stable exchange rates in the region. Exchange rate policies in the region were widely criticized for encouraging excessive borrowing abroad and giving one way bets to speculators. However, the question of appropriate exchange rate regime under free capital mobility remains unresolved. No regime of exchange rates can guarantee stable rates. Evidence shows that currency crises can occur under flexible exchange rates as under fixed exchange rates. When capital inflows are strong, floating could lead to nominal appreciations, pushing up real exchange rates even further. It is probable that if currencies in East Asia had been allowed to float in the first half of the 1990s when inflows were in excess of what was needed for current-account financing, the result could have been nominal appreciations, pushing up the real exchange rate further and encouraging even more inflows in pursuit of capital gains from currency movements. On the other hand, greater flexibility at times of turmoil cannot prevent a free fall, as seen in East Asia in 1997, notably in Indonesia.

The main policy error relates to domestic financial de-regulation and capital account liberalization. The East Asian economies had been urged to follow Japan on a path of liberalization, granting financial institutions more freedom in their borrowing and lending decisions, and introducing market-based monetary policy by loosening direct regulatory controls. In Korea the departure from the post-war practice in two key areas, control over external borrowing and state guidance of private investment played an important role. Financial liberalization went further in South East Asia. Thailand created the Bangkok International Banking Facility to intermediate foreign investment in the region. In reality, it served instead as a conduit for short-term foreign lending to the liberalized Thai banks and finance houses. Leveraged lending for property funded abroad was allowed to go unchecked, leading to a boom in property markets, making borrowers highly vulnerable to a downturn in property prices, a rise in interest rates or a depreciation of the baht.

Thus, in the build-up of external financial fragility, overinvestment in manufacturing, speculative investment in property and excessive short-term borrowing in foreign currencies played a crucial role. However, unlike the contention of mainstream ideologues at the time, the main reason for these

was not that there was too much government intervention and control, but too little.

The crisis broke out in Thailand when its reserves fell rapidly as net capital inflows fell short of the funds needed to meet the widening current account deficits which had reached 8 per cent of GDP at the end of 1996, and the Bank of Thailand could no longer maintain the currency within the fluctuation band. Other economies in the region with better balance-of-payments fundamentals suffered primarily from contagion through the exchange rate. The decision to float the baht called into question the assumption of exchange rate stability upon which existing regional division of labour had been built. As exchange rates came under pressure, markets soon became aware of the similarities in financial vulnerability and inadequacy of reserves, and governments were forced to float.

As the panic spread to the whole region, foreign speculators selling domestic currencies were joined by domestic financial and non-financial firms seeking to escape from the squeeze on their balance sheets caused by rising domestic cash needs to service foreign debt and falling cash flows to meet them. Although Korea had not experienced a speculative property bubble, it also suffered corporate bankruptcies. The South-East Asian scenario was repeated in Korea as domestic debtors attempted to hedge or reduce their foreign exposure, causing a downward spiral in the currency market.

2. Lessons and Policy Responses

Recurrent currency, balance-of-payments and financial crises in emerging economies in the 1990s and early 2000s, including the 1997 Asian crisis, show that at times of surges in capital inflows vulnerabilities can emerge in at least four areas: (i) currency and maturity mismatches in private balance sheets; (ii) domestic credit, asset and spending bubbles; (iii) unsustainable currency appreciations and external deficits; and (iv) reliance on IMF assistance and policy advice rather than self-insurance against sudden stops and reversals of capital flows. In the new millennium governments in many emerging economies have taken measures to remove vulnerabilities in some of these areas, particularly as they faced a new surge in capital inflows, first thanks to the very same credit and spending bubbles that culminated in a severe crisis in the US and Europe in 2008 and then the ultra-easy monetary policies pursued in these economies in response to the crisis. However, they also liberalized further the capital account for non-residents and residents, leading to a deeper integration into the international financial system and cre-

ating new channels of transmission of external financial shocks without removing the traditional channels.

In some respects the boom in capital flows in the new millennium has been somewhat better managed in East Asia than the boom of the 1990s, and better than in most other emerging economies. One of the first steps taken was to move to more flexible exchange rate regimes. However, unlike other emerging economies which used monetary policy primarily for inflation targeting and left the currency to the whims of capital flows, most East Asian economies avoided significant currency appreciations despite strong surges in capital inflows. They have done this not only through interventions in foreign exchange markets, but also by using market-disincentives for certain types of capital inflows such as taxes on interest income and capital gains from foreign holdings of local securities, taxes on banks' short positions, and higher reserve requirements for non-resident local currency deposits. Korea used such measures to such an extent that the won became one of the weakest currencies in the aftermath of the 2008 crisis when there was a strong surge in capital inflows. However, it should be kept in mind that while Thailand and Malaysia had moderate real appreciations in the run-up to the 1997 crisis, this was not the case in Korea and Indonesia.

Second, East Asian economies, like many others, made strong efforts to build self-insurance by accumulating large amounts of international reserves. Unlike most other emerging economies, in East Asia reserves did not just come from capital inflows. An important part has been generated by current account surpluses – that is, they are earned reserves rather than borrowed reserves. All countries hit by the 1997 crisis made a significant progress in the management of their current accounts in the new millennium, running sizeable surpluses or moderate deficits. They also sought to strengthen regional cooperation in contingency financing by extending and multilateralizing the Chiang Mai Initiative.

