

**ARE FINANCIAL CRISES A NECESSARY  
CONSEQUENCE OF CAPITAL ACCOUNT  
LIBERALISATION?**



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## Foreword

In the wake of the East Asian financial crisis, academicians and policymakers have been called upon to reappraise financial liberalisation and integration of world capital markets. In this context, reform of the existing international financial institutions and adoption of common banking regulatory and accounting standards have been especially emphasised. Another set of proposals have focused upon self-protection policies, which outline countries' protection against external shocks. Bearing in mind the relevance of the subject in Indian policy-making, ICRIER took the initiative of inviting Professor Kenneth Kletzer to deliver a lecture on "Are Financial Crises a Necessary Consequence of Capital Account Liberalisation" in December, 1999.

The lecture analyses financial crises in conjunction with financial integration, autonomy of economic policy, choice of exchange rate regime and macroeconomic policies. It discusses the relevance of capital controls and increased government liquidity to safeguard economies against crises during or after financial liberalisation. While clearly coming out in favour of international financial integration because of the inherent economic gains that can be extracted from it, the lecture spells out how financial crises are historically natural events. The lesson it draws therefore is that countries ought to incorporate self-protecting liquidity enhancing measures, temporary capital controls and a flexible exchange rate regime while framing policies for integration of the domestic economy with the international economy.

I have no doubt that Professor Kletzer's lecture will prove to be immensely thought provoking for all those concerned with these issues.

**Isher Judge Ahluwalia**  
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## About the Author

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Professor Kletzer's research interests include both international macroeconomics and international trade. He has written a number of articles on sovereign debt, fiscal policy sustainability and co-ordination, European monetary unification and international financial integration.

## **I. Introduction**

In the wake of the recent financial crises in East Asia, many observers and professional policymakers have called for a reappraisal of international financial integration and management. Concerns have even been raised that capital account convertibility and international financial deepening may be more costly than beneficial for developing countries. The Asian financial crisis has brought new life to the view that international capital markets may be a menace for developing countries, spreading external disturbances through volatile short-term capital flows. If financial crises are a natural consequence of capital account convertibility and a liberal international capital market, then the reconsideration of a completely open and unprotected domestic financial regime could be warranted. However, if crises are an avoidable outcome of inappropriate or inadequate economic policies, then they need not justify resistance to financial integration and reform.

In the last few years, several policy proposals have been advanced that might protect developing countries against financial crises during financial liberalisation and international integration. Some of these have been modest, while others have been more extreme. Much attention has been given to potential reforms of the international financial system and the redirection of the international financial institutions, in particular, the International Monetary Fund. In addition to redesigning the international financial architecture, the adoption of common standards for banking regulation and accounting procedures has advanced on the international policy agenda by the recent events in global financial markets. Other proposed policy responses have focussed on self-protection policies: what can countries do to protect themselves against external disturbances. More extreme responses have questioned the conventional wisdom in favour of financial openness and against capital controls. The recent use of capital controls by countries that have sought openness and integration has led to a reconsideration of the possible usefulness of temporary restrictions on short-term capital flows by economists.

The Asian crisis has been embraced as evidence that capital account inconvertibility may be a desirable and responsible policy by policy makers and members of the press in countries that had not yet liberalised. This may be an unfortunate consequence. Many currency and banking crises originate from national macroeconomic policies and domestic financial management. Even if some crises are due to the attack of international speculators or contagious panic on the part of foreign lenders in the absence of domestic policy mismanagement, closing the capital account may be a very poor alternative to other interventions.

## **II. Crises and Financial Integration**

Financial crises are not new events for international capital markets. During the classical gold standard period, world capital mobility grew rapidly reaching a level as a share of world production by the onset of World War I to which we have only recently returned. Between 1880 and 1913, there were many crises in the emerging markets of the day which included countries several of today's advanced industrialised countries. It is well known that the frequency of currency crises and domestic banking crises rose significantly during the interwar period. These crises were concentrated in the industrialised countries and had more severe consequences for incomes and employment than those suffered under the classical gold standard.

