CAUSES AND SOURCES OF THE ASIAN FINANCIAL CRISIS

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A. Introduction

So much has been written and revealed since July 1997 on the causes of the Asian crisis that it should now be possible to produce a final synthesis and reach a consensus. However, economics would become a boring subject if economists ever discovered the truth and reached agreement. Thus, I do not want to pretend that my account of the crisis constitutes the ultimate truth with which economists of different conviction must readily agree. This account derives in large part from that given in , drafted almost two years ago. What has been written and revealed since then does not warrant a fundamental revision of the substance of the explanation given in *TDR 1998*. Thus, I will stick mainly to it, while covering a few additional issues.

Our analysis seeks to explain the Asian financial crisis in the context of the increase in systemic global financial instability that has become visible after the collapse of the Bretton Woods arrangements and the increased liberalization and mobility of international capital flows. The systemic nature of global financial instability was discussed in *TDR 1990,* well before the surge in private capital flows to developing countries, with a warning that the international financial system was structurally vulnerable and that, unless action was taken for more collective control over international finance, the potential for an extremely costly crisis would remain. Since then the world economy has witnessed further bouts of financial instability at less than two-yearly intervals. First, there was debt deflation in the United States, followed by the EMS crisis in Europe in 1992–1993; that crisis was followed by the Mexican crisis of 1994–1995, by the East Asian crisis beginning in 1997, and more recently by the crises in Brazil and the Russian Federation.

With few exceptions, the recent financial crises in emerging markets have combined currency instability with banking crises. While each episode has its own characteristics, a number of common features have marked the history of the post-Bretton Woods crises. Many of them have been preceded by liberalization of the economy, notably the financial sector. Almost all episodes of currency instability have been started by a sharp increase in capital inflows followed by an equally sharp reversal. In such boom-bust cycles, international investors and creditors manifest herd-like behaviour in exiting as well as in investing or lending. Surges in capital inflows are usually associated with internal or external policy changes that produce divergences in domestic financial conditions relative to those of the rest of the world, often reflected in interest-rate differentials and prospects of capital gains. Reversals of capital flows are frequently associated with a deterioration in the macroeconomic conditions of the recipient country. This deterioration often results from the effects of capital inflows themselves and includes currency appreciation, current account deterioration, rapid domestic credit expansion, and speculative bubbles in asset markets.

However, it is also notable that financial crises in emerging markets have occurred under varying macroeconomic conditions. They have occurred when current-account deficits were large and unsustainable (Mexico and Thailand), but also when such deficits were relatively small (Indonesia and the Russian Federation). Although significant overvaluation has often been characteristic of countries experiencing currency turmoil (Brazil, Mexico and the Russian Federation, all of which used the exchange rate as a nominal anchor to bring down inflation), this has not always been the case; in most East Asian countries the appreciation of the currency was moderate or negligible. Similarly, while in some cases crises were associated with large budget deficits (Brazil and the Russian Federation), in others the budget was balanced or in surplus (Mexico and East Asia). Finally, crises occurred when external debt was owed primarily by the public sector (Brazil and the Russian Federation) or primarily by the private sector (East Asia).

Of these various episodes, the Asian crisis was generally more difficult to predict than the Mexican, Russian or Brazilian crises. This is in part because these economies had been held up as examples of prudent and sustainable economic policies, and in part because of the orthodox faith in the

infallibility of markets and the undisputable benefits of free capital movements. However, there were exceptions. The *BIS Report 1996* warned about the exposure in East Asia. Similarly, the *1996 TDR* sounded a clear warning on South-East Asia, noting that growth in the region relied excessively on foreign resources, and that these economies could suffer from loss of competitiveness and were highly vulnerable to interruptions of capital inflows.

Like elsewhere, the crisis in East Asia broke out with a sudden loss of confidence and massive withdrawal of capital by both domestic and foreign investors as well as unhedged debtors. The course of events is well known and needs no repetition here. What I propose to do instead is to analyse the crisis by distinguishing between the build-up of external vulnerability and the factors that triggered the loss of confidence and exit. In both respects, external as well as internal factors, including domestic policies, appear to have played a crucial role.

