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<th>Cambodia liberalization and globalization: limitation and challenges</th>
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You probably all have heard about these terms like Globalization, Liberalization, economic and political jargon. What’s it all mean? In fact, it’s taken place at a pretty unscheduled rate and there’s globalization and liberalization both in terms of labour market, capital market but of course it’s the capital market liberalization that has been much more of an issue in the 90’s. As you know labour, mobility of skilled workers has been quite a problem. In some cases the so-called brain drain problem, which a lot of skilled workers embraced for better pay and conditions and prospects. This brain drain problem has left many developing countries without the human resources and without the skills and knowledge base for development. This is both in terms of upgrading the manufacturing base but very importantly also in terms of the technocrats and bureaucrats that are actually needed to implement development programmes. But of course on the other side there’s been also a large exodus of unskilled labour and this probably has reduced a lot of the pressure of unemployment and importantly has fostered economic development mostly by providing foreign exchange through scarce foreign worker remittances.

In this talk, basically I’m going to concentrate on capital market liberalization.

It’s really the globalization of capital movement that has been vastly more important and has had much more of an impact on the developing countries, particularly of late, with the East Asian crisis. The capital flows to developing countries can actually be divided into three components. I will discuss each of these in turn and then look at some implications and how to foster information regarding what is actually going on in the world economy. Firstly, and the most important for this Indochinese region, is the Foreign Direct Investment Inflow (FDI) - this refers to the establishment of plant and equipment or to net inflow of controlling equity in companies. It also includes the economics of controlling equity as in joint partnership.
Second, there is the Net Inflow of Portfolio Investment. This takes into account changes in Foreign Liabilities for the banks in particular, the private sector and government, and also flows of uncontrolled equity, mostly flows into share markets.

Finally we have Net Inflows of trade credits and loans and official development finance.

Foreign Direct Investment (FDI) is probably the most significant to the IndoChinese economy, given the state of development in the region. But because of the lack of capital markets and capital accounts convertibility, capital inflows for IndoChinese economy is not important as yet but you probably already have heard a lot of what’s happened in terms of the East Asian crisis and perhaps you can learn quite a bit, given that these countries are in the next stage where they have actually got the capital markets and capital account convertibility.

Foreign Direct Investment has been generally seen as positive and this is mostly because it’s also less likely to be prone to reversal in flows. Political stability is very vital for attracting Foreign Direct Investment, As is government policy. What is the government willing to do to actually attract the foreign direct investment? What sort incentives are they willing to give and what is their economic policy, particularly in relation to the micro economic conditions? So, Foreign Direct Investment has been important but its also important to realize that in fact, all this investors are there for profits. That is the main motive of foreign direct investment and therefore when we talk about the positives that are supposed to come out from Foreign Direct Investment, mostly its in terms of technology transfer and providing marketing management and human resource skills. You actually also need the right economic conditions and the willingness to transfer technology. Basically you need human resources and human resources capability and you also need institutions to be actually able to take advantage of any sort of technology transfer that is going on. In fact you already need certain conditions to be there to be conducive for achieving the outcome.

It’s less reversible but it must always remembered that FDI can always be shifted to other locations. A lot of Foreign Direct Investors are continually monitoring what’s going on in the world economy and they are in search always for better opportunities. So the thing is to remember that they can leave just as they came and as the saying goes “easy come easy go”. So you should remember that it’s less reversible but they are attracted by all sort of availability of concessions and in terms of privileges that they can get for example if they operate in Cambodia, they can get the CST privileges and MNF
privileges and government concession but for each country you really need to be accessing what is the costs and benefits of having Foreign Investors in your economy and what sort of changes it makes to your institutions; to make sure that you can benefit from the technology transfer if you can actually negotiate appropriate technology transfer as part of the contracts for accepting these Foreign Direct Investments.

In Cambodia, I understand the Foreign Direct Investment is about 6.9% of GDP with Malaysia in fact surprisingly being the largest investor. Korea and China are also very important large investors. So, this flow you can be reasonably expect to be deflated because of the currency turmoil of these countries. FDI might be less reversible to flows but you have to remember that the Foreign Direct Investors have a lot impact on the micro economic situation as well. This is mostly to the repatriation of profits and is leads to some problems in terms of current account deficit. So the money comes in but the investors do take it out in terms of profits and that shows up in your current accounts deficit. I understand that the current account deficit in Cambodia is pretty massive something like 15% of the GDP. If you are running massive current account deficit to finance, if you like, some of this Foreign Direct Investment and if the FDI is there mostly to exploit cheap labour either directly in terms of labour intensive, textile industries or in terms of assembly of low skill and simply transform manufacturers then with largely imported components the benefits of having foreign direct investors are actually eroded. But this makes it all the worst, if it actually involves exploitation of non-renewal resources, like forestry for instance with externalities in terms of environmental degradation and impacts adversely on the host economies generally.