Third, in order to reduce vulnerability to external debt crises, East Asian economies, like several emerging economies, have sought to move from debt finance to equity finance on grounds that equity liabilities are less risky and more stable. Foreign direct investment regimes have been liberalized and overall limits and sectoral caps over direct and portfolio equity inflows have been relaxed or removed. As a result non-resident holding of equities as a percent of market capitalization rose sharply, reaching 30–40 per cent and even exceeding 50 per cent in some compared to 15 per cent in the US. It has been in the order of 20 per cent in Malaysia and Indonesia, 30 per cent in Thailand and almost 50 per cent in Korea.

While Korean equity market is quite deep, coming among top 12 globally in capitalization, many emerging economies lack a strong local investor base. Consequently, the entry and exit of even relatively small amounts of foreign investment can result in large price swings. Even in countries with little foreign presence, such as China, equity prices have thus become highly susceptible to changes in the global risk appetite because local investors now act with a global perspective.

Fourth, since currency mismatches in balance sheets played a central role in crises in emerging economies, governments have sought to reduce their exposure to the exchange rate risk by opening local bond markets to non-residents and borrowing in local currencies. In East Asia the development of regional bond markets was also seen as a solution to the problems of currency and maturity mismatches, culminating in the Asian Bond Market Initiative in 2003. Governments in several emerging economies have effectively stopped issuing foreign currency debt in international markets. A much higher proportion of public debt held by non-residents is now issued locally, denominated in local currencies and subject to local jurisdiction.

Domestically issued local-currency debt held by non-residents is not always included in external debt statistics even though according to the conventional definition based on the residency of holders such debt is part of external debt. Because of this discrepancy, the external debt of emerging economies is often underestimated. For instance when Bank Negara of Malaysia started using a new definition of external debt in 2013, including all debt owed to non-residents irrespective of currency and place of issue, total external debt of Malaysia went up from 30.5 per cent of GDP to over 60 per cent.

Whether in local currency or dollars, foreign ownership of debt is a key indicator of external vulnerability. For instance the US has always been uneasy about foreign holdings of its treasuries. Around one-third of US treasuries are held by non-residents. Sovereign debt in many emerging economies is now internationalized to a greater extent. In some emerging economies the share of non-residents in local government bond markets exceeds 50 per cent. In Indonesia and Malaysia this proportion has varied between 30 per cent and 40 per cent in recent years. The proportion is much higher when internationally issued government debt is included. Furthermore, unlike US treasuries this debt is not in the hands of foreign central banks and other official bodies, but mostly in the portfolios of fickle investors.

Opening local bond markets and borrowing from non-residents in local currency have no doubt allowed the sovereign to pass the currency risk to

lenders. However, it has also led to a significant exposure to interest rate shocks and loss of autonomy in controlling domestic long-term rates and heightening their sensitivity to fluctuations in debt markets of major advanced economies. It has impaired the ability of local markets to act as a 'spare tyre' for local borrowers at times of interruptions to access to external financing. This could prove equally and even more damaging than currency exposure in the transition of central banks of major advanced economies from low-interest to high-interest regimes and normalization of their balance sheets.

Fifth, most emerging economies have also shifted from cross-border borrowing to local borrowing from international banks by opening up their banking sector to them. There has been a sharp increase in the share of foreign banks in emerging economies in the new millennium even though the crisis in the US and Europe resulted in a certain degree of withdrawal of their banks from these economies. In Indonesia half of banks are foreign. Korea had no foreign banks in 1996, but their number increased rapidly in the new millennium. Local currency claims of international banks on residents of emerging economies rose from 15 per cent of their total claims in mid-1990s to 40 per cent on the eve of the global crisis. Local lending by foreign banks in all currencies, including foreign currencies, is now greater than their cross-border lending. As seen during the Eurozone crisis, foreign banks tend to act as a conduit of financial instability in advanced economies, transmitting credit crunches from home to host countries, rather than insulating domestic credit markets from international financial shocks.

Sixth, in East Asia banking regulations and supervision have improved, promoting more prudent lending and restricting currency and maturity mismatches in bank balance sheets. However, banks now play a much less prominent role in the intermediation of international capital flows than in the 1990s. International bond issues by corporations have grown much faster than cross-border bank lending directly or through local banks. More importantly a very large part of capital inflows now go into the local securities market, bypassing the banking system.

Seventh, opening of domestic asset and credit markets to non-residents has been accompanied by extensive liberalization of the capital account for residents in East Asia and elsewhere. Since the global crisis there has been a massive accumulation of debt in dollars by non-financial corporations, mainly through international bond issues. In major emerging economies such issues have also been made though foreign subsidiaries. These are not always repatriated and registered as capital inflows and external debt, but they have a similar impact on corporate fragility. In East Asia dollar debt accumulation is particularly notable in Indonesia and Korea. This means that the reduction in

currency mismatches in balance sheets is largely limited to the sovereign while private corporations have been building up debt in low-interest reserve currencies very much in the same way as in the 1990s.

Eighth, most Asian emerging economies have also allowed and even encouraged corporations to invest abroad and become global players, occasionally by leveraging internationally. Limits on the acquisition of foreign securities, real estate assets and deposits by individuals and institutional investors have been raised or abolished in Malaysia, Korea and Thailand. During the surges in capital inflows, a main motive for outward liberalization was to relieve upward pressures on currencies and avoid costly interventions in foreign exchange markets. In other words, liberalization of resident outflows was used as a substitute to restrictions over non-resident inflows.