B. Build-up of external vulnerability

The crisis in East Asia, like crises almost everywhere else, was preceded by a sharp increase in capital flows to the region. Starting in the early 1990s, there was a rapid increase in short-term lending by commercial banks to both banks and firms in the region. Most bank lending was non-syndicated and directed to non-financial private firms, but in the Republic of Korea, and to a lesser extent elsewhere, the financial sector was also an important recipient of funds. Clearly, such transactions must have been perceived to be profitable by both international lenders and the Asian borrowers. However, it turned out that more capital flowed into these economies than could be profitably used at modest risk; i.e. there was a misjudgement of return and risks by both lenders and borrowers.

There are a number of reasons for this increase in short-term bank lending to East Asia, on both the supply and the demand sides:

1. Why did the lenders lend?

On the supply side an important reason for the surge in international lending in East Asia was clearly the response of developed-country investors to "yield famine" resulting from falling interest rates and liquidity expansion in their domestic markets. In the early 1990s, the major industrial countries adopted low interest rates in response to the recession. Interest rates in Japan were reduced dramatically after the failure of its economy to recover from the collapse of property and stock market bubbles in 1989–1990, while in the United States official rates were cut drastically in an effort to overcome debt deflation. The relatively higher returns in high-growth, low-risk Asian economies with a record of relatively stable exchange rates made them attractive investment locations. By 1994 an increasing volume of this investment consisted of short-term arbitrage funds seeking to profit from the interest rate differentials, rather than funds seeking long-term returns on productive investment. The Mexican crisis reinforced this, triggering flight to quality as the Asian emerging markets looked safer.

It is also suggested that moral hazard played an important role in international lending. First, the Mexican bailout may have encouraged imprudent lending. Second, many governments in East Asia may have been expected to stand ready to bail out private debtors – something that has also been seen as an even greater source of moral hazard for the Asian borrowers. It is difficult to know precisely the role of moral hazard in imprudent lending. However, it is notable that in the event the international intervention in East Asia was designed primarily to guarantee repayment to foreign lenders. Again, negotiated settlements resulted in the socialization of private external debt when the governments were forced to assume loan losses, particularly in the Republic of Korea.

Further, it is often suggested that lenders and investors did not have a clear, transparent picture of the real situation of the borrowers, and hence were unable to assess the true risk; in other words, the borrowers cheated the lenders. Inadequate information is also seen as the major reason for the failure of multilateral financial institutions and rating agencies to forecast the East Asian crisis. However, this is grossly exaggerated. Although there were some important gaps in information, data were generally available concerning key variables in the countries concerned, such as balance of payments, short- and

longer-term external debt and external assets (in particular in the periodic reports of the BIS concerning international bank lending), capital inflows, the exposure of banks and other financial firms to different sectors or categories of economic activity, and the problems of the property sector. What was missing was adequate evaluation by both multilateral financial institutions and market participants of available information. Such arguments indeed lost credibility after the Russian crisis. Much of the increase in the external financial exposure to the Russian Federation took place during a period when information was widely available concerning the shortcomings of Russian macroeconomic policy, the weaknesses of the country's banks, and the underdeveloped state of the country's legal and regulatory framework and of its system of corporate governance. Moreover, most of the capital inflows into the Russian Federation took place when the country was carrying out IMF stabilization programmes. A few months before the outbreak of the Russian crisis, there was over-subscription to Russian bonds in Wall Street. This was known as moral hazard play, on the assumption that if the Russian Federation did not pay, someone else in the West would.

2. Why did the borrowers borrow?

There can be little doubt that a large part of the inflows was due to the attempt of domestic financial and non-financial firms to reduce their financing costs by borrowing from cheaper foreign markets, thus accumulating foreign-currency liabilities that were not balanced by foreign-currency assets. However, firms were also driven by reduced earnings resulting from a series of external and internal factors to seek lower financing costs. For a number of reasons, the growth of export earnings dropped markedly after the mid-1990s throughout the region. While the 1990–1991 recession in industrial countries had little impact on Asian export growth, paradoxically trade started to slow when recovery started in those countries in 1994–1995, because of a decline in their import propensities. For many countries it was also becoming increasingly difficult to maintain competitiveness in labour-intensive manufactures because of the entry of low-cost producers. This was reflected in the emergence of the global excess supply and rapidly falling prices of many of the manufactured products exported from East Asia. Dollar prices of semiconductors, which accounted for more than 40 per cent of exports of some countries in the region, fell by 80 per cent in 1996. Many East Asian firms reacted

to loss of competitiveness by augmenting investment in productive capacity in the hope of increasing productivity and market shares, and by expanding into new areas of production, but added in the process to global excess supply. In a sense the process was similar to the post-Plaza response of Japanese firms to loss of competitiveness; there, too, rapid expansion of production capacity was a key factor in the subsequent financial difficulties.

