Global Crisis Links
Are Arab Financial Markets at Risk?

by Khaled Sherif

Less than US$50 billion of private capital flowed to the developing world in 1990. By 1996, however, it had grown to over US$250 billion. Although largely beneficial, the crises that struck Mexico and Argentina, South-East Asia, South Korea, Russia and, most recently, Brazil, reminded the international community of the threats associated with large flows of private investment. PHARAOHS examines the crises, analyses the factors that precipitate economic upheavals of such magnitude and wonders whether MENA is similarly vulnerable.

WHAT HAPPENED?

TEQUILA CRISIS (MEXICO)

After the debt crisis in 1982, Mexico suffered a sharp recession followed by several years of slow and sputtering growth. By the end of the decade, however, things were beginning to improve. The election of reform minded President Carlos Salinas de Gortari in 1988 and the implementation of the Brady Plan helped resolve the debt crisis after years of inaction, leading to the return of both investor confidence and foreign capital to Mexico. From US$100 million in 1988, Mexico received over US$21 billion in 1993.

In sharp contrast to the period before the debt crisis when capital inflows financed government deficits, tighter fiscal policies during this period meant that the government ran modest surpluses. There was less concern about the sustainability of the capital flow. It was thought that since the inflows were based upon the rational investment decisions of private parties, they must reflect Mexico's potential for growth.

Despite the large capital inflow, potential problems remained. First, growth remained modest. Although faster than in the 1980s, it averaged only about 3.7 per cent per year between 1990 and 1993. A second perhaps related concern was that some of the capital inflow was financing increased consumption rather than increased investment. Two events contributed to a collapse in investor confidence in 1994: the peasant uprising in Chiapas in January and the assassination of the PRI presidential candidate in March.

Since 1991, the exchange rate had followed a crawling peg but the political setbacks resulted in a sharp depreciation, forcing the Central Bank to intervene. International reserves fell from US$25.1 billion in January to US$17.7 billion in April. To prevent a decrease in the monetary base or an increase in interest rates – controversial moves in an election year - the Central Bank expanded domestic credit. To offset an increase in its cost of borrowing, the government switched from long-term to short-term debt and issued Tesobonos, bonds valued in US dollars rather than pesos.

These policies turned out to be riskier than the government imagined. The Attorney General's resignation in November deepened the crisis, increasing capital outflow and causing a steep drop in reserves - from US$17.7 billion at the end of October to US$12.9 billion at the end of November. Suspicions that a devaluation of the peso was imminent further undermined confidence, provoking attacks on the peso. When the Central Bank finally widened the exchange rate band to 15 per cent on December 20, 1994, the modest devaluation was insufficient. Two days later, the government was forced to float the peso. A December 27 auction of Tesobonos also failed, raising concerns about the government's solvency. Fearing collapse, the US government and the IMF arranged a US$52 billion package. Mexico was briefly plunged into severe recession, the economy shrunk by 6 per cent in 1995 and the crisis threatened to spread to Argentina, but meltdown was avoided.

ASIA

Barely had the world recovered from the Mexican imbroglio when alarm bells began to sound off in the Asian sub-continent. What affected Thailand, Indonesia, Malaysia and the Philippines eventually threatened to engulf South Korea as well. Malaysia, Thailand and the Philippines allowed their currencies to fluctuate against the US dollar within fixed nominal bands. Indonesia, on the other hand, targeted the real exchange rate, allowing the nominal rate to fall from 2200 Rp/$ at the end of 1994 to 2450 Rp/$ by mid-1997. The rupiah, however, still appreciated in real terms. Between mid-1995 and the onset of the crisis in 1997, all four South East Asian currencies appreciated, increasing the relative cost of their exports while reducing the

Vulnerability to Crisis – Crisis Countries and Comparator Countries in Middle East and North Africa

	Crisis Countries (Year Before Crisis)				Comparator Countries in Middle East and North Africa (1997)					
	Russia	Mexico	Thailand	Malaysia	Egypt	Morocco	Tunisia	Jordon	Lebanon	Syria
Pegged Exchange Rate (including Crawling Pegs)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Current account deficit (>5% of GDP)		Yes	Yes						Yes	
Budget Deficit (>3% of GDP)	Yes					Yes	Yes		Yes	Yes
Short-term Debt (>50% of reserves)		Yes	Yes				Yes			
Private Sector Credit (Growth>10%)	Yes	Yes		Yes	Yes					

export growth rate.