Finally, like many others East Asian economies have not been able to prevent ultra easy monetary policies in the US, Europe and Japan from producing domestic credit and asset market bubbles in the past ten years. Increases in non-financial corporate debt in Korea and Malaysia are among the fastest, between 15 and 20 percentage points of GDP, including both external and domestic debt. At around 90 per cent of GDP Malaysia has the highest household debt in the developing world. In Korea the ratio of household debt to GDP is higher than the ratio in the US and the average of the OECD. Thailand has also seen a significant increase in household indebtedness since 2007, by some 25 percentage points of GDP.

3. Vulnerability to Global Financial Shocks

Capital account regimes of emerging economies, including in East Asia, are much more liberal today both for residents and non-residents than in the 1990s. Foreign presence in credit, equity and debt markets has reached unprecedented levels, strongly affecting their liquidity and valuation dynamics and making them highly susceptible to global financial conditions. In the same vein, residents of these economies have increasingly become active in international financial markets as borrowers and investors. As a result all emerging economies have now become susceptible to global financial cycles and shocks irrespective of their balance-of-payments, external debt, net foreign assets and international reserves positions although these play an important role in the way such shocks could impinge on them.

Indeed, asset and currency markets of all emerging economies, including China and other East Asian economies with strong international reserves and investment positions were hit on several occasions in the past ten years, starting with the collapse of Lehman Brothers in September 2008. The Lehman impact

was strong but short-lived because of the easy money policy introduced in response by the US. Subsequently these markets came under pressure again during the 'taper tantrum' in May 2013 when the US Federal Reserve revealed its intention to start reducing its bond purchases; in October 2014 due to growing fears over global growth and the impact of an eventual rise in US interest rates; in late 2015 on the eve of the increase in policy rates in the US for the first time in seven years.

These bouts of instability did not inflict severe damage because they were temporary, short-lived dislocations caused by shifts in market sentiments without any fundamental departure from the policy of easy money. But they give strong warnings for the kind of turmoil emerging economies could face in the event of a normalization of monetary policy in the US, hikes in interest rates and contraction in global liquidity.

After the Asian crisis external vulnerability came to be assessed in terms of adequacy of reserves to meet short-term external debt in foreign currencies, defined as debt with a remaining maturity of up to one year. While this is the most widely used indicator of external sustainability, empirical evidence does not always show a strong correlation between pressure on reserves and short-term external debt. Often, in countries suffering large reserve losses, sources other than short-term foreign currency debt played a greater role.

Vulnerability to liquidity and currency crises is not restricted to short-term foreign currency debt. Countries with extensive foreign participation in equity, bond and deposit markets could be highly vulnerable even in the absence of high levels of short-term foreign-currency debt. Currencies can come under stress if there is a significant foreign presence in domestic deposit and securities markets and the capital account are open for residents. A rapid and generalized exit could create significant turbulence with broader macroeconomic consequences, even though losses due to declines in asset prices and currencies fall on foreign investors and mitigate the drain of reserves.

Financial turmoil could be aggravated if foreign exit is accompanied by resident capital flight. Indeed resident outflows rather than exit by foreign investors may well play a leading role in the drain of reserves and currency declines as seen in some previous episodes including in the $1 trillion dollar decline in China's reserves during 2015-16.

Such market pressures have emerged in Malaysia from mid-2014 onwards mainly due to political instability when foreign holders of domestic securities started to unload ringgit denominated assets. Equity and currency markets fell sharply and foreign reserves declined from over $130 billion to $97 billion by June 2015. In October 2015, the ringgit came under strong pressure, hitting

the lowest level since September 1998 when it was pegged to the dollar. Although it showed some recovery subsequently, at the end of 2016 it reached below the lows seen during the turmoil in January 1998 as investors continued to download domestic assets, reacting to measures restricting currency speculation as well as prospects of higher US interest rates.

In all four East Asian countries directly hit by the 1997 crisis, international reserves now meet short-term external dollar debt. But they do not always leave much room to accommodate a sizeable and sustained exit of foreign investors from domestic securities and deposit markets and capital flight by residents. This is particularly the case in Malaysia where the margin of reserves over short-term dollar debt appears to be quite small while foreign holdings in local debt and equity markets are sizeable.[1] According to the latest figures by Bank Negara, international reserves are RM425 billion while short-term external debt, including short-term loans obtained and bonds and notes issued abroad and non-resident holdings of ringgit-denominated short-term debt securities and deposits are about RM413 billion. However, the latter does not include long-term local-currency debt held by non-residents which, together with large equity holdings by them, constitute an important source of drain on reserves in the event of market stress, as seen after 2014.

By contrast Thailand's foreign reserves position looks comfortable, exceeding its short term dollar debt by a large margin (some $150 billion) and providing ample buffer against a rapid exit of foreign investors from its securities markets. In Indonesia reserves exceed short-term dollar debt also by a large margin ($80 billion), but foreign holdings in its local bond and equity markets are also substantial and the current account is in deficit. The country was included among the Fragile 5 in 2013 by Morgan Stanley economists for being too dependent on unreliable foreign investment to finance growth.

