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A portfolio based theory of excessive foreign borrowing and capital control in a small open economy

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Abstract

We develop a simple model of portfolio choice in a mean variance framework to address the issue of international borrowing and financial crisis. Instead of adverse selection or moral hazard of lending and borrowing activities we emphasise the role of exchange rate movement. Syndicated borrowing by way of internalising the aggregate effect tends to restrict excessive borrowing from external source. However, this may undermine the welfare consequences by further aggravating the extent of risk undertaken in the process. There is a built-in externality in the model that leads to over exposure to foreign currency debt and readily calls for intervention by the government. Government intervention by way of a tax on foreign borrowing may help restrain the amount of external debt and implement the first best.
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1. Introduction

Since the Asian crisis hit the world, economists, financial experts and policy makers have been busy reinvestigating the reasons and consequences of intervention in the financial markets. Most of such discussions take the form of exploring what went wrong in the fastest growing segment

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of the global economy. Generally the germ of the crisis has been traced to the classic problems of moral hazard and adverse selection (Krugman, 1998) associated with financial intermediation, etc. and/or to the careless attitude of macroeconomic policies as reflected in overvaluation of exchange rates, associated current account problems, composition of external debt, etc. (see, for example, Burnside et al., 2001; Rakshit, 2002). Although the aftermath of the crisis has drawn attention of the researchers all around the world, the potential of such crises has been explored extensively in the earlier works of financial economists such as Diamond and Dybvig (1983).[1] In fact regulatory mechanisms which prevent run on banks or Tobin's tax which penalises speculation in foreign exchange markets are pretty well known in the areas of banking, finance and international finance.

Typically arguments in favour of unhindered free flow of goods and capital often undermine the role of intervention. In case of a closed economy regulations of financial markets, banks, capital markets, etc. may distort the environment within which trade and exchanges take place. Cause of intervention here has to be justified in terms of some pre-existing distortions which markets cannot fully internalise. In case of a small open economy standard text books do not prescribe restricting trade or capital flows. In trade theoretic terms such intervention does not yield any terms of trade advantage for a typical small economy. They only tax and distort consumption, making it more expensive. However, intervention does occupy a prime position in the theory of international trade and a host of interesting results on theory of tariffs, quotas, trade related subsidies are available for nations which can favourably alter their trading positions through restrictive regulatory policies. But a small country cannot do much in this regard.

A lesson seems to have emerged from the recent discussions on the issue of financial crisis, bank failures and balance of payments problems. It seems that (mis)information has played havoc in Asia. The debt structure of commercial banks was not properly monitored by the regulatory authorities. Mutual funds or those financing real estate boom kept the lenders in the dark. As a result the consequences of the crisis were largely liquidity induced—in the face of capital flight firms could not roll over short-term debt.[2] While rushing to convert Asian assets into dollars, investors hardly looked at the sound macroeconomic indicators of the economies in trouble—a reflection of what is known as "herd-behaviour" (Banerjee, 1992). In case of earlier financial crises (for example in Mexico in 1987), economists have blamed over valuation of exchange rate in a pegged exchange rate regime (Krugman, 1979; Rakshit, 2002). In his study, Rakshit (2002) has, however, argued that informational problems were found to be more important in generating the financial crisis in Asia. Once started in Thailand it spread through contagion effect. In some other studies economists have also expressed similar views (see, for example, Allen and Gale, 1998, 2000, 2002). Informational problems being at the epicentre of such crises, the necessity of intervention evolves around smoothening the process of information flows.

If clients know about the "capital adequacy" index of a bank or a financial intermediary or its true 'net worth' well ahead in time, they should take precautionary action and jumps are not likely to take place. As Krugman (1998) puts it, the limited liability clause coupled with a belief that in time of a crisis the government will step in and save the ailing intermediary leads to too much investment in risky projects. To the extent the regulatory authorities are able to enforce 'transparent' behaviour, the system has lesser of a chance to be hit by a crisis. Without informational problems such as 'noise' of any kind, markets should take care of the anomalies

[1] Classical version of this type of bank runs was discussed in Kindleberger (1978) where it is called "mob psychology" or "mass hysteria".

[2] We are grateful to an anonymous referee for drawing our attention to emphasise this point.

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