In 1997, slower export growth and mounting current account deficits resulted in speculative pressure against the Asian currencies, especially the Thai baht. Rather than allowing monetary contraction and higher interest rates, the countries attempted to regulate their foreign exchange markets through exchange control mechanisms. While some argued that the Thai government was concerned that higher interest rates would reduce investment and slow growth, others believe the policy was dictated by fears that higher interest rates would spawn a wave of bankruptcies in the corporate sector, putting pressure on a weak, underdeveloped banking sector. The Thai government eventually abandoned its efforts to maintain a fixed exchange rate and allowed the baht to float on July 2, 1997. It depreciated 18 per cent on the first day alone. The baht collapse was followed by increased speculative attacks against the Indonesian rupiah, Malaysian ringitt, Philippine peso and South Korean won, leading to a further round of forced devaluation.

The swift downfall of these Asian economies was numbing. These were the Asian Tigers, their success attributed to strong fundamentals: high savings rates, high investment in human capital, prudent fiscal management and macro-economic stability. They seemed to have got the basics right and the accepted indicators of a pending financial crisis - slow growth, large fiscal deficits, high rates of inflation and low savings and investment rates – just didn't manifest themselves. Until the financial crisis, Asia had taken rapid economic growth for granted.

What, then, went wrong? Was there something essentially flawed in Asian economic management? Before the crises, observers attributed the success of East Asia to "an uninhibited closeness between the business and government elite; a sort of cozy, collaborative relationship." Crony capitalism – a catchy, but ambiguous, phrase – described everything from outright corruption to government favoritism towards enterprises managed by those with personal connections to the powers-that-be. Although corruption was a problem in some East Asian countries like Indonesia, in some others like Malaysia, it didn't appear to be significantly worse than in other developing countries.

Several authors have suggested, therefore, that the most likely immediate cause of the crisis was herd-like panic on the part of investors. Whatever the cause, growth dropped sharply in 1998. In 1996, GDP was growing at a robust annual rate of at least 5 per cent; in 1998, it had shrunk by at least 5 per cent everywhere, except for the Philippines. Private investment flows collapsed, companies went bankrupt and banks folded. In the popular press, East Asia went from 'miracle' to 'basket' case in one year.

In contrast to the crises in Asia and Mexico, the financial crisis in Russia displayed many classic symptoms of a currency crisis. The government was running large fiscal deficits; the macro-economy was unstable and domestic savings low.

RUSSIA

In contrast to the crises in Asia and Mexico, the financial crisis in Russia displayed many classic symptoms of a currency crisis. The government was running large fiscal deficits; the macro-economy was unstable and domestic savings low. Foreign investment was primarily directed towards the government sector rather than risky private sector ventures or over-valued real estate as in Asia.

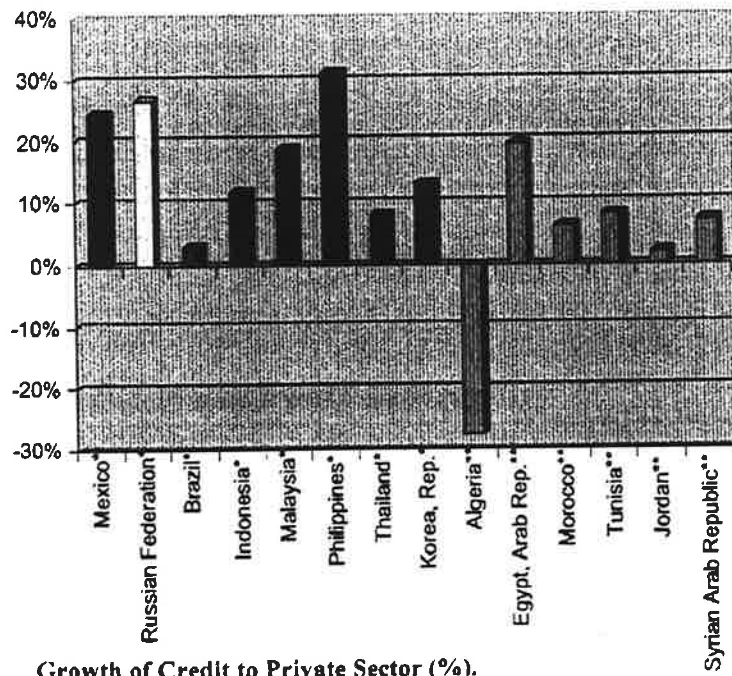
Unlike the Asian crisis that caught the world by surprise, the crisis in Russia was anticipated. Between mid-1997 and mid-1998, the Central Bank's international reserves fell from US$20.4 billion to US$11.1 billion. On May 27, 1998, the Russian Central Bank was forced to triple the refinancing rate from 50 per cent to a whopping 150 per cent to defend the ruble against attack. In an attempt to calm the markets, the IMF announced a bailout package of US$22.6 billion in mid-July. Central Bank reserves were bolstered with an immediate payment of US$4.8 billion; the spread between ruble and dollar denominated debt fell from around 80 per cent to around 35 per cent. The Duma amended an anti-crisis program slated to increase tax revenues and raise privatization targets and on August 12, the Central Bank announced that the inter-bank market was suffering from a loss of liquidity.