These structural difficulties were aggravated by adverse movements in exchange rates originating from swings in the dollar-yen rate. Stable exchange rates were an important ingredient of the export-oriented development strategy of the East Asian countries and the regional division of labour. Because of the concentration of Asian exports in dollar-denominated markets, exchange rates in the region, although not fixed, had been generally stable within a band of around 10 per cent in relation to the dollar since the late 1980s. The yen-dollar rate was extremely volatile in the 1990s. Initially the yen appreciated significantly, reaching 80 yen per dollar in the spring of 1995, then fell back to around 130 yen per dollar by the end of 1997 – a depreciation of over 50 per cent. While the earlier appreciation of the yen against the dollar brought an increase in the burden of yen-denominated debt, this was accompanied by lower interest rates and increased Japanese investment in East Asia. By contrast, yen depreciation reduced not only the incentive of Japanese firms to invest in East Asia, but also the competitiveness of those East Asian producers that maintained stable exchange rates vis-à-vis the dollar. Moreover, in the same period China took steps that resulted in an adjustment of the external value of its currency, thus increasing the competitive challenge to East Asian exporters.

However, given that there are many ways of measuring exchange rate misalignments, the extent of appreciation of the currencies in the region is highly contentious. On most counts, it appears that while Thailand and Malaysia had moderate appreciations in the order of some 10 per cent, this was not case in Indonesia or the Republic of Korea. On the other hand, appreciation was greater in the Philippines than in any of the crisis countries.[1] Thus, as noted by a Brookings study: "... if real

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[1] See UNCTAD, *TDR 1998*, box 2. According to a recent report of the Council on Foreign Relations, relative to the 1987–1997 average, the trade-weighted effective exchange rate went up by 9 per cent in Malaysia, 7 per cent in Thailand, 4 per cent in Indonesia and 12 per cent in the Philippines. See Safeguarding Prosperity in a Global Financial System, *The Future International Financial Architecture Report of an Independent Task Force*, Council on Foreign Relations, November 1999: 32–33.

exchange rate appreciation is defined as the critical variable affecting the likelihood of a crisis, the countries that actually experienced crises would seem not to have been the most vulnerable”.[2]

An important question is why the borrowers did not hedge against the currency risk. Certainly, the history of stable exchange rates was a major factor. More importantly, an export-oriented firm that borrows in foreign currency implicitly hedges against foreign exchange risk with export earnings. In this respect, the East Asian firms were in a better position than those in Mexico, where 60 per cent of the liabilities of large firms was in foreign currency, compared with 10 per cent of their total sales.[3] In East Asia the rapid growth in exports was expected to continue, and hence provide continued protection against currency devaluations. Thus, against the background of a decade of relatively stable exchange rates and sustained high export growth, little of the currency risk in foreign loans needed to be explicitly hedged. The same factors also led creditors of exporting firms to consider it unnecessary to explicitly hedge credit risk due to currency fluctuations. However, as export growth decelerated, the implicit hedging decreased, and firms were left with increasing foreign exchange risk exposures. While continued short-term foreign borrowing provided some cushion against their financial difficulties, it also rendered firms extremely vulnerable to changes in exchange rates and international interest rates.

However, not all international borrowers were firms engaged in export activity. There was a speculative surge in the property market supported by borrowing abroad, notably in Thailand. Similarly, some private firms invested heavily in other non-traded activities, notably in physical infrastructure with the funds borrowed abroad. Their exposure to currency risk was thus even greater.

3. Policy errors

Domestic policy errors have certainly played a role in the build-up of external vulnerability and the eventual outbreak of the crisis. Exchange rate policies in the region have been widely criticised for

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[2] J. Furman and J. Stiglitz, Economic Crises: Evidence and Insights from East Asia, *Brookings Papers on Economic Activity*, 1998, 2: 38–39.