Even in countries like Malaysia which is the economy I know more about and which is trying to go on the higher level of industrialization, there's been a real struggle for technology transfer in terms of inadequate human resources and institutions to actually make this come about. So, this is something that you in Indochina can probably think of for the future.

So, I’m moving now on to look at the biggest impact of Globalization and Liberalization and that is in Capital Flow. The impact of Liberalization on the financial market on the scale of Capital Flow has actually became a very familiar tale but the phenomenal growth of international capital flows in recent years mostly in 1991-1996, actually makes it a story worth re-telling. It’s the most important systematic transformation of the world economy since the establishment of the New World and the end of World War II with the demise of specially Bretton Wood Institutions.

In 1996 it was estimated that foreign exchange trading to world trade was something like 17 to 1 and greater than all of the total quantitative qualities of the official gold and foreign exchange reserves. So, since the collapse of the Bretton Wood Institutions and
fixed exchange rates, there has been significant exchange rate fluctuations that has become quite common place and regulatory structures which inhibit the flows of this capital flows were challenged as being inefficient and against the national interest. Arising from this challenge, these institutions began to be dismantled and there you have the infrastructure of speculation that was constructed. So, the incentive to deregulate international capital flows was powerfully reinforced by the need to hedge the cost with fluctuations of exchange rates enforced in the private sector. So, under Bretton Woods with a fixed exchange rate, in fact the risk was borne by the public sector but the privatization of risk has now imposed a great strain on domestic banking institutions because they have demanded new financial instruments, which have in, turn, required the removal of a lot banking regulations and regulation barriers.

The World Bank in fact has also become active in encouraging capital market liberalization and international finance corporations have also fostered stock market development in developing countries and encouraged them to open their capital markets.

So free capital markets what is so good about them? Basically, it is meant to ensure that savings are directed to the most productive investments without any regard for national boundaries. So in theory capital can flow from capital rich developed countries to opportunity-rich emerging economies. But if you really look at what has been going on, this hasn’t really been the case. In fact developed countries particularly the U.S. have seen the greatest flow of capital. Flows to emerging markets have proved to be volatile with investors really reluctant to purchase anything but the most liquid of financial assets. So Liberalization has led to a wide range of opportunities for savers. There has been proliferation of pensions funds and other funds which pursue a persistent search for new investment opportunities with high return and easy exit. So low cost for borrowers has not really materialized as such. There has been a greater sophistication on financial instruments that have come about and this includes derivatives for hedging. Its not so much that financial liberalization has been accompanied by the benefits of growing numbers of derivatives but rather liberalization has actually meant that the fluctuating exchange rate has created many risks and derivatives are actually designed to hedged this risk. This actually creates a lot of complex problems for both management and regulators, there’s also been a lot of autonomy of government in terms of pursuing the economic policy as investors can actually withdraw funds if they perceive that government policy is expansionary/inflationary or that the government policy is something that don’t approve of. While this may be construed to increase policy discipline, Governments may be worried in terms of what they do or how the impact on foreign investors. It also means that it holds the policy of legitimately elected government and markets generally known to have poor expansionary rate policy. Markets are also known to be erratic and waves of excessive optimism can be easily followed by waves of excessive pessimism and this can be exacerbated by overheating, particularly in exchange rates and speculations.
So if you think about of what’s going on today with the liberalization, the speculation can be filled with large exposure for a very little capital so you can have very little capital but can raise quite a bit of it in terms of borrowing or using derivatives for instance. Markets also known for using or having the tendency to act on herd instincts and basically they are there to guess what the average reactions would be and to act accordingly. This herd mentality actually means that its not really based on any sort of sophistication in terms of integrity or economic data. To sum up, markets are volatile and can react roughly with no proper evaluation of the fundamentals and can lead also to a contagion effect and as markets became more globalized their contagion effect can impact on whole regions. It's amply demonstrated by the currency crisis in East and South East Asia and contagion spreading from Thailand to different economies like Korea and Malaysia, Indonesia etc.