The next day, in an open letter to the Russian government published in the Financial Times, investor George Soros advised the Russian government to devalue the ruble and introduce a currency board. Despite President Yeltsin's subsequent statement that the ruble would not be devalued, panic ensued and the stock market declined precipitously. The subsequent devaluation and restructuring of debt effectively froze up the Russian banking and payments system. To avoid a systematic banking crisis, the Russian Central bank swapped some short-term zero-coupon Central Bank bonds for frozen government debt and reduced reserve requirements. Notwithstanding its efforts, banking sector assets fell from US$107 billion to US$40 billion in 1998 alone. By the end of the year, the Central Bank estimated that 720 banks, including five of the ten largest, were insolvent.

Although credit rating agencies did not downgrade credit risk in the Asian countries through the first half of 1997, the Russian credit risk was downgraded before the crisis struck. Since the Russian government had been running fiscal deficits in excess of 4 per cent GDP since 1995, attempts to defend the exchange rate by increasing interest rates increased the government's cost of borrowing. The government's commitment to a fixed or semi-fixed exchange rate was rendered non-credible, since any increase in the interest rates would make the budget deficit larger and more difficult to sustain.

WHY DID IT HAPPEN?

SHORT AND LONG-TERM CAPITAL FLOWS



Growth of Credit to Private Sector (%).
Source: International Monetary Fund, *International Finance Statistics*.
* Year before crisis
** 1997.

The swift downfall of these Asian economies was numbing. These were the Asian Tigers, their success attributed to strong fundamentals: high savings rates, high investment in human capital, prudent fiscal management and macro-economic stability.

Exchange Rates and Capital Account Convertibility

Interestingly, most of these countries had fixed exchange rates and allowed inflow and outflow of foreign capital. Since fixed exchange rates and capital account convertibility prevent countries from using monetary policy to stabilize the economy, the crises led to considerable discussion about the costs and benefits of capital account convertibility. Several prominent economists, including Krugman (1999) and Bhagwati (1998) suggested that capital account convertibility, especially for short-term and speculative flows, might cause instability.

Compare now Egypt, Jordan and Lebanon, all of whom have substantial capital account convertibility. While Jordan and Lebanon have almost no restrictions on either inflow or outflow of either direct or portfolio investment, Algeria, Morocco, Syria and Tunisia all have significant restrictions, primarily on outward flows of portfolio investment. Financial markets in these countries are not highly developed, however, and they do not attract large amounts of portfolio investment. Again, while Egypt and Lebanon have anchored their exchange rates to the US dollar, Morocco and Tunisia have managed pegs.

Current Account Balance and Private Capital Flows

Throughout the 1990s, Mexico, Brazil and afflicted East Asian countries ran large trade and current account deficits, while Russia was running a modest current account surplus one year before the onset of the crisis. A decline in oil prices in early 1998 reduced the value of Russia's exports and resulted in a modest current account deficit in the early part of that year.

The five Asian governments had, in fact, small budget surpluses while Mexico's budget was close to balance. The capital inflows that funded the large current account deficits essentially funded private investment and, in Mexico, private consumption. Although the rate of savings was high in most of the Asian countries, the rate of investment was even higher. The high current account deficits would have been worrying if they had been financing government deficits. The exception to the low budget deficit rule was Russia, where the government was running large deficits due to poor tax collection and the large tax arrears owed by many Russian companies.