[3] See Council on Foreign Relations, op. cit.: 31.

encouraging excessive borrowing abroad and for giving one way bets to speculators. However, it should be remembered that the question of appropriate exchange rate management under free capital mobility remains unresolved. Under free capital mobility, no regime of exchange rates will guarantee stable and competitive rates. Evidence provided by the World Bank and others suggests that currency crises are as likely to occur under flexible exchange rates as under fixed exchange rates, and that flexible exchange rates provide no more guarantee against real appreciation than fixed or pegged rates.[4] Differences among pegged, floating and fixed exchange rates lie not so much in the extent to which they can prevent volatility of capital flows or contain their damage to the real economy as in how the damage is inflicted. The damage can only be prevented by effective regulation and control of destabilizing capital flows.

It is probable that if currencies in East Asia had been allowed to float in the early 1990s, when inflows were in excess of what was needed for current account financing and there was rapid accumulation of reserves, the result could have been further appreciations. Nor is it clear that abandoning the pegs would have reduced the incentives for lending or unhedged borrowing; a vicious circle could have emerged between capital inflows and currency appreciation. Indeed, counterfactual simulations over the pre-crisis period in East Asia show that alternative currency arrangements would not have reduced the risk of overvaluation and currency attacks.[5]

Thus, the main policy error relates to financial deregulation and capital account liberalization. Certainly, financial policies in debtor countries have considerable influence on how much the private sector can borrow, at what terms, and what they do with the money. Indeed, the developments described above were accompanied by fundamental changes in the financial system in the region. The East Asian economies were being urged to follow Japan on a path of financial liberalization, granting financial institutions more freedom in their borrowing and lending decisions, and introducing market-based monetary policy by loosening regulatory controls. In the Republic of Korea the departure from the post-war practice of control over private external borrowing coincided with the

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4 See UNCTAD, : 129.

5 See UNCTAD, ibid.

country's bid for membership of OECD. However, financial liberalization went further among the second-tier NIEs. Thailand created the Bangkok International Banking Facility to intermediate foreign investment expected to be directed to the next tier of Asian NIEs, which might otherwise have gone to Singapore or Hong Kong (China). In reality, it served instead as a conduit for short-term foreign lending to the liberalized Thai banks and finance houses. Offshore borrowing was also encouraged by tax breaks.

Domestic financial deregulation, together with capital account liberalization, was at the root of asset bubbles in some countries in the region. This gave more freedom to financial institutions to diversify their portfolios for higher returns. In view of the high levels of private savings, there was little possibility of expansion of consumption lending, while returns on manufacturing were believed to be on the decline. In South-East Asia, with rapid growth and increasing foreign interest, the commercial and residential property sector emerged as an attractive area of high return. Construction and property development companies thus appeared to be good investments from the point of view of both expected returns and diversification by banks, just as they had appeared to be to the newly deregulated savings and loan associations in the United States a decade earlier, except that, unlike in the United States, they were funded to an important extent by short-term foreign borrowing. The result was an increase in leveraged lending, which made the success of these companies and the banks that financed them dependent on a continuation of the increase in property prices. Banks and property companies were thus extremely vulnerable to a downturn in prices, a rise in interest rates or a depreciation of the baht.

Lack of effective prudential regulation and supervision of the banking system is often mentioned among the major causes of the East Asian crisis. Indeed, despite the fact that the East Asian economies had started to improve their regulatory and supervisory systems far earlier than most other developing countries, these were ineffective in checking the excessive build-up of risk and fragility in the financial sector. However, this is as much a reflection of the well-known limits of prudential regulations in preventing real estate bubbles or exposure to market risk as institutional shortcomings. As seen in Europe in the early 1990s, attacks on currencies can come irrespective of the health of the financial system and the existence of effective prudential regulations. Indeed, Malaysia had effective prudential

regulations in checking short-term foreign borrowing, but these did not prevent the attack on its currency and crisis.[6] Moreover, much of the private borrowing from international banks was by non-bank firms (one third in the Republic of Korea, around 60 per cent in Malaysia and Thailand, and even more in Indonesia) which fell outside the scope of banking regulations.

4. Institutional weaknesses

A number of institutional features of the East Asian economies have been advanced among the principal causes of the crisis, including government-business relation, interlocking ownership between banks and non-bank corporations, and high corporate leverage. These are said to be at the origin of weak corporate governance, implicit government guarantee, moral hazard, excessive risk taking and inefficient and unsound investments.