Basically they look at the whole region and perhaps some of the common features prevailing there and there’s a herd reaction. In fact if you look at properly managed globalization, this can actually create some sort of virtuous cycle and the market can discipline, can actually enhance financial systems. If everything works according to the theory, then this is the real rule. If you are looking at what is actually the case in a lot of developing countries, there is a problem in terms of major debt and inefficiency in their financial systems. Many developing countries lack perhaps the institutions to regulate their financial systems. But there is also a lot of information uncertainty in global markets as well, so this combination actually leads to some very devastating results.

Advanced economies have actually evolved a variety of financial markets. They have markets for government security, sport and foreign exchange rate markets, markets for corporate securities, equities, mortgages insurance, derivative instruments like futures and auctions.

There’s a wide variety also of financial intermediaries and banks in industrial countries must be compete with other institutions and markets both as borrowers and lenders and this competition tends to improve the efficiency of intermediation by increasing the breath and depth of markets and to reduce the sensitivity of the financial system to adverse shocks.
Industrialized countries also have adequate legal and regulatory frameworks to support these markets, most developing countries however have gaps in the structure of their financial systems and lack the adequate regulatory frameworks. Banks are the core financial intermediaries, virtually in all these countries and a sound banking sector is probably the single most essential element in well functioning systems.

They transform maturities by borrowing in relatively liquid instruments demanded by savers, such as demand and time deposits and then taking the funds generated to provide credit for borrowers. In doing so, banks are supposed to perform a crucial function. But if you think about what’s going on in the banking systems in developing countries, it is not a very competitive system and also perhaps the credit is not necessarily directed on risk and return but is sometimes based on government fiat and the directed credit is sometimes going to influential individuals with the right connections.

In East Asia, a lot of money went in index capital flows with short term and they went into very unproductive sectors. What is known as unproductive in a sense that it’s not going to generate future, goods and services and it’s not exportable. So a lot of it went into real estate and construction as well as credit to purchase shares and a lot of this short term mentality has meant that the banks have said, “here is the collateral, this is a good short term return lets lend money to these sectors”. Basically that’s going on to produce a lot of asset bubbles and when capital reversal occurred together with the recession then you have the problem that the burst bubbles have actually caused and there will be massive bank loans, rendering the central banks quite incapable of raising the necessary foreign exchange.

Basically a lot these economies were pegged to the US Dollar when the capital reversible occurred and capital plight of the investors occurred. The correct response if you so believe in that sort of theory is to raise your interest rate. But if you have banking systems that are very fragile, raising interest rate will cause default on the loan or having more bad loans to contend with. This actually means a closer banking supervision. So where does the short term capital inflows end up? It must always be remembered as with the FDI, this is borrowed money and in some way it has to be repaid. Has it actually gone to productive investments? And with the very high savings rate in East Asia, have we really needed this Capital Flows? Could East Asia have done just as well by not having Capital Flows but using the very high savings rate internally to good effect or putting into very productive type of investments?
Developing countries generally have been characterized by very strong policy formulation but weak policy implementation. I think there’s a quite a lot of difficulty in terms of overcoming it and what happens when your policy implementation fails and you realize the worst has happened, as in East Asian crisis. Then you’ll know it can actually culminate in an IMF bail out, when the IMF is called. But what happens next? There’s a lot of debate as to the role of IMF and what it has done in East Asia.

But essentially what is going to happen is that the largely private sector did in the East Asia case ends up being borne by public sectors and justified to avoid the stigma of bail out. In fact, what happens is the sharp contractions that results leads to a lot of social dislocation, increase in poverty and increasing economic inequality and basically the people who benefit from this are going to be the banks, mostly in developed countries that have actually lent the loan in the first place. So, the contractions are actually borne by the countries that have borrowed the money. There’s a lot of talk up about the East Asian countries crises that in fact Asia borrowed too much money. There was this crony capitalism that is going on and money has not gone to the most productive users. Borrowers should do their sums as well, they do know what the situation is, or if they don’t, they should, and there’s where they put their money.

Crony capitalism before the East Asian crisis was seen as quite a facilitating feature of East Asian economic growth. But after the crises it was called crony capitalism. Bank should know if they lending too much or we borrowed too much or where is the money going. So why it is that the borrowers haven’t actually paid such as high price as you think? These should be some sort of sharing of this burden.