REZENSIONEN - BOOK REVIEWS

Agénor, Pierre-Richard, Marcus Miller, David Vines and Axel Weber (eds.), The Asian Financial Crisis. Causes, Contagion and Consequences. Cambridge, New York, Melbourne, 1999. Cambridge University Press, XXVIII, 417 pp.

Reviewed by Marcel Fratzscher in Weltwirtschaftliches Achiv 2000, Vol.136 (4).

The book is an excellent collection of many original papers on the Asian crisis. It covers the main debates and controversies still surrounding the crisis, including the extent to which domestic policy mistakes and fundamental weaknesses caused the crisis (Parts One and Two); how the crisis may have spread contagiously not because of the strength of countries' fundamentals, but due to their interdependence (Part Three); and finally, what policy changes are needed, in particular by international institutions such as the IMF, to reduce the risk of future crises and to resolve crises more effectively (Part Four). Although one may not agree with all the conclusions drawn by the papers, the book is highly stimulating and worthwhile reading for anyone interested in financial crises.

In PART ONE, there is a remarkably strong consensus among all four chapters that the domestic cause of the Asian crisis was not only the weakness of the countries' financial sectors but also the pursuit of fixed exchange rate regimes, tight monetary policy and open capital accounts (the inability to achieve these three objectives simultaneously has been referred to as the "Impossible Trinity") together with the moral hazard created by explicit and implicit bail-out guarantees to investors.

Chapter I by Pedro Alba, Amar Bhattacharya, Constantijn Claessens, Swati R. Ghosh and Leonardo Hernandez provides an extensive overview and some compelling data about the underlying vulnerabilities of Asian countries prior to the crisis. Their central argument is that it was particularly the inflexibility of the exchange rate policy together with tight monetary policy that made the Asian crisis inevitable. Faced with substantial capital inflows, countries attempted to sterilize these inflows in order to avoid excessive inflationary pressure. Tight monetary policy led to a significant interest rate gap between domestic and foreign rates that further encouraged capital inflows and a buildup of foreign currency debt, which raised the countries' vulnerability to capital flow reversals.

Jenny Corbett and David Vines in chapter 2 add two important arguments to those of chapter 1. First, they claim that moral hazard, created by explicit and implicit bail-out guarantees, induced excessive and unprofitable investment because investors considered only the case of a positive outcome of their investments and discounted their potential failure as in the latter case the government would bail them out. Second, Corbett and Vines argue that what made the crisis so severe was the interaction of a financial sector collapse and a currency collapse. What caused these collapses, according to Corbett and Vines, was the failure of governments to establish an anchor after an initially modest devaluation (such as the inflation anchor adopted by the UK after their forced exit from the ERM in 1992), which would ensure investors that the currency will fall no further. The failure to adopt an anchor or credible target led investors to expect loose monetary policy whereas governments actually adopted tight monetary policy (as imposed by

IMF bail-out programs). The result was a continuation of the large currency depreciation, causing a rapid rise in debt that ultimately led to a financial collapse and a far more severe economic downturn than economic fundamentals could have warranted.

The main contribution of Michael Dooley’s chapter 3 is that he goes beyond the analysis of the causes by providing a compelling discussion of policy options to reduce the risk of future financial crises. He believes that the large excessive capital inflows into Asia made the recipient countries highly vulnerable and ultimately caused the crisis. The large capital inflows were the result of the governments' pursuit of the "Impossible Trinity" and the existence of moral hazard which provided investors with three types of "securities": (1) an exchange rate guarantee through fixed currency regimes; (2) a credit guarantee through public bail-out guarantees; and (3) a capital mobility guarantee through the convertibility of capital accounts. Dooley asserts that to prevent a repetition of excessive capital inflows and investments, investors have to be forced to assume some of the risks associated with their investments. Thus governments ought to stop providing at least one of these three guarantees. According to Dooley, it is not possible to reverse capital account convertibility and financial liberalization. It is equally impossible to stop providing credit guarantees, because not bailing-out financial institutions is too costly for the domestic economy and thus not a credible commitment. Therefore, by default, a government facing open capital accounts ought to abandon fixed exchange rate regimes because, in Dooley's opinion, more currency flexibility won't much affect the size of desirable capital inflows, such as FDI, while discouraging speculative inflows.In chapter 4, Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini's hypothesis is that it is moral hazard and weak economic fundamentals, in particular external imbalances and "financial fragility", which caused the Asian crisis. They attempt to test these two hypotheses empirically for a cross-section of 24 developing countries. Unfortunately, the empirical evidence is not compelling for either of the two hypotheses. It may be difficult to test for the existence of moral hazard as it is hard to know what the underlying motivations of investors are. The interaction of various economic variables and the introduction of many dummies that lack a strong theoretical intuition make the evidence for the second hypothesis quite suspicious. The main contribution of chapter 4 rather lies in its convincing discussion of the role of the IMF crisis response and of the controversy over whether or not capital controls could be an effective tool to prevent and to deal with crises.

