Comment on "The East Asian Crisis—Two Years Later," by Eisuke Sakakibara

Andrew Berg

Two themes run through the article by Eisuke Sakakibara. One is that crises in emerging markets, both the recent Asian crises and, implicitly, those we may have to worry about in the future, are driven not by fundamentals but by "hot money" and irrational "jumps" between different equilibria. While Sakakibara gives an occasional nod to weak banking systems and other structural problems, these are largely a sideshow.

The second theme is the importance of regional—in particular, Asian—responses to the problem of how to manage international capital markets.

The Pure Liquidity Response

Sakakibara's view is that liquidity shocks, almost alone, caused the Asian crises, so that a pure liquidity response would have been appropriate. But it would be a mistake to conclude that all the analysis over the past couple years has led to a consensus around this view. Just as bank runs in the United States before the creation of the Federal Reserve System in 1914 often came not out of the blue but in response to perceptions of real weaknesses, so real weaknesses were a key part of the problem in the Asian crisis countries.

These countries showed deep problems before the crisis, not just inadequate reserves and excessive short-term external debt. Thailand, of course, along with Malaysia, showed important signs of traditional macroeconomic problems, particularly exchange rate overvaluation and excessive current account deficits. In work with Catherine Pattillo, I have shown that problems with traditional macroeconomic fundamentals in these countries led to a high risk of crisis (Pattillo and Berg 1999). In contrast, Indonesia and the Republic of Korea presented few signs of tra-

Andrew Berg is deputy division chief of the Developing Countries Studies Division at the International Monetary Fund. At the time this paper was written he was deputy assistant secretary for East Asia and Latin America at the U.S. Department of the Treasury. The interpretations expressed here are entirely those of the author and do not necessarily represent the views of any organization with which he is or has been affiliated.

Annual World Bank Conference on Development Economics 2000

ditional macroeconomic vulnerabilities. But a range of studies of the precrisis situation, from the study by World Bank economists Stijn Claessens and Tom Glaessner (1997) to the prescient book by Adam Schwarz (2000) on Indonesia, outlined the deep structural weaknesses in these economies.

Sakakibara recognizes these issues. But he takes a couple of positions that cast doubt on their importance: First, while plenty of countries have structural weaknesses of this kind, not all of them have crises. Second, these weaknesses had been around for years or even decades, so they cannot explain the timing, at least, of the crises.

The obvious resolution of these two points of view is that structural weaknesses set the stage, but that the timing was a function of external shocks, contagion, and other factors. But against the argument that illiquidity was the only key consideration, consider the case of Malaysia. It is not quite right to say, as Sakakibara does, that while plenty of countries had weak banking systems, only the currencies of the illiquid countries were attacked. Malaysia, with short-term external debt at less than half its reserves, did not have a serious external liability problem. Yet it suffered a crisis about as severe as Korea's and only a bit less so than Thailand's (with severity measured by decline in real output). Moreover, in many of these countries, notably Korea, underlying problems were intensifying.

It is surely true, nonetheless, that illiquidity—measured, for example, by a high ratio of short-term external debt to reserves—played an important part in the incidence and severity of the crises and that stability and growth could not be restored until substantial foreign liquidity was provided. But should providing liquidity have been the entire response?

The pure liquidity response—to what was then an incipient crisis—is exactly what Thailand attempted through late 1996 and early 1997 and, indeed, what Korea tried until late 1997. It didn't work. As these cases show, a country can easily run through huge stocks of reserves defending its exchange rate or accommodating capital outflows through sterilized intervention—that is, by selling reserves (or using other, less transparent mechanisms) while preventing interest rates from increasing significantly.

An adequate infusion of liquidity would presumably have bought substantial breathing room. But the amount of foreign exchange that would have had to be available would have dwarfed the already huge financial support programs. It might be argued that availability alone would have been enough to stem the outflows. But while there is surely some truth to this argument, experience in Mexico (in 1995) and elsewhere suggests strongly that merely promising money is not enough; there are always uncertainties about its true availability. Substantial disbursements are also required, as well as substantial progress in economic reforms.

The Need for Conditionality

Sakakibara spends little time on the role of macroeconomic and structural conditionality, a well-worn topic. But he makes two interesting points with respect to

Malaysia. First, he emphasizes the importance of financial system reforms and efforts to improve transparency and reduce corruption in turning things around in Malaysia. It is reasonable to suspect that in the other crisis countries the large official financing packages reduced the need and therefore the incentive to engage in this kind of difficult reform. This implies a role for conditionality.

Second, Sakakibara lauds Malaysia's lack of macroeconomic austerity. Indeed, Malaysia's monetary policy response was somewhat weaker than those in countries with International Monetary Fund (IMF) programs. While the depreciation of the ringgit was relatively large, reflecting this fact, Malaysia did not therefore have a much smaller recession than the other economies. Indeed, given Malaysia's apparently somewhat stronger initial conditions—in particular, the absence of major external vulnerability—the size of its recession is surprising.