During the Bretton Woods era, financial crises were rare as the developed countries shied away from capital account convertibility and exchange rate flexibility in reaction to the events of the 1930's. Since the demise of Bretton Woods, there have been a number of financial crises. Many of these have been pure currency crises, and others have involved domestic banking crises either alone or in tandem with a currency crisis. Crisis episodes have also become more frequent, often occurring in episodes, since 1973. Examples of crisis episodes include the 1982 Latin American debt crisis, the 1992 ERM crisis and the 1997 East Asian twin, currency and banking, crises. Empirical studies have found that the growth rate declines following a crisis have been modest for emerging markets. On average, the decrease in output in the first year following a crisis of any variety was approximately 3 percent which was followed by full recovery in the rate of growth within 3 years. A closer look at the data reveals that frequent currency crises have been concentrated in a few countries, notably, Brazil and Indonesia. The output contractions following these pure currency crisis episodes have been small. However, broader financial crises, such as those suffered by Chile (1982), Mexico (1994) and East Asia (1997) create much larger output losses and increases in conventional poverty measures.

The consequences of the East Asian crisis seem to be rather severe and have justifiably led to a rethinking of international financial market integration for the developing countries and possible means of crisis prevention. One World Bank study estimates the cumulative loss for the five affected East Asian countries to be more than 25 percent since July 1997. The crisis appears to have affected the poor disproportionately. Oxfam has estimated that the number of Indonesians living in poverty rose fourfold to 100 million from 1996 to 1999. The World Bank reports a rise in poverty in Thailand by 32 percent and in Korea by 123 percent. These numbers are far greater than what one would expect from the decrease in per capita income. Oxfam also calculates that preventive health care expenditures in the Philippines on malaria and tuberculosis fell by 27 percent and 36 percent, respectively, and that these cuts are expected to lead to an increase in malarial deaths of 29,000 and in cases of untreated tuberculosis of 90,000.

If the costs appear to be so large, why should we encourage international capital market integration in the first place? Economic theory is clear about the potential benefits of global financial trade. International capital flows allow the savings of residents in any country to be allocated to the most productive investments regardless of location. Developing countries with low incomes and little capital can borrow to finance investment, thereby promoting economic growth at a lower sacrifice of current consumption than would be required under self-finance. International financial markets allow the residents of different countries to pool asymmetric risks. This can allow greater risk diversification and encourage the investment of resources in higher risk but higher return activities than would be taken when risks can only be shared domestically. Furthermore, a country suffering a temporary recession or natural disaster can borrow from abroad to smooth private and public consumption and investment.

Another frequently mentioned, potential benefit of capital account convertibility is the disciplining of governments that have a tendency to exploit a closed domestic capital market through excessive public sector borrowing. International market discipline may also work to reduce various forms of cronyism in the domestic industrial or financial sector. An open capital account exposes unsustainable domestic fiscal and monetary policies to speculative capital outflows and higher interest rates. However, it may take some faith to open the capital account for the purpose of disciplining an otherwise undisciplined fiscal authority or central bank.

One of the most important lessons from economic theory is that the benefits of free trade are not so simple in the presence of market imperfections. International financial integration may bring welfare losses rather than gains without policy intervention in the presence of domestic financial market imperfections. An important worry is that domestic financial markets need to be well developed with a significant level of prudential regulation in place prior to capital account liberalisation. The conventional wisdom is that liberalisation should be sequenced with capital account convertibility following domestic financial reforms. This wisdom has been clearly observed in the breach by emerging market governments. Recent arguments that the pace of liberalisation be slower reaffirm the conventional view in light of the inadequacy of domestic financial regulation in the Asian miracle countries.

### **III. Integration and Policy Autonomy**

An open capital account does pose a policy challenge for fiscal and monetary authorities. Currency crises are frequently associated with pegged exchange regimes. By fixing the value of the domestic currency in terms of foreign currency, the central bank gives up control over the money supply with an open capital account. This means that the central bank cannot influence the nominal interest rate for stabilising domestic incomes and production. With a closed capital account, the central bank can peg the exchange rate and exercise influence over domestic nominal interest rates. Under a floating exchange rate

regime, the central bank can control the money supply to meet domestic objectives and maintain an open capital account. The ability to choose only two of three objectives, capital account openness, influence over domestic nominal interest rates and a pegged exchange rate, has come to be called the 'trilemma' of international macroeconomics.

Many developing countries have pursued pegged exchange rate regimes while others have adopted more flexible but managed regimes. Even under a flexible exchange rate regime, it has been very common for the central bank to maintain the nominal exchange rate within a band or to resist rate fluctuations. It appears that a 'fear of floating' is common among central bankers who display concerns about the impact of real exchange rate volatility on national economic performance. The resistance to floating may also be associated with capital flows. A more volatile nominal exchange rate implies greater uncertainty for foreign lending in domestic currency and perhaps higher risk to foreign lending denominated in foreign currency. Once lending is denominated in foreign currencies, exchange rate fluctuations increase the volatility of the domestic currency cost of debt servicing, raising risk for both creditors and domestic borrowers. These risks provide a simple incentive to resist exchange rate volatility.