In Korea too, the margin is large, over $250 billion, but foreign holdings of domestic securities are more than twice as much. Thus a rapid exit from securities market can also put pressure on the won. Indeed when Korea was hit by fallouts from the US crisis in 2008, it lost some $60 billion in reserves and was given a swap line by the US Federal Reserve.

There has been no severe financial crisis in major emerging economies in the last decade and a half when global financial conditions have remained highly favourable thanks to policies of easy money in the US, Europe and Japan. This has created addiction to cheap funds, a massive accumulation of debt and a sharp increase in foreign presence in securities, credit and property markets of emerging economies. As a result they have become highly vulnerable to a severe and sustained reversal of these conditions. The self-insurance

they have built up in international reserves may prove inadequate in the event of a sudden stop in capital inflows, massive exit of foreign investors and capital flight by residents. Nor can they count on South-South cooperation such as the Chiang-Mai Initiative Multilateralization (CMIM) of East Asian countries and the Contingent Reserve Arrangement (CRA) of BRICS. The CMIM is inadequate in size and flawed in design – some 1.5 per cent of total GDP of the countries involved and access beyond 30 per cent of quotas is tied to an IMF programme.

The initiative has never been called upon; during the Lehman collapse, Korea and Singapore approached, instead, the US Federal Reserve, and Indonesia secured finance with a consortium led by the World Bank. The CRA does not look very much different from the CMIM. It is designed to complement rather than substitute the existing IMF facilities. Its size is even smaller and access beyond certain limits is also tied to the conclusion of an IMF programme.

That leaves two options in the event of a serious liquidity crisis – seek assistance from the IMF and central banks of reserve-currency countries or engineer an unorthodox response, even going beyond what Malaysia did during the 1997 crisis, bailing in international creditors and investors by introducing, *inter alia*, exchange restrictions and temporary debt standstills, and using selective controls in trade and finance to safeguard economic activity and employment. The East Asian countries, like most emerging economies, appear to be determined not to go to the IMF again. But, serious obstacles may be encountered in implementing unilateral heterodox measures including creditor litigation and sanctions by creditor countries. Consequently, deepening integration into the inherently unstable international financial system without securing multilateral mechanisms for orderly and equitable resolution of external liquidity and debt crises could prove to be very costly.

End note:

[1] According to the latest figures given by Bank Negara Malaysia on 14 July 2017, short-term external debt of banks and non-banks add up to RM 398 billion. At the current exchange rate this comes to more than $90 billion while reserves are $99 billion. Since much of this private short-term debt is in dollars (or in other reserve currencies) the margin of reserves over short-term external dollar debt can be estimated to be relatively small, possibly less than $20 billion.

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ARGENTINA'S LONG HISTORY OF (ECONOMIC) UNCERTAINTY

Cecilia Rumi[*]

Abstract

Instability and uncertainty have been the hallmark of Argentina's political economy throughout its history. Volatility in GDP, inflation, the exchange rate, the terms of trade, and capital flows characterizes the burden that Argentines—ordinary citizens, investors, and policymakers—have had to endure for as long as anyone can remember. The internal design of monetary, financial, and capital-market institutions has made possible a 13-zero depletion of the currency and several confiscations of bank deposits. Argentine fiscal institutions have long been partial to short-term, pro-cyclical planning. Self-centered discretion has been the rule, with complete disregard for the huge costs created by uncertainty. Is there any way for Argentina to rid itself of this disastrous tendency and put itself on a path to sustainable growth and improved welfare?

JEL Codes: E63

Keywords: Argentina, uncertainty, fiscal deficits, institutions

[*] Universidad Nacional de La Plata. This paper was prepared for the Turkish Economic Association's 19th National Economic Symposium on "Economic Decisions and Policies under Uncertainty," held in Kyrenia, November 3-4, 2017. I would like to thank Prof. Dr. Ricardo López Murphy for his valuable insights and Prof. Dr. Ercan Uygur for his invitation and enriching comments. The views expressed and any errors are my own. E-mail address: cecilia.rumi@gmail

1. Introduction

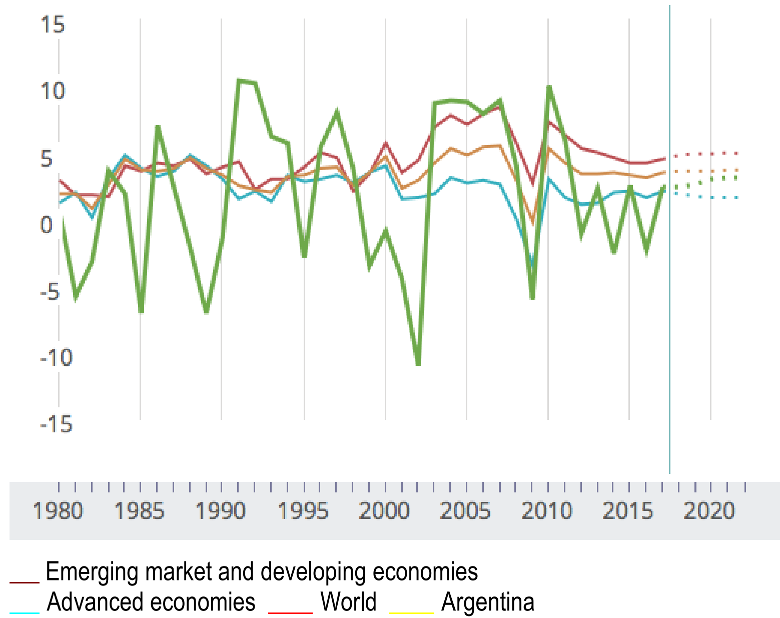
Argentina is a land of paradoxes and contrasts: prosperity coexists with poverty, booms abruptly alternate with busts. But one of the most puzzling riddles is how until the 1920s–just a century ago–Argentina managed to be among the top ten economies in the world, ahead of France, Germany, and Italy. Its income per capita was more than 90% of the average of the richest economies; nowadays, that percentage is less than 45% (*The Economist*, Feb. 2014). Argentina was rich, but, over 100 years, somehow it fell off a cliff, lowering its people's living standards down a very steep ladder. In the process, the population has since acquired a certain attitude that has become part of the culture, or DNA: an awareness (or expectation) of constant volatility and uncertainty.