One need not be obsessed with the problem of "moral hazard" to worry about disbursing large loans with no conditions to economies with a deeply troubled financial system—in particular, profound problems relating to the government's role in the system. Perhaps the immediate problems could have been avoided with huge increases in the financing packages available and no structural or macroeconomic reforms. But the adjustments that the recipient countries would eventually have had to make would have been that much larger.

While large, unconditional liquidity support may have theoretical merits, there are also practical limits. The experience in Mexico and Asia showed that political accountability requires that assistance be conditional. The Mexican experience also gave many people a greater appreciation for the importance of having the crisis country and a third party, such as the IMF, work out the conditions.

Capital Controls and Currency Arrangements

Given the roots of crises in external factors and liquidity problems, what are the possible responses? Sakakibara proposes various kinds of solutions to the problem of unstable global capital markets. Here I focus on just a few.

One solution that he proposes is capital controls, but I fear that he fails to come to grips with the issues. Although he makes much of the Malaysian experiment with capital controls since the crisis, there is a much broader set of experiences with capital controls of various kinds, and these have produced several lessons.

First, capital controls cannot prevent large outflows that would normally occur, particularly of capital held by residents, from countries with fairly well-developed financial markets. Second, while controls on short-term capital inflows may at times be justified as prudential measures, they are by no means a panacea: Thailand enacted such controls in the mid-1990s. Moderate controls, such as the famous Chilean-style tax on short-term capital inflows, have small effects at best. Finally, while financial liberalization can be dangerous and is easy to get wrong (such as liberalizing short-term bank lending before foreign direct investment, as in Korea, or giving favorable treatment to short-term external liabilities, as in the Philippines and Thailand), there is little serious debate about the first-best goal: a modern, open financial market, both domestically and, ultimately, internationally. Even China and Malaysia, for example, are firmly on the path toward this goal.

Nothing in Malaysia's limited experience in the past few years contradicts any of these conclusions. Malaysia's controls on outflows went untested. They were imposed only after the exchange rate had been largely stabilized, with broadly appropriate supportive policies, and during a time that most currencies in the region were tending to appreciate. That no parallel markets emerged suggests not that the controls were remarkably effective, as Sakakibara implies, but that they were not on the whole binding, having been imposed when the worst of the crisis was over and appropriate fundamental reforms were under way.

The upshot of these conclusions is that capital controls are not a real long-term solution to global financial instability. Liberalization is risky and should be pursued carefully, but for countries that have already gone far in this direction, as the Asian crisis countries have, capital controls are no solution. Measures to reduce the risks associated with short-term flows are reasonable but not likely to make a big difference, and adoption of a Chinese-style system of comprehensive capital controls is inconsistent with long-term goals of developing modern financial markets.

Sakakibara also proposes regional currency arrangements. He suggests that while a regional currency union is a long way off for Asia, the region might want to work toward an arrangement of regionally pegged currencies—similar to the precursor to the European Monetary Union—backed by the sharing of reserves or regional swap arrangements. Second thoughts are in order here. The European system proved extremely unstable initially, of course, and its experience suggests that only the near-term goal of a common currency can "anchor" such an arrangement. Moreover, in Europe countries followed Germany's lead in monetary policy. In the absence of such a clear leader, a tremendous degree of political cooperation and discipline would likely be required.

Conclusion

In contrast with a few years ago, most countries in Asia are heading toward a similar long-term development model. While the application of this model will certainly have "Asian characteristics," these characteristics will be less pronounced than in earlier models: Asian countries now generally recognize the need for deeper financial markets, including a greater role for bond markets, and for regulation and supervision in place of the more intimate and multifaceted relations between the state and the financial sector. And rule of law has a stronger place.

How do we avoid crises, and how do we deal with those that do occur? Most of those debating the issue, including Professor Sakakibara, share a consensus on what is needed: more attention to national balance sheets, less dependence on short-term capital flows, more transparency, stronger banking systems, and so on. Do capital controls have a much bigger role to play? Probably not. Will there be a regional currency regime in Asia backed by a regional monetary fund or central bank? Probably not for decades.

History suggests that crises cannot be avoided entirely. Clearly, however, we need to do more to avoid them and to mitigate their impact. Unfortunately, much of what is necessary may not be exciting new initiatives but more determined attention to boring old lessons.

References

Berg, Andrew, and Catherine Pattillo. 1999. "What Caused the Asian Crises? An Early Warning System Approach." *Economic Notes* 28 (3): 285–334.

Claessens, Stijn, and Tom Glaessner. 1997. *Are Financial Sector Weaknesses Undermining the East Asian Miracle?* Washington, D.C.: World Bank.

Schwarz, Adam. 2000. *A Nation in Waiting: Indonesia's Search for Stability*. Boulder, Colo.: Westview.