At the same time, central banks have sought to use monetary policies to achieve domestic policy objectives in conflict with capital account openness. One of the primary features of speculative attacks on exchange rate regimes has been an inconsistency between domestic fiscal and monetary policies and the attempts of the central bank to maintain a given exchange rate. In the classical case of a collapsing exchange rate regime, public sector budget deficits are financed by domestic credit creation by the central bank. With finite reserves, depreciation is inevitable as the fiscal policy and exchange rate peg are mutually incompatible. A flexible exchange rate regime can reduce the vulnerability of countries to pure currency crises. However, managed exchange rate regimes can still suffer speculative attacks, while a truly floating exchange rate eliminates the possibility of a currency crisis.

#### **IV. What Causes Financial Crises?**

A discussion of policy responses to recent financial crises requires an overview of competing explanations for these crises. If a mismatch between macroeconomic policies and an exchange rate peg is the proximate cause of a crisis, then a reasonable approach might be to reform fiscal or monetary management or to allow greater exchange rate flexibility. However, if crises are endemic to the process of financial liberalisation and development, then safeguards or other interventions may play a key role. Two competing views of how domestic financial markets and foreign capital inflows interact to create crises have been put forward in recent years. One view is based on the traditional model of a speculative attack on a pegged exchange rate regime. This

is an approach in which a financial crisis is the outcome of economic fundamentals. The other view regards the recent banking and currency crises as financial panics that resulted from the simultaneous actions of creditors and were not justified by fundamental inconsistencies in national economic policies.

Short-term foreign currency lending is a key ingredient for the volatile interactions between domestic financial markets, international capital flows and domestic policies that can lead to financial crises under either of these interpretations. Short-term lending to finance long-term investment exposes countries to possible sudden reversals of capital inflows. The inability to rollover short-term debts can render the domestic financial system illiquid and collapse ongoing investment projects. The reduction in investment generated by a cessation of future inflows and sudden reversal of short-term credit is a mechanism for the output collapses following financial crises. Another is the loss of intermediation services by a suddenly illiquid financial sector.

Many currency crises can be attributed to the government's choice of an exchange rate regime that is unsustainable with reduction in the rate of monetary expansion given an open capital account. The monetisation or expected future monetisation of public sector budget deficits is a common factor to many currency crises experienced by both developing and advanced industrialised countries. Many forms of policy inconsistency can lead to the anticipation of future public sector liabilities that will or may be monetised eventually. In the past, some Latin American countries have attempted to reduce inflation by pegging the currency to the US dollar under backward-looking wage indexation. The resulting sudden increase in the real cost of public sector wages meant a rise in future deficits that would be monetised. The attempted disinflations ended in a currency crisis and renewed high rates of inflation. Other countries have experienced rapid inflows of capital to finance current account deficits due to a consumption boom. Expansionary public spending, tax reductions and subsidy increases often precede contested elections. Although views differ, it appears that fiscal policy was expansionary in Mexico during 1994 during the consumption boom before the December devaluation.

The liquidity panic view of recent crises holds that the sudden unwillingness of foreign lenders to provide new short-term credits forces banks to liquidate assets that have a low liquidation value but would yield high future returns upon project completion. By holding back new funds and withdrawing current credits, banks and firms become insolvent during a 'fire-sale' of their domestic assets. If only creditors had continued to lend, the crisis would never have materialised. The missing element is an explanation of how a sudden shift in investor attitudes arises. One interpretation of a pure liquidity view is that it explains contagious crises. A fundamental financial problem in one country, say Thailand, raises concerns about other countries in Southeast Asia for distant lenders. As they withdraw short-term funds from the region, liquidity problems arise, leading to full-blown currency and banking crises in neighboring countries.

The alternative interpretation emphasises the role of government guarantees of private foreign currency debts. Carlos Diaz-Alejandro observed after the onset of the debt crisis of the 1980's that countries find it very difficult to refuse to assume the foreign debts of the private sector in a crisis, no matter how explicitly they proclaimed beforehand that they would not. Under explicit or implicit guarantees of private foreign currency debts, the government incurs contingent liabilities that may be invoked in the event of a devaluation. When a crisis hits, the government's realised liabilities jump. If market participants anticipate that the implied increase in future public sector deficits are likely to be monetised, then a conventional speculative attack on the exchange rate peg can be generated. When foreign debt is denominated in units of foreign currency, devaluation has an immediate impact on the balance sheets of domestic banks or other corporations. They face a sudden increase in liabilities, but not assets, in terms of domestic currency. The combined currency and banking crises are self-fulfilling as they lead to the rise in government liabilities that justifies the speculative attack on the currency peg. This is just another version of self-fulfilling crises that would not occur if everyone expected that it would not.

