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Recent Financial Crises & Their Aftermath

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The series of financial crises which hit the world economy during last two years left us with many lessons to reflect upon. They prompted us to consider how best we could prevent and cope with similar crises which may come back in future. In fact, Finance Ministers and Heads of States from G7 countries who met in Germany recently had intensive discussions on the issue and agreed upon several steps which would be further studied and worked out.

In my view, there are five problems which, in the aftermath of recent crises, are urging us to make a serious reconsideration of our previous consensus. They are, exchange rate regime, treatment of capital flows, international lender of last resort facilities, policy coordination and the reform of IMF.

Crisis-hit countries and regions need a composite package of specific measures to cope with their problems in these five key areas. Many of the problems are of universal nature, but some of them are of country-specific or region-specific nature. The important point is how to devise specific measures which are compatible with the orientation of countries and regions within the globalized economy.

Because the issue of the rethinking of the international financial system has become a focus of global interest as a result of the synchronized crises of 1998 which stemmed from the instability brought about by the East Asian Crisis of 1997 I would like to review briefly relevant features of the five aspects in the context of the East Asian crisis and discuss some of the specific measures which, in my view, seem to be necessary and desirable for policy makers to give thought to.

Exchange Rate Regime

It is a fair argument that in many crisis-hit economies in East Asia the rigidity of exchange rate regime has provided a feeding ground of distortion. Also, the sudden collapse of the rigidity resulted in an exaggerated disintegration of the economy concerned. Indeed, it cannot be denied that the rigidity of the exchange rate regime has inadvertently encouraged the influx of excess foreign capital as it created a fallacy of government guarantee against exchange risk. It also left the economy concerned unprotected against the changes of its international price competitiveness. It is now almost a consensus that the so-called “dollar peg system”, which was followed by many economies in the region, was the culprit of the crime of rigidity and therefore to be blamed. It is true that the “dollar peg system” of crisis-hit economies worked in such a way that it caused damages as mentioned above to the economies concerned.

However, we have to recognize that the real culprit was not the “dollar peg system” per se, it was rather other factors which made the “dollar peg system” a villain. There are two major factors I can cite. One is the internal disequilibrium in the economy concerned, and the other is the volatility of the dollar-yen exchange rate. Even under the fixed exchange rate of the Bretton Woods regime a country was asked to alter the parity when there was a fundamental disequilibrium in its economy. Many crisis-hit economies in East Asia were experiencing disequilibrium which was demonstrated in savings-investment gap, inflation gap, interest rate gap, and the disequilibrium certainly justified greater flexibility of exchange rate. Unfortunately, those economies underestimated the danger of rigidity because they considered that the benefit of rigidity could overweigh the risk which was associated with the regidity. At the same time, while countries in the region had to use two currencies, i.e. dollar and yen for their international transactions, they were faced with wild fluctuations of the dollar-yen exchange rate which tended to induce sudden and involuntary changes of their competitiveness thus exacerbating their disequilibrium. Dollar's value vis-a-vis yen fluctuated from 246 in 