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Asian Financial Crisis

Gregory W. Noble and John Ravenhill (eds), ***The Asian Financial Crisis and the Architecture of Global Finance,*** *Cambridge University Press, Melbourne, 2000*

Reviewed by ***George Fane***

The distinctive feature of this study of the Asian financial crisis is that both of the editors and most of the contributors are political scientists. Seven out of 11 chapters focus on why countries chose the policies they did choose, and most of these chapters deal with particular countries, or comparisons between pairs of countries. The remaining four chapters, which deal mainly with general economic issues from a regional perspective, are the editors' introduction, Stephen Grenville's chapter on capital flows, a partial defence of the role of the IMF by Barry Eichengreen (who was director of research at the IMF during the crisis), and Benjamin Cohen's study of monetary and exchange rate policies.

The political science focus gives the book a different flavour from those written by economists, who usually try to explain why chosen policies had the effects that they did, rather than on why they were chosen. As a result, this book fills a gap left by the more numerous economic studies. My main criticisms are that the quality of the chapters is uneven, and that the editors should have gone even further than they did to make their political science contributors focus on their area of comparative advantage: explaining policy choice by governments. Overall, however, it is one of the more useful books to be written on this very popular topic.

The editors' introductory chapter provides a useful overview of the (mainly economic) literature on financial crises and policy responses to them. Several chapters, including this one, note that there has been a long-running debate between those who argue that the 1997-98 Asian crisis resulted from fundamental weaknesses in the crisis countries and those who argue that it resulted from self-fulfilling panic by foreign and domestic investors. The two positions are reconciled in Goldstein's 'wake-up call' hypothesis: a crisis in one country provoked panics among investors in countries believed to have similar weaknesses, but panics were only self-fulfilling in countries with fundamental weaknesses. Countries like Hong Kong, which had sound banks and credible macroeconomic policies, successfully resisted speculative attacks. Noble and Ravenhill argue that the main weaknesses that distinguished the countries whose financial systems collapsed from those that survived were large foreign debts, relatively small foreign exchange reserves, the absence of capital and exchange controls, the absence of financial repression and the absence of effective prudential supervision and regulation. Of course the correlation between these

factors and the occurrence of crises was imperfect, and in some cases, the medicine – even if it is effective – may be worse than the disease. Noble and Ravenhill do not suggest that financial repression is desirable, and in my view capital and exchange controls are also an excessively blunt way of trying to prevent crises. I would add to the editors' list of factors that contribute to vulnerability, the absence of an effective system for resolving bankruptcies.

Stephan Haggard and Andrew MacIntyre argue that political constraints that limit the ability of governments to respond to crises are an important source of the fundamental weaknesses that can lead investors to panic and make panics self-fulfilling. They set out to apply this thesis to policy making in Thailand and Korea. They argue that in Thailand's case, governments based on coalitions of weak political parties were unable to take decisive actions, while in Korea's case, similar effects resulted from internal divisions within the ruling party. Haggard and MacIntyre's argument would be more powerful if they–or anyone else–could be sure which policies would be effective in restoring investor confidence once a crisis has begun. Promising to bail out banks helps in the short run, but generates increased moral hazard in the long run; tight monetary and fiscal policies risk being counterproductive, while expansionary policies might lead to hyperinflation. A second problem with the 'political weakness' theory of crises is that it is very hard to obtain objective measures of political weakness. After the event it is always possible to point to weaknesses in any government. If, for example, Indonesia had resisted the crisis and Soeharto had remained in power, many people would have seen this as further evidence of the advantages of his firm hand. Instead, Soeharto's fall and Indonesia's collapse have become the main evidence used to demonstrate the ill effects of crony capitalism.

The chapter that focuses mostly clearly on policy choices is also the one I found most interesting. This is Noble and Ravenhill's study of Korea and Taiwan. These countries provide a better basis than Thailand and Korea for testing the importance of political factors because their performances were so different: Korea's financial system collapsed, while Taiwan's did not. It also helps that the authors focus more on policies that contributed to vulnerability or strength in the decades before the crisis, rather than on the more difficult question of how to contain a crisis that has begun. Their thesis is that the Korean government's adoption of relatively risky economic policies and the Taiwanese government's preference for very cautious economic policies arose from differences in government-business relations in each. The Korean government opted for 'big push capitalism', i.e. rapid industrialisation on a broad front. Beginning with the heavy and chemical industries drive in 1973, it tried to pick winners by licensing monopolies, or oligopolies, in each industrial sector. As a result of this strategy, the economy was dominated by business conglomerates ('chaebol'). Because the government channelled resources to favoured enterprises by directing banks to lend to them at low (and often negative) real interest rates, the conglomerates were financed mainly by debt, rather than equity. Because the conglomerates were highly leveraged, and because the banks had had to lend to them at low interest rates, Korea was highly vulnerable to a rise in world interest rates. In addition, the

policy of holding down domestic interest rates encouraged the build-up of foreign debt, by discouraging savings and raising investment. When capital controls were partially eased in the 1990s, the government kept tighter controls on long-term borrowing and inward foreign direct investment than on short-term borrowing. As a result, Korea's foreign debts were mainly short-term, and were therefore not renewed when the crisis occurred.