As an overall critique, the central argument of Part One - that it is the combination of the pursuit of the "Impossible Trinity" and the presence of moral hazard that is the core explanation for the Asian crisis - has two major weaknesses. First, this argument gives far too much weight to the moral hazard argument, which is flawed for various reasons. It ignores the fact that many investors did not enjoy a full or even partial bail-out guarantee and many, especially in Asia's equity markets, indeed incurred large losses from the Asian crisis. Although the moral hazard argument may help us understand why international lenders were so reckless in their lending decisions, it fails to explain why borrowers were so eager to borrow, in particular nonfinancial institutions which mostly enjoyed no bail-out guarantees.

The second shortcoming of the argument of Part One is that what are described as "weaknesses" of Asian economies by some of the papers (fixed exchange rates, high investment rates, large capital inflows and foreign investment, etc.) have as recently as 1996 been seen as the cornerstone of the East Asia's remarkable success story of rapid economic growth and development. The question one therefore has to ask is whether and how these economic policies could turn from a great virtue into a vice within such a short period of time? The answer to this question seems to be that these factors were not weaknesses in and of themselves. They only constituted vulnerabilities that made a crisis possible but not inevitable. The call of Part One to basically abandon and fundamentally alter the policy stance that had proved successful in Asia for so long therefore seems exaggerated.

The theoretical chapters of PART TWO provide a convincing counter-argument to that of Part One. In essence, chapters 5 and 6 show how the onset and severity of the Asian crisis may be explained by the countries' openness to capital flows without requiring the existence of weaknesses in the countries' fundamentals and policy mistakes. In chapter 5, Philippe Aghion, Philippe Bacchetta and Abhijit Banerjee state that a crisis, as experienced by the Asian countries, may be considered "normal" for emerging markets at an intermediate level of financial development. In their model, financial liberalization and capital inflows lead to an increase in investment, higher output and profits, which in turn set off a virtuous cycle of increased investment and profits. The drawback of this process is that the investment boom leads to price increases of non-tradables. At some point the costs of these price increases start to outweigh the benefits from higher output, inducing a drop in profits and investment and thus turning the cycle into a vicious one where investment and output fall dramatically. The existence of high investment rates, good confidence and a non-tradable boom prior to the Asian crisis makes this explanation an important one that has been widely ignored, even if it may not tell the full story of the factors underlying the Asian crisis.

The central argument by Pierre-Richard Agénor and Joshua Aizenman in chapter 6 is that financial liberalization exposes the domestic economy to higher volatility of international financial markets, in particular interest rate volatility. This causes domestic investment and output to become more volatile and magnifies domestic distortions. The theoretical model shows that due to this exposure to increased volatility, financial liberalization may be welfare-reducing and entail significant costs, at least in the short to medium term. Despite the narrow focus, this volatility effect of financial liberalization indeed seems to have played some role in recent crises, and thus the paper is an insightful and original contribution to the policy discussion of crisis prevention and resolution.

In chapter 7, Stephen Morris and Hyun Song Shin provide a fundamentals-based model of currency crises in which a lack of common knowledge about the true state of the economy may, under certain conditions, be sufficient to trigger a speculative attack. Building on their 1998 AER paper, the important contribution of their work is that in the absence of common knowledge investors may want to run on the domestic currency because there is a possibility that some investors consider the domestic fundamentals as unsustainable, even if in reality these fundamentals are compatible with a fixed exchange rate regime if all investors had this knowledge. Thus in this model there are no multiple equilibria, but the creation of uncertainty may be sufficient to cause a speculative attack on the currency. The strength of their model is that it provides an explanation for the precise timing of speculative attacks, which standard second-generation models with multiple equilibria fail to give.

PART THREE on contagion attempts to answer the questions which are left open by the first two parts due to their exclusive focus on domestic factors: what explains the timing of crises and their simultaneous occurrence in countries of the same region? The fact that the papers focusing on individual countries' fundamentals not only lack compelling evidence but fail to answer this crucial question reveals the importance of looking at factors that transmit crises across countries. Little attention has been given to this important issue so far, and the three chapters of Part Three constitute a valuable step towards a better understanding of the international aspects of crises and their dynamics.

Chapter 8 by Paul Masson provides an introduction to the important concept of contagion, i.e. how a crisis can be caused by factors that are external to a country's fundamentals. The main strength of the chapter lies in its categorization of such external forces into factors that lie in industrialized countries ("monsoonal effects"); factors that are due to real interdependence, i.e. bilateral trade and third-market competition, with countries where a crisis occurred ("spillover effects"); and factors that are due to investors changing their perception of domestic fundamentals ("pure contagion").

Reuven Glick and Andrew Rose's chapter 9 is one of the very few papers written so far that offers a systematic empirical assessment and comparison of the role of contagion versus the importance of domestic fundamentals. Glick and Rose find evidence that the spread of some currency crises over the past three decades was due to trade linkages rather than the weakness of countries' fundamentals. However, their measure of trade linkages in some cases produces counter-intuitive linkages as their measure is based only on aggregate data and ignores bilateral trade.