Unfortunately, banking crises often precede currency crises, as in the case of Thailand in the 1990's. Government guarantees of foreign-currency borrowing by domestic financial institutions can create or exacerbate problems of weak prudential supervision and regulation. Such guarantees create moral hazard, as banks make riskier loans or firms undertake riskier projects than they would if they bore all of the downside risk. As bank portfolios deteriorate, the greater the incentive for bankers to gamble on redemption, making ever-riskier loans with improbable but large payoffs. When this occurs, the contingent liabilities of the government progressively rise until only monetisation or default can be expected. Domestic financial liberalisation, implicit or explicit government insurance and limited prudential regulation and supervision are a recipe for a domestic financial crisis. With short-term capital inflows and an exchange rate peg, twin financial and currency crises are a consequence. These are crises generated by inadequate or unwise policies, not by bad spirits influencing foreign lenders.

Contingent government liabilities associated with private foreign borrowing and inadequate regulation of private sector financial activities played a prominent role in the 1997 financial crises in East Asia. The Korean chaebol were able to incur foreign-currency debts without revealing to either government regulators or foreign creditors their true financial condition. When the crisis hit, the public covered these debts. By all accounts and reminiscent of the 1982 Latin American debt crisis, the magnitude of these debts were a surprise to government officials. In the Korean case, fiscal policies were tightened without monetisation in response to the public debt increase. However, the anticipation that it would be monetised helps explain the subsequent depreciation of the won. The policy failure was a combination of inadequate regulation of self-interested parties that can incur obligations implicitly backed by the government for the purpose of

protecting depositors and maintaining access to foreign capital inflows. Closing the capital account would be a poor substitute for choosing the model of corporate disclosure requirements and banking supervision provided by many advanced industrialised countries.

The cases of Indonesia and Thailand also provide examples of domestic financial mismanagement in the presence of short-term foreign capital inflows. In each of these countries, the domestic banking sectors were in fragile financial shape before the currency crisis. The banking crises in these countries may have been fueled by access to foreign capital flows, but poor regulation, government favoritism and outright corruption are the leading sources of a banking crisis built on government subsidization of foreign borrowing.

The liquidity view of crisis has gained favour among many economists due to the timing of crisis episodes across countries. The East Asian crisis raises concerns that international capital market integration can spread crises, as foreign creditors faced with a crisis in one country choose to reduce their exposure in similar countries. Crisis contagion has two popular explanations. One is pure financial market contagion. Fundamentals may explain a crisis in one country with an out-dated currency peg, say Thailand, causing lenders to worry about the fundamentals in other countries they understand equally poorly. An outflow of short-term capital from one market can cause a liquidity crisis that is self-fulfilling although unjustified by fundamentals. The other type of contagion is transmitted through international markets. As the demand for imports declines in one country struck by a financial crisis, the demand for the products of major trading partners declines stimulating investment reductions and capital outflows.

The empirical evidence to support either explanation of contagion is not very strong. Despite the coincident crises in East Asia, other financial crises have been isolated events. The spread of capital outflows to Malaysia and the speculation against the Hong Kong dollar may evidence concerted actions by foreign financial institutions (as has been alleged) or could reveal rising uncertainty about the future policy regimes in each.

## **V. Can Capital Controls Help?**

Recent financial crises in emerging markets have been costly, although countries without long-term systemic financial sector problems have recovered fairly quickly. It is possible that some currency and banking crises were caused by a sudden reversal of capital flows leading to a liquidity crunch that need not have occurred. It is also possible that crisis episodes are linked through lender expectations and the volatility of short-term capital movements, so that contagion rather than an inappropriate choice of policy has brought crises to some countries. These possibilities have been used to rationalise resistance to capital account convertibility in some countries. Indeed, countries with tight controls on

private international financial transactions did not suffer currency crises along with the East Asian crisis five, Brazil, Mexico or Russia.