The Taiwanese government never encouraged the growth of large private conglomerates. Relative to Korea, the state owned sector in Taiwan was larger and private firms were smaller and more numerous. The banking sector in particular was dominated by state owned banks. Small firms were able to play a large role in Taiwan partly because technological know-how was provided by quasi-public research organisations. Noble and Ravenhill attribute the decision to maintain a relatively large state sector and a private sector dominated by small and medium firms to the strong party discipline and dominance in domestic politics of the ruling Kuomintang party, which was strong enough not to need a partnership with the private sector. They attribute Taiwan's cautious macroeconomic policies, and its decision to hold foreign exchange reserves of almost $100 billion, to its vulnerable external situation: 'its diplomatic isolation meant that it could not hope for aid from the IMF, Japan or the United States' (p. 102). They do not comment on the irony in this explanation for Taiwan's ability to resist the crisis, given the discussions in other chapters of the alleged need for a new global financial architecture to ensure that other emerging markets can count on external aid.

The chapter by Thomas Callaghy describes how the US government pressured the international (but mainly American) banks that were Korea's major creditors, to renegotiate (i.e. partially forgive) their loans to Korea in late 1997 and early 1998. It then deals with the Japanese government's reluctance to force analogous debt forgiveness on the international (but mainly Japanese) banks that were Indonesia's main creditors. This is one of the most interesting chapters because Callaghy appears to have contacts that allow him to give what seems to be an insider's account of the negotiations. According to Callaghy, the Paris Club of official creditors rescheduled Indonesia's official debts in September 1998, but to avoid embarrassing the Indonesian government, it agreed to a half hearted pretence that the negotiations did not involve the full Paris Club, but rather the 'Group of Creditor Countries to Indonesia'. Callaghy notes (p. 228) that 'all the press coverage referred to it as a Paris Club rescheduling, which it was'. It is a pity that this chapter is marred by repetition and careless inconsistencies: the data on external debts on pages. 215-6 are contradicted by the data in Figure 10.1, which itself involves glaring inconsistencies that any reader will be able to spot at once.

Among the chapters by the economists, I found Grenville's wholesale rejection of conventional economics too negative to be useful. He asserts that the massive capital flows in the lead-up to the crisis cannot be understood in terms of conventional equilibrium adjustment processes, but does not provide a theory of disequilibrium adjustment. He also rejects the portfolio model of exchange rates, the efficient markets hypothesis and the uncovered interest parity principle,

without suggesting what should replace them. He scorns the idea that interest rate differentials are the best predictor of exchange rate movements, but does not say what is.

The 'new architecture of international finance' is the subject of the chapter by Miles Kahler. Kahler lists what the former managing director of the IMF, Michel Camdessus, called its five core features: transparency, prudential regulation of the financial sector, 'involvement of the private sector' in the cost of crises, cautious and orderly liberalization of capital flows, and the implementation of codes of international best practice. In my view, Kahler is not sufficiently critical of the alleged economic benefits of the proposed new architecture. For example, 'cautious and orderly liberalization' looks like a formula designed to cover up the fact that those using it have avoided analyzing the difficult question of what capital controls, if any, are optimal. If, as Kahler seems to believe, some controls are desirable, then liberalization is only desirable if existing controls are excessive and even 'cautious and orderly' liberalization is undesirable once existing controls have been reduced to those that are optimal. The question for Kahler and the IMF is what controls are optimal.

The new architecture is also discussed by Callaghy and by Eichengreen. Callaghy notes that in 1999 the IMF was 'encouraging' Ecuador to default on its bond debt service as a condition for continuing assistance. It is easy to see that this way of 'involving the private sector' in the cost of crises has short-term benefits to the IMF and the governments of the G-7 countries. It is much harder to see how such official encouragement of default could be part of an optimal international financial structure, and it is a pity that none of the contributors tackled this question head-on.

Kahler's chapter focuses on the political implications of the new international architecture. He argues that, if fully implemented, fiscal and financial transparency would revolutionise politics and government in developing countries. He is therefore sceptical about the likelihood that it ever will be fully implemented. Of course, governments might implement the new architecture if they thought that it would work, or in Kahler's terms that it would provide 'insurance' against potential future crises. Kahler seems not to notice the irony in his dismissal of this possibility: 'Unfortunately, any benefit from insurance is both uncertain and distant'. So much for the new international architecture!

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