In chapter 10, Ishac Diwan and Bernard Hoekman provide a very thorough analysis of the trade channel of contagion. They make the important point that a devaluation in one country does not necessarily raise the devaluation pressure in closely related countries due to competition, but that this devaluation can actually benefit other countries if their export structure is "complementary", i.e. they produce different goods or sell in different markets. If such complementary effects dominate competition effects, the devaluation of one country may help other regional economies by making the joint product of the region more competitive worldwide. The chapter then argues that Japan's economic weaknesses in the mid-1990s, and to a lesser extent also China's growth for some countries, played a significant role in explaining East Asia's vulnerability to adverse shocks.

Overall, Part Three's argument that contagion played an important role in the Asian crisis is compelling, although future research on contagion should broaden its approach and analyze other contagion channels, particularly those resulting from financial interdependence. The policy implication is that it may be wise to restrict channels of real and financial interdependence through which crises are transmitted and to adopt a stronger, internationally coordinated policy intervention to at least lessen the contagious spread of adverse shocks.

PART FOUR then looks at policy options and implications. In chapter II, Amar Bhattacharya and Marcus Miller argue convincingly that, due to the existence of contagion and investor panic in recent financial crises, what is needed for future crises is a three-pronged approach. First, the

IMF role as lender of last resort (LOLR) should be strengthened to reduce the scope for investor panic and contagion. To deal with the resulting moral hazard problem, they believe that the second element of the approach should be to enable the IMF to function as bankruptcy court in order to signal to investors credibly that they may not be bailed-out. The third element is the creation of orderly debt work-out and standstill procedures to give insolvent countries time to raise funds or arrange a rescheduling of obligations. Only when these three elements are in place will lenders and borrowers have the proper incentives to avoid an excessive build-up of debt and unproductive investments. The authors argue that if the international community fails to adopt such an approach, individual countries may be pushed to prevent excessive vulnerability by enacting substantial capital controls or by even outright suspending capital account convertibility. This latter option would be highly undesirable for both the country itself and for the global community as a whole. The aim of reforming the International Financial Architecture should be to strengthen global integration and to prevent countries from adopting this option, Joseph Stiglitz in chapter 12 very much echoes the arguments of chapter 11, but he goes to the root of the debate on whether or not there is a rationale for public intervention in the international financial system. The strongest point of this essay is that the call by many economists to let markets regulate themselves is logically inconsistent: global integration and financial development means more decentralization of information. The increasingly asymmetric information and incomplete markets do not allow for Pareto-optimal outcomes and provide the theoretical rationale for public action and intervention. While providing better information and transparency is certainly imperative, it is clearly insufficient. The remarkable point is that Stiglitz advocates some types of capital controls in order to reduce the destabilizing effects of short-term capital flows.

In the Round Table Discussion of chapter 13, Richard Portes makes the point that it may be unrealistic to expect any major changes in the International Financial Architecture after the Asian crisis, just as this failed to happen after earlier crises. He believes that this failure together with the IMF's inability to function properly as a lender of last resort makes a market solution the only viable option. Phillip Turner puts forward some concrete proposals to strengthen the regulatory environment. He also emphasizes the difficulties of transparency arising from rapid financial development, such as the growth of derivatives. Finally, Charles Goodhart argues that current financial crises share some features with those of the 19th century. He stresses the importance of orderly debt workouts in resolving crises.

In conclusion, the book makes an important contribution not only to a better understanding of the underlying causes of the Asian crisis but also to the debate on the prevention and resolution of future crises. The different chapters of the book nicely illustrate the controversy that is still surrounding the causes of the Asian crisis. Part One argues forcefully that East Asia's economies exhibited some fundamental weaknesses. However, the fundamentals-based arguments brought forward fail to explain some important aspects of the crisis, in particular its timing, simultaneous occurrence and its irreconcilability with East Asia's past success. Due to these failures, the authors of the contagion papers in Part Three seem to win the debate by arguing that a full explanation of the Asian crisis can only be found by also analyzing how crises can spread contagiously across countries.

The chapters also reveal the significant difference in opinion among the authors in terms of what policies should be adopted to prevent and resolve future crises. Work on contagion is still rare. But if the importance of contagion can be confirmed, it will have highly relevant policy implications as it would require a fundamental change in our thinking about crisis prevention and resolution. As argued by chapters 11 and 12, the importance of contagion means that improving domestic fundamentals is clearly insufficient. The increasingly international nature of crises requires that we create international institutions that are capable of dealing with the issues of crisis prevention and in particular crisis resolution. Many of the proposals in the book focus on the need and the feasibility for the creation of a lender of last resort, an international bankruptcy court, debt contracts and orderly debt work-outs and standstill procedures. Such policies won't prevent the occurrence of future crises, but they should make them far less likely and much less severe than the Asian crisis.

Marcel Fratzscher