There are however, alternatives to foregoing the potentially large gains from access to international financial markets by maintaining a non-convertible currency and closed capital account. One measure that has become very popular to discuss and propose in recent years is the adoption of capital controls as either a temporary or permanent measure to reduce the impact of volatile short-term international capital flows on domestic financial stability. Three types of controls have been discussed most often or used recently.

The first is a transaction tax on capital inflows or outflows for the purpose of reducing the total volume of two-way flows. James Tobin has proposed such taxes on transactions in financial assets as a way of taxing speculation in asset markets. As proposed, a Tobin tax should raise the cost of arranging speculative positions in asset markets. However, Tobin taxes do not distinguish between short-maturity and long-maturity flows and would tax net inflows at the same rate regardless of maturity. The purpose of the proposal applied to international capital flows is to reduce the probability of a crisis arising when crises are a consequence of speculative behavior by traders. Unfortunately, there are theoretical reasons to worry about the impact of a Tobin tax. It can be shown that when speculative movements drive asset purchases, a transaction tax can raise rather than lower volatility.

The natural alternatives to imposing a tax on all transactions all the time are imposing capital controls during periods of vulnerability or on only certain transactions associated with volatile capital flows. Capital controls have been adopted during domestic financial market reform or periods of international capital market volatility and distress by many countries over the years with success. Restrictions have also been applied to trade in specific financial instruments with little success. For example, Brazil recently imposed various taxes on different detailed asset types but found that these were easily circumvented using combinations of other assets. Chile on the other hand, adopted taxes that effectively decreased with the maturity of the capital inflow. As first imposed, foreign creditors could find ways to circumvent the controls and make untaxed short-term loans. These loopholes were progressively and successively closed.

The Chilean controls on short-term capital flows have attracted widespread attention. Chile did not suffer from speculative attacks on the target zone for its exchange rate during the Mexican or East Asian crises. The majority of studies of the impact of these controls conclude that they did lengthen the maturity of capital inflows, but at the cost of higher domestic real interest rates. Sebastian Edwards has demonstrated that Chilean interest rates were not protected from external sources of volatility by showing a significant response to the Asian crisis. I argue that this does not necessarily show that the controls failed in their

objective. If the purpose of adopting these controls was to reduce short-term capital flows while allowing international financial integration through long and medium term flows, then we should expect to see the variability of domestic interest rates responding to foreign interest rate volatility. It does seem that the purpose of controls was to insulate Chilean financial markets from international financial markets. By targeting short-term movements, the central bank appeared to be trying to change the maturity composition of capital inflows without eliminating interest rate linkages with the rest of the world. As Edwards shows however, a cost of reducing the volatility in short-term capital movements may be a rise in the volatility of interest rates all along the yield curve.

Chile has since relaxed these capital controls, having adopted them to protect against speculative inflows during a period of rapid financial reform. As a temporary measure for assisting in financial reform and liberalisation, the Chilean controls offer a potentially beneficial policy that can protect against currency and domestic financial crises albeit at a cost.

Malaysia chose to impose controls on capital outflows during the crisis. Effectively, Malaysia suspended convertibility temporarily. This works to stop a crisis, but it could be used to avoid capital outflows in response to a deterioration in the economic fundamentals for a country. If lenders anticipate that controls will be imposed on any future date that they wish to reduce exposure to the country, then they should lend less in the first place. A reputation for imposing emergency controls in response to outflows may discourage inflows.

## **VI. Can Increasing the Liquidity of the Government Help?**

Other ways have been proposed for countries to protect themselves against financial crises that may not be a consequence of poor policy choices. These include measures to enhance the liquidity available to the government during a crisis episode. One policy, proposed in different forms by Alan Greenspan and by Pablo Guidotti is to target international reserves to short-term indebtedness. As proposed by Greenspan, this means covering the full amount of expected debt amortisation for the coming year plus potential short-term contingent liabilities of the government. This is a modification of old-fashioned rules for reserves based on international trade flows. A common rule of thumb is that international reserves should provide a three to four month cover of imports. It is interesting to note a strong correlation between short-term debt amortisation and the value of imports for four months across a wide range of developing countries. That is, the Greenspan rule corresponds to the conventional rule for most countries. In 1996, however, Thailand and Indonesia did not have sufficient reserves to meet one year's debt amortisation but could cover four months of imports. Malaysia, the Philippines and Brazil all had sufficient reserves to meet the debt target. Russia and Korea met neither reserve target.