Volatility in GDP, inflation, the exchange rate, the terms of trade, and capital flows characterizes the burden that Argentines—ordinary citizens, investors, and policymakers—have had to endure for as long as anyone can remember. Compared to the world as a whole and to other groupings (both advanced and developing economies), Argentina's real GDP shows *more extreme variability*, marked by frequent boom and bust phenomena (see Graph 1, based on IMF Datamapper 2017). Also, having a history of devastating hyperinflations, Argentina is nowadays struggling to exit the Losers' Circle (countries whose *inflation rates are higher than 25%*; Argentina (26.9%), Sudan (26.9%), Angola (30.9%), Libya (32.8%), Congo (41.7%), South Sudan (182.2%), and Venezuela (652.7%)). See Graph 2, based on IMF Datamapper 2017.

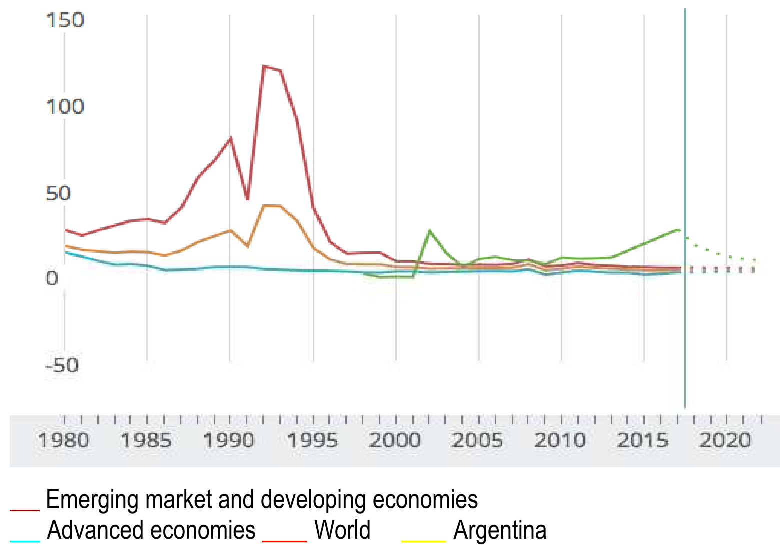
Is there any way for Argentina to rid itself of this disastrous tendency and put itself on a path to sustainable growth and improved welfare? Mainstream macroeconomic theory argues that a sustainable increase in per capita income requires macroeconomic stability. At the same time, microeconomic theory stresses that a sustainable rise in per capita income results from investment, both in physical and human capital.

Both arguments –macroeconomic stability and investment– have a common prerequisite: a low degree of uncertainty. Without certainty, there is widespread refusal to extend long-term contracts; reluctance to plan and put money, effort, or time into making profits in the long term. Societies lacking a fair degree of certainty and respect for the rule of law are doomed to short-termism and its corrosive after-effects on economic growth, welfare, and progress.

Graph 1. Real GDP Growth, Annual Percentage Change



Graph 2. Inflation; Average Consumer Prices Annual Percentage Change



Source: IMF, Datamapper, 2017

2. Measures of Uncertainty

As Jurado et al. (2015) point out, at a general level, uncertainty is typically defined as the conditional volatility of a disturbance that is unforecastable from the perspective of economic agents. In partial- equilibrium settings, increases in uncertainty can depress hiring, investment, or consumption if agents are subject to fixed costs or partial irreversibilities (a "real options" effect), if agents are risk averse (a "precautionary savings" effect), or if financial constraints tighten in response (a "financial frictions" effect). In general-equilibrium settings, many of these mechanisms continue to imply a role for time-varying uncertainty, although some may also require additional frictions to generate the same effects.

Dimensions of economic uncertainty affect (i) a country and its macroeconomic performance, (ii) a country and its institutions, (iii) a country and its political/electoral outcomes and systems, and (iv) a country and its relationship to the outside world. Macroeconomic and structural/institutional uncertainties are within the scope of governments. Political/electoral issues also matter, especially in countries where the political cycle is somehow diluted and all years are electoral. Therefore, it is up to a government to bring about a healthy macroeconomic situation with predictable market movements and ironclad observation of the rule of law; only then will it be in a position to withstand external shocks from the world economy.