However, before the outbreak of the crisis, these institutional features of the East Asian economies were often considered among the factors accounting for the Asian miracle. The existence of a robust network of government and business institutions was seen as the key element in the successful management of economic rents and prevention of market failures due to information and coordination problems. Again, it was generally held that concentration of ownership in the hands of inside investors and the internal capital market organized within banks and firms had the advantage of permitting the enterprise to take a long view, ensuring greater efficiency and stability, and reducing the borrower's risk and the cost of investment, compared to the Anglo-American system of fragmented ownership based on stock markets. Extensive government intervention in such financial systems was seen as another form of internal capital market, leading to a more efficient allocation of credit. Finally, high corporate leverage was often cited as an indication of animal spirit and investment drive by the entrepreneur class. It was also thought that in East Asia the way in which public policy was formulated and implemented, and government-business relations were conducted prevented the emergence of corruption, collusive behaviour and inefficiency observed in most other developing countries with similar institutional arrangements.

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[6] Furman and Stiglitz, op. cit.: 29.

What has changed to alter these features of the East Asian economies? A main reason for the sharp deterioration in the performance of such institutional arrangements in East Asia is the dismantling of checks and balances needed for an efficient functioning of such arrangements. The break with past practices is notable in two crucial areas: control over external borrowing and state guidance of private investment. For instance, the Republic of Korea had always tapped external finance in its post-war industrialization primarily through borrowing from international banks, but this was almost always subject to government approval and guarantee. On the other hand, policy always played a major role in coordinating private investment decisions in order to avoid excessive competition and excess capacity. Abandoning this coordination seems to be one of the main reasons for misallocation and overinvestment, while the fact that the government relinquished control over the financial sector explains why the country became vulnerable to an external debt run and an attack on its currency. Again, there can be little doubt that high corporate leverage was vulnerable to a slowdown in growth, but it was already on a declining trend in the Republic of Korea. However, it proved fatal when corporations were allowed to raise money abroad without the traditional supervision and control, treating external and domestic debt as perfect substitutes, even though there was no international counterpart to the domestic lender of last resort to smooth out liquidity problems.

There can be little doubt that in the build-up of external financial vulnerability factors such as overinvestment in manufacturing, speculative investment in property and excessive short-term borrowing abroad played a crucial role. However, the main reason for these was not that there was too much government intervention and control, but too little. This point was also made by Joseph Stiglitz in his 1998 WIDER lecture:

> Some ideologues have taken advantage of the current problems besetting East Asia to suggest that the system of active state intervention is the root of the problem ... But ... the heart of the current problem in most cases is not that government has done too much, but that it has done too little ... The fault is not that the government misdirected credit. ... Instead the problem was the government's lack of action, the fact that the government underestimated the importance of financial regulation and corporate governance. ... The East Asian crisis is not a refutation of the East Asian miracle. The more dogmatic version of the Washington Consensus does not provide the right framework for understanding both the success of the East Asian economies and their current troubles.[7]

[7] J. Stiglitz, "More instruments and broader goals: Moving towards the Post-Washington Consensus", The 1998 WIDER Annual Lecture, Helsinki, January 1998: 3.

C. The outbreak of the crisis and contagion

Despite the clear evidence of increased external vulnerability and symptoms of financial instability, particularly in Thailand, foreign investors continued to pour funds into the region, and sovereign credit ratings remained extremely favourable until early 1997, when pressures mounted and reserves fell rapidly as net capital inflows were not sufficient to meet the widening current account deficits. The crisis broke out in early July 1997, when the Bank of Thailand could no longer maintain the currency within the fluctuation band in view of massive withdrawal of funds.

One can interpret the Thai crisis as a typical balance-of-payments crisis, aggravated by excessive short-term debt and capital account openness – very much like the Mexican crisis of 1994–1995 – while the other economies in the region suffered primarily from contagion. The sudden loss of confidence in Thailand appears to have come out of concern about the fundamentals of the Thai economy, including in particular the current account deficit, which had been rising constantly from 1993 onwards, to reach 8 per cent of GDP at the end of 1996; huge amounts of short-term and liquid foreign liabilities, which exceeded liquid international assets by a large margin; and, to a lesser extent, an appreciated currency.