Higher reserves allow a country to postpone a currency crisis caused by macroeconomic inconsistencies or financial market problems. They also can reduce the possibility of a pure liquidity crisis generated by lender expectations rather than fundamentals. However, they are costly to hold. A government that holds large international reserves could reduce its outstanding, privately held, public debt by selling reserves and engaging in an open market purchase. Public debt issued by the US and other advanced industrialised countries pays a lower rate of interest on international markets than domestic public debt issued by developing countries. By reducing reserves and outstanding public debt one for one, a developing country with an open capital account can reduce its public sector budget deficit. The net interest cost of holding international reserves is called the quasi-fiscal costs of reserves.

As a developing country accumulates reserves, the government is essentially borrowing these reserves. This translates in a higher budget deficit without compensatory tax increases or expenditure growth decreases. Under an exchange rate peg, if fiscal policies are not tightened, then future domestic credit creation must rise to maintain public sector solvency. In this way, a mismanaged accumulation of additional reserves to protect against a currency crisis can be counterproductive. It can bring on the very event it was meant to thwart. A further worry could be that targeting reserves to short-term capital inflows could encourage short-term capital inflows by raising the liquidity available to the government. If this were to occur, then the only impact of raising reserves will be to raise government interest expenditures.

Reserves can reduce the exposure of countries to crisis that might be generated as pure liquidity runs. This protection comes at the cost of a tighter fiscal policy. If macroeconomic policies are not consistent with sustaining a currency peg, then this does not solve the problem and may only increase the social costs of macroeconomic mismanagement.

An alternative means of raising the liquidity available to the government in a crisis is the pre-arrangement of contingent lines of credit. These can be drawn upon in the event of a rapid outflow of short-term capital to stop an incipient crisis. If crises are generated by self-fulfilling expectations, contingent credit lines may eliminate crises from ever beginning. Contingent credit lines may be offered by official sources, for example, the International Monetary Fund, or by private creditors. Several such contingent credit lines have been negotiated recently between emerging market countries and private lenders.

It has been argued that these arrangements are vulnerable to offsetting portfolio adjustments by private lenders. As a contingent credit is invoked, a private lender may reduce other lending to the country so that the credit provides no net inflow of resources. The purpose of these credit lines may not be to provide additional resources, but just to offset these other outflows. As short-term loans are not rolled over, the pre-arranged loans replace them. Contingent credits effectively

extend the maturity of short-term credits in a crisis. This amounts to an automatic rollover of existing loans when liquidity is tight. Like reserves, contingent credits come at a cost. Lenders charge for the option of borrowing in a future contingent event. This cost may be comparable to the quasi-fiscal costs of reserves with the same consequences for fiscal policy.

None of these self-protection policies is a panacea. Each has different costs and provides different benefits. Countries may be justified in using temporary capital controls to discourage speculative capital flows during some periods of financial reform and liberalisation. There could well be a trade-off between attempting to raise reserves or arranging contingent lines of credit in response to a rise in short-term capital inflows. There is, however, no substitute for macroeconomic reforms or serious prudential regulation and supervision of financial intermediaries. The costs of accumulating additional reserves, arranging contingent credits or imposing capital controls will then be incurred without benefit. Letting go of the exchange rate peg, tightening monetary and fiscal policies or domestic financial reform as appropriate are needed when fundamentals are leading a country towards a currency crisis or financial distress.

## **VII. Conclusion: Is Convertibility Still a Good Idea?**

International financial integration offers significant economic gains for countries. It also poses the possibility of sudden financial crises when domestic financial markets are undergoing liberalisation and reform. The history of international financial market growth and economic development suggests that financial crises are a natural event. One that policy makers need to take into account when formulating policies and contemplating capital account liberalisation. A poor response to this policy challenge is to maintain non-convertibility of capital account transactions. Superior policy alternatives include self-protective liquidity enhancing measures, temporary capital controls to reduce capital flow volatility during financial reforms and a flexible exchange rate regime. In most financial crises, policy mismanagement has played a central role.

In the Asian crises, liberalisation may have proceeded adequate domestic safeguards against imprudent lending practices by banks and sufficient disclosure of corporate finances. In other crises, macroeconomic policy has been inconsistent with the choice of an exchange rate peg. In no case, can we find a justification for financial autarchy. We certainly do not see a justification for keeping capital account closed, allowing governments to maintain weak financial systems and a captive domestic capital market for financing public expenditures. What we do find are mistakes and pitfalls from which policy makers can learn. Self-protection and modifications of the international financial architecture may reduce the frequency and consequences of financial crises in emerging markets, but we should not expect them to eliminate volatility as a feature of economic reform, integration and growth.

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