Even though holistically measuring uncertainty under different scenarios or across episodes is still regarded as a challenge in the economic literature, three proxies are available to outline Argentina's sorry experience with massive uncertainty over the years. These uncertainty metrics include:

a) *High inflation rates.* This phenomenon encompasses not only continuous rises in the prices of goods and services in the economy but also the accompanying volatility. Not knowing the future direction of inflation (i.e., will it get even worse?) hobbles economic decision making. Argentina's rotten reputation in this area includes hyperinflations (with monthly inflation rates as high as 197%, in July 1989) and a tradition of tinkering with published statistics in order to put the best (and a totally false) face on unpleasant economic and financial facts.

b) Expensive black-market premium. This premium is the difference between the value of the local currency on the illegal market and its official exchange rate in relation to the US dollar. For instance, in January 17, 2013, the official exchange rate for the Argentine peso was AR$4.95 per US$1,

while on the black market, one US dollar was yielding AR$7.50; a 50% markup.

c) Elevated country-risk premium. The Emerging Markets Bonds Index (EMBI) is a leading indicator of country credit risk. JP Morgan calculates it as the difference in the interest rate paid on dollar-denominated bonds, issued by a national government, and US Treasury Bonds, which are considered *free* of risk.

The greater the perceived risk, the higher the interest paid and the wider the spread between these bonds and US Treasury bonds. In other words, the lucrative returns coming from a risky bond is really compensation for running the risk of default by the issuer. Table 1 shows the last 18 years of Argentina's country-risk premium. Two noteworthy points emerge: the quantum of the maximum country-risk premium Argentina has been saddled with, and the variability of the index.

Table 1. Argentina in the 21st Century Country Risk Premium, Data as of Nov. 1, 2017

President Presidential period	# days with country risk premium data	minimum CRP (a)	maximum CRP (b)	Rank (a)-(b)
Mauricio Macri 10 Dec 2015 – ongoing	490	342 (day #483)	569 (day #103)	227
Cristina Fernández de Kirchner (2nd mandate) 10 Dec 2011 – 10 Dec 2015	1034	466 (day #1022)	1348 (day #250)	882
Cristina Fernández de Kirchner (1st mandate) 10 Dec 2007 – 10 Dec 2011	1033	357 (day #1)	1965 (day #242)	1,608
Néstor Kirchner 25 May 2003 - 10 Dec 2007	1179	185 (day #955)	6769 (day #530)	6,584
Eduardo Duhalde 2 Jan 2002 - 25 May 2003	359	3943 (day #33)	7222 (day #156)	3,279
4 peronist mandates in 10 days 21 Dec 2001 – 31 Dec 2001	7	4404 (day #7)	5495 (day #3)	1,091
Fernado De la Rúa 10 Dec 1999 – 20 Dec 2001	**523**	509 (day #17)	4449 **(day #523)**	3,940

Source: Ámbito Financiero database. EMBI+, elaborated by JP Morgan. Note: A measure of 100 basis points means that the government in question would be paying one percentage point (1%) over the yield of risk-free bonds (U.S. Treasury Bills).

As Ávila (2011a) states, the country-risk premium captures not only the relative price volatility within an economy but also the likelihood of a long list of events that hinder capital accumulation in that country: sovereign default, confiscation of assets, nationalizations, bank runs, bank lock-outs, substantial currency devaluations, endemic inflation, prohibitions on exports, and the like. One estimate of the welfare cost of Argentine risk for the period 1976-2006 (Ávila (2011b)) puts it at 20% of GDP, a figure several times larger than the welfare cost of any conventional distortion.

Since independence in 1816, Argentina has defaulted on its sovereign debt eight times. In 1890, when it could not honor its foreign debt, the merchant bank Barings Bank suffered a near-collapse as a result. Much later, in 2001, the Argentine government had the dubious honor of being the world's biggest defaulter—$100 billion. The negative publicity that followed the decision of international creditors to hold out for better terms from the 2005 debt restructuring effort turned Argentina into a pariah state in international capital markets.

As of 2017, however, after a settlement was reached with the holdouts the year before, Argentina is back in the global bond markets, putting out huge debt issues, even one with a 100-year term. Even so, whenever an even minor jitter roils the financial markets over the soundness of Argentine debt, the uncertainty that goes along with the credit analysis delivers a body blow to the overall Argentine economy: the population again subconsciously is ready to expect the worst, having had a century of economic mismanagement, where governments in trouble with international creditors have ofter resorted to confiscatory measures imposed on their citizens to pay the foreign piper. Argentines' resigned expectation of this is part of that special DNA that sets these people apart as a *rara avis*.