All the Middle Eastern and North African countries mentioned with the exception of Lebanon had relatively modest current account deficits. Egypt and Syria have modest surpluses and only Tunisia has a deficit that is greater than 3 per cent GDP. However, most governments are running large budget deficits (between 2 per cent and 5 per cent GDP).

Short-term Investment Flows and Foreign Direct Investment

When investors quickly reverse investment decisions, financial markets can be subject to herd-like panic. Consider portfolio investment the year before the crisis, the year the crisis occurred and the year following the crisis in Mexico and Asia. In all countries for which data is available, foreign portfolio investment fell dramatically after the onset of the crisis. In Mexico, the Philippines and Indonesia, the net flow became negative the year after the crisis.

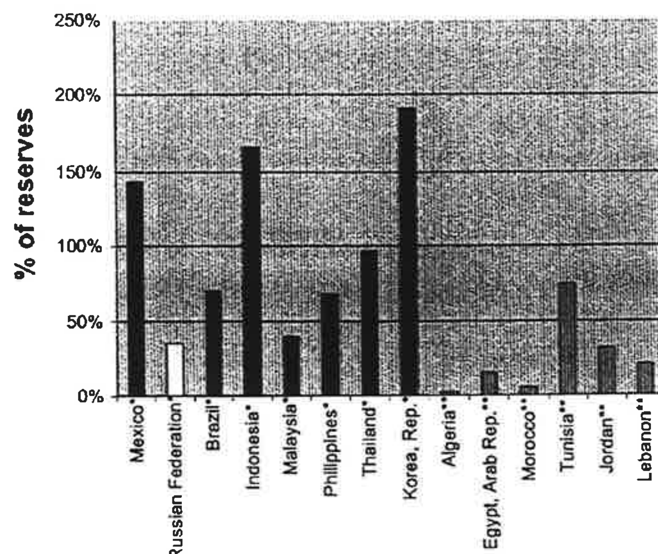
In a cross-country analysis of financial crises, Radelet and Sachs (1998a) found that an increase in the ratio of short-term foreign debt to international reserves increased the likelihood of a crisis. They argue that if a country does not have sufficient foreign exchange reserves to pay off all short-term creditors in the case of a panic, foreign creditors might try to quickly withdraw funds before reserves run out, provoking a crisis. South Korea, Indonesia, Thailand, the Philippines, Mexico, Russia and Brazil had high ratios of short-term debt to reserves. Malaysia, however, did not have an especially high ratio and Russia's ratio had fallen by 1997. None of the countries referred to from the Middle East had especially high ratios of short-term debt to gross international reserves in 1997. The only country with a comparable ratio is Tunisia, where short-term loans were about 75 per cent of gross international reserves.

In contrast to portfolio investment, foreign direct investment (FDI) might be more stable. This is possibly because it is more difficult for a multinational to move plants and equipment out of a country than for an investor to withdraw investments. Because FDI appears less volatile than short-term loans and portfolio investment, countries where FDI investment covers a large portion of the current account deficit might be less prone to crises than those where FDI is less important. Subtracting net FDI from the current account deficit does not have a large effect on most of the Middle Eastern and North African countries referred to above.

Conclusions

Russia was wrestling large fiscal and macro-economic imbalances that made commitment to a fixed exchange rate non-credible. The interest rate increases required to defend the ruble would have increased the government's cost of borrowing, making the budget deficit even less sustainable. Mexico's crisis, on the other hand, was mainly caused by large inflows of short-term capital used partially to fund private consumption. Consequently, large capital inflows were not sustainable in the medium term.

Almost all the affected economies shared relatively fragile banking systems, none more so than Russia. Although a sharp decrease from the 3000 banks considered active in 1994, Russia boasted 1675 banks at the beginning of 1998. Even before the crisis, many were thought to be insolvent. A weakened banking infrastructure perhaps prevented the Asian countries from raising interest rates when faced with speculation against their currencies. With the exception of Russia, all the other economies had large current account deficits. Several of the countries relied heavily on short-term capital to finance their investment needs. Cross-country studies have also found that relying heavily on short-term capital to finance investment needs – a practice followed in several of the countries – could lead to a bank and currency crisis.■



Short-term debt (as % of International Reserves)
Source: World Bank, *World Development Indicators*.
*Year before onset of crisis
** 1997