The deterioration of the current account and the appreciation of the currency were largely the outcome of capital inflows themselves, as well as of external trade and exchange rate shocks. Despite the worsened payments position from 1995 onwards, as noted above, the region continued to receive large amounts of foreign money. What, then, caused the sudden and catastrophic change in the willingness of foreign investors to continue to hold baht-denominated assets? Just as in the case of Mexico, it is difficult to identify a particular cause of the shift in market perceptions. The prevailing political uncertainty was clearly important, but external factors also played a role. Paradoxically, the most important factor in triggering the crisis seems to have been the sudden reversal of the dollar relative to the yen in early May 1997: the dollar fell from around 127 yen at the beginning of May to 114 yen at the end of June – an over 10 per cent depreciation. This was accompanied by widespread

expectations of a rise in Japanese interest rates, and caused the short-term arbitrage funds from East Asia to flow back to Japan, thereby generating strong selling pressure on the baht.

The balance-of-payments fundamentals were better in the other countries of the region, although many of them were financially vulnerable because of a rapid accumulation of short-term foreign liabilities. This was particularly true for Indonesia, where there was little currency appreciation and the current account deficit as a proportion of GDP was less than half of what it was in Thailand. At some 4 per cent of GDP, the Republic of Korea's current account deficit was not much above the levels that had been sustained in previous decades. Malaysia had a greater appreciation and larger current account deficit, but the latter was on a declining trend. The balance-of-payments fundamentals of the Philippines were worse than those of both Indonesia and the Republic of Korea, but its external financial vulnerability was much less. While all the currencies in the region came under attack, it was the extent of external financial vulnerability that was the determining factor in the incidence of the crisis.

The regional contagion operated 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. The Philippine peso and the Malaysian ringgit came under pressure as soon as the Thai move was announced. After market intervention supported by increased interest rates, both currencies were allowed to float. Because it was generally accepted that Indonesia had better underlying fundamentals, particularly regarding its current account, it took some time for the selling pressure to move to that country. The Bank of Indonesia responded quickly, enlarging the intervention band in an attempt to stop contagious speculation – a move widely praised at the time – but soon the rupiah was also traded down.

As the panic spread to the whole region and currencies collapsed, foreign exchange traders and speculators selling domestic currencies were joined by an increasing number of domestic firms and financial institutions 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. This triggered the

downward spiral characteristic of a debt deflation in which firms' efforts to escape insolvency simply worsened their balance sheet positions by driving down exchange rates and asset values even further.

The contagion to North-East Asia resulted from the recognition that the extent of the exchange rate adjustments in South-East Asia had reached the point of disturbing relative competitiveness within the entire East Asian region. First Taiwan Province of China and then Hong Kong (China) came under pressure. For the same reason, the Korean won also came under speculative attack. Although the Republic of Korea had not experienced a speculative property bubble, it had suffered corporate bankruptcies. Conditions were not helped by the announcement by Taiwan Province of China that it would not intervene in support of its currency. As exchange rates came under pressure in the rest of East Asia, markets soon became aware of the similarities in the financial vulnerability as well as the inadequate levels of reserves. The South-East Asian scenario was thus repeated in the Republic of Korea as domestic debtors attempted to hedge or reduce their foreign exposure, causing a downward spiral of currency values. Thus, the implicit assumption of stable exchange rates that had dominated financing behaviour was replaced by the expectation of a free fall, and attempts were made to hedge not only against the current declines but also against the expected future declines, giving an additional impetus to the downward spiral.

D. Conclusions

Perhaps it does not make much sense to try to apportion responsibilities between international investors and the East Asian debtors and governments in the financial crisis. One of the main lessons drawn from the post-war experience of Japan and the Asian tigers was that successful examples of modern industrialization are distinguished by the way integration into the global economy is managed. The main lesson of the East Asian crisis leaves this conclusion unshaken. There can be little doubt that the international financial markets and capital flows are inherently unstable, capable of creating boom and bust cycles and gyrations in exchange rates and asset prices, and real economic crises with far-reaching consequences. This potential threat is much greater for developing countries for obvious

reasons. In East Asia, this threat was overlooked and a large part of the problem came from governments' own efforts to attract short-term capital.

This crisis shows once more that when policies falter in managing integration and regulating capital flows, there is no limit to the damage that international finance can inflict on an economy. It is true that control and regulations over such flows may reduce some of the benefits of participating in global markets. However, until systemic instability and risks are adequately dealt with through global action, close integration may cause more harm than good, and the task of preventing such crises falls on governments in developing countries.