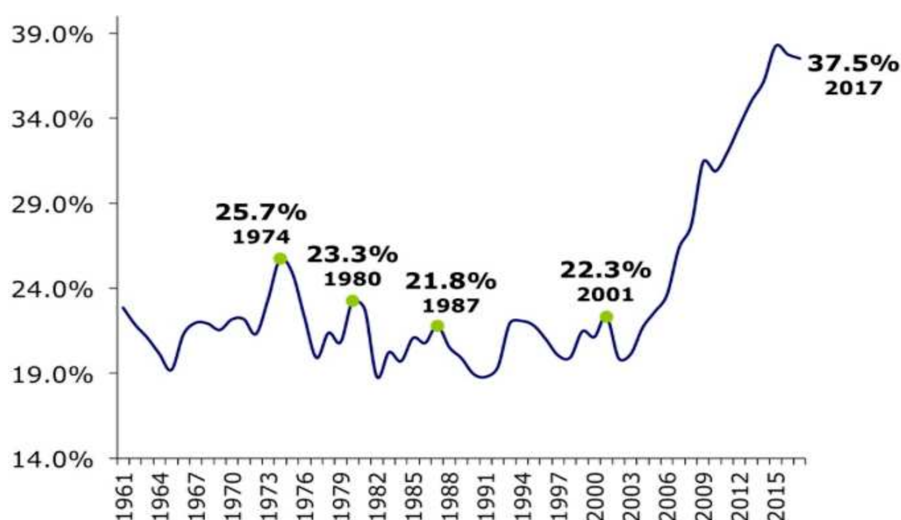
3. Uncertainty and Fiscal Deficits

Fiscal deficits are a foremost source of macroeconomic uncertainty in Argentina. The persistence of towering deficits, financed either by debt issues or inflation of the currency (not to mention other unscrupulous practices like confiscating private assets—such as bank savings accounts—that totally disregard the rule of law), stokes even greater inflation. In response, investment projects are postponed or canceled, reducing the capital stock per worker, restraining technical progress, and reducing per capita income.

Argentina's public spending is one for the record books; in 2017, on a consolidated basis, the primary expenditures of the national government, provinces and municipalities amounted to 37.5% of GDP; see Graph 3.

The Argentine state bulks even larger than those of most of the developed countries. But unlike those countries, Argentina's supply of quality public goods (education, health, security, justice, infrastructure) is still very low. Instead, over the last decade, public finances in the country have been characterized by populism, unprofessional management of public resources, and pervasive corruption.

Graph 3. Primary Expenditure Consolidated Public Sector, as Percentage of GDP



Source: Perspectiv@s based on MECON and INDEC

Acemoğlu et al. (2003) present a very thorough and sound discussion on the sources of volatility in Argentina and argue that the main driver of macroeconomic uncertainty there is not *bad* policies (such as excessive government spending, high inflation, and overvalued exchange rates) *per se*, but, rather, underlying institutional weaknesses. Weak institutions (including political institutions that do not constrain politicians and political elites, ineffective enforcement of property rights for investors, widespread corruption, and a high degree of political instability) foster the adoption of distortionary macroeconomic policies, which, in turn, produce macroeconomic uncertainty.

The repetitive nature of unsustainable and unwise macroeconomic policies in Argentina stems from an underlying pattern of weak institutions; the existence of this "skeleton" under the surface is what makes the unconscionable periodic redistributions of income feasible and even politically rational.

4. Into the Argentine DNA

Argentina has suffered a countless number of economic crises. Besides hyperinflations and international credit defaults (both to the greatest extent possible), national governments have become accustomed to pursuing policies that put property rights at risk and undermine the rule of law in the process. All such experiences have imprinted themselves on the Argentine DNA, making the people more aware than their counterparts in other countries.

There are many economic textbooks that spell out precisely the types of economic measures that, if implemented by a government, will lower the disposable income of the population, as a whole or limited to a subgroup or groups within the society not in favor. Usually, other groups, having more power, will be the beneficiaries of such favoritism preferences. Not receiving as much attention to date are those harmful economic policies that violate the institutional order or take control of private assets, resulting in a shrinking of disposable income. The purpose of this paper is to fill that gap.

As mentioned, the very anatomy of Argentine monetary, financial, and capital - market institutions has paved the way for a hollowing out of the value of the national currency (a total of 13 zeroes have been lopped off it to make it manageable) and the confiscation of the citizens' bank deposits on several occasions.

Table 2. Monetary Designations in Argentina Zero Removals

Monetary designation	**1 unit in current (2017) pesos**	**Zeroes**	**In force for**
Peso (current) Decree 2128/91	1	Removes 4 zeroes from Austral	**25 years and counting** (01/01/**1992** – nowadays)
Austral Decree 1096/85	0.0001	Removes 3 zeroes from Peso Argentino	**6 years** (15/06/**1985** -31/12/1991)
Peso Argentino Law 22.707	0.0000001	Removes 4 zeroes from Peso Ley	**2 years** (01/06/**1983** - 14/06/1985)
Peso Ley Law 18,188	0.00000000001	Removes 2 zeroes from PMN	**13 years** (01/01/**1970** - 31/05/1983)
Peso Moneda Nacional Law 3,871	0.0000000000001		**88 years** (05/11/**1881** - 31/12/1969)

Source: Author's compilation

Over the last century, Argentina has revamped its currency designation four times (peso moneda nacional, peso ley, peso argentino, austral, and

peso). Table 2 presents each currency title with its date of introduction and the number of zeroes taken off its predecessor. It also presents the equivalent of one unit of each currency with respect to the current peso.

At least five episodes of general explicit confiscation of Argentines' money took place over 55 years. Interestingly, Modigliani's life-cycle consumption theory does not even consider the possibility of such a scenario, assuming that all such *institutional details* were discounted. Table 3 summarizes the list of confiscatory episodes.

Table 3. Explicit Confiscations in Argentina: 20th and 21st Centuries Five Concrete Episodes

Date	Episode
April 1964	*Pesoification of deposits*
October 1983	*Frozen deposits for 2 months*
January 1990	*7-day deposits for 10-year bonds*
January 2002	*Asymmetric pesoification of deposits*
December 2008	*Nationalization of pension funds*

Source: Author's compilation

In April 1964, Argentina was overwhelmed by an external debt that it was unable to service or redeem. "Back then, like now, the government took a drastic decision," writes *La Nación* (2002), one of the few newspapers that actually kept records going back 50 years that chronicled the episode. It was during Arturo Illia's presidency (October 1963–June1966) that all saving deposits denominated in dollars were pesofied (i.e., mandatorily converted into pesos). The amount impounded was some $200 million (equivalent to $1.6 billion today), and the banks were in no position to return the dollars to their rightful owners. Savers had only one month to sell their dollars.

In October 1983, only three weeks before the first presidential elections (after years of dictatorship), the Argentine government decreed that all foreign-currency deposits would henceforth be unavailable—at least until December 4th. Maturities were extended for 60 days, and deposits did accrue interest during the time period. Only foreign officials and diplomats were exempted from this measure.

A prominent Spanish daily (*El País*, October 7, 1983) stated that "a high official from the Palacio de Hacienda denied that the government was pre-

pared to break into banks' safe-deposit boxes, where much of the black market of US dollars has been stashed away. However, over the last two days, there have been scenes of panic in the financial center of Buenos Aires, with long queues of depositors seeking information or emptying their safe-deposit boxes.

The “parallel” dollar—formerly the only store of value in the Argentine economy—is now technically valueless and is reportedly declining in price. In turn, the prices of imported goods, which had been skyrocketing, have been dynamited. The flight of the American currency into private residences or abroad (thanks to the porous borders with Bolivia and Paraguay) can be described as a “dollar stampede.”

Again, all bets were on the government’s applying these foreign currencies taken from the citizenry toward its most urgent international obligations: payments for strategic imports and service of foreign debts. In effect, what had happened was a private-to-public-transfer *solution*.

In January 1990, as part of the Bonex Plan, and with a backdrop of accelerating inflation, the government, having required the exchange of short-term dollar-denominated debt for 20-year versions in December 1989, then forced the swapping of 7-day accounts for 10-year BONEX. The 7-day (*plazo fijo*) holders were allowed to withdraw only around $500 from their accounts, with the remainder being transformed (by government order) into 10-year dollar-denominated bonds (BONEX Series 89).

The dollar immediately collapsed on the foreign-exchange market. The new minimum term for deposits was lengthened to 90 days. This confiscation of 7-day accounts amounted to a $3 billion removal of liquid assets from the economy. Further arm-twisted refinancings occurred in October 1990, when $8 billion owed to contractors was suddenly frozen and then converted into 10-year negotiable indexed government bonds.

In January 2002. In December 2001, Argentina restricted bank withdrawals in a last-ditch attempt to save the imploding banking system ahead of an expected sovereign default in international markets. These restrictions, referred to as the “*corralito,*” allowed only withdrawals between $1,000 and $1,200 per month. In January 2002, in the wake of the resignation of Fernando de la Rúa and his replacement by Eduardo Duhalde as the new president, the government was worried about impending personal and corporate bankruptcies on a huge scale, To counteract this threat, the authorities imposed an “asymmetric pesoification,” thereby devaluing bank deposits to a rate of AR$1.4:US$1 while keeping bank debt at AR$1:US$1; this created disproportionate losses for savers and profits for debtors. The move also left

banks in a fragile state, so the government had to step in and compensate them with some $8 billion in sovereign bonds.

In December 2008, Argentina nationalized the country's private pension plans (AFJPs): nearly $30 billion in private pension funds was transferred to government custody in order "to protect retirees from falling stock and bond prices as the global financial crisis continues." This infusion of funds shored up state coffers, giving it the chance of heading off a fiscal crisis in 2009, when the government might be struggling to make good on billions of dollars in debt payments (*The New York Times*, 2008)

Argentina remains the worst offender in the small group of countries that have helped themselves to their citizens' pension assets to pay various obligations, whether domestic or international; other culprits are Hungary (2010), Poland (2013), Portugal (2011), Bulgaria (2014), and Russia (2014).

5. Conclusions

As della Paolera and Taylor (2001) claim, it is only by examining the relationship between institutional structure, policy choices, and economic conditions that we can begin to offer an explanation for Argentina's puzzling decline from its Golden Age at the turn of the 20th century. It was then one of the richest countries in the world, but its potential went to waste over the many years following that time under the pall of a constant incoherence in economic policies that became standard.

This is a sad story that serves as a cautionary tale for the developing world today, where many governments are grappling with the challenges of economic reform. Argentine economic history dramatically demonstrates that prosperity in incomes and prosperity in institutions are two very different things. A failure in the second can be the undoing of the first.

The persistent nature of economic crises and government expropriations in Argentina, and the fact that the same macroeconomic policies are continually resorted to, only to be followed by inevitable collapse, could well justify a despairing attitude.

However, Argentina now has a unique opportunity to turn itself around and leave behind those institutions built merely on quick and clientelist redistribution. A determination to create strong state institutions that are free of political conflict, inefficient redistribution, and utter predation will go a long way toward restoring the economic stability and prosperity that Argentines once knew.

With a sustainable growth rate and an upward welfare path, Argentina could consign to its past the memory of weak institutions that worsened competition and fanned uncertainty, weakening markets' ability to work, create, invest, and produce. The special Argentine DNA is already a parameter to be reckoned with, but new government elites should take their responsibilities to heart and ensure a healthy and thriving economy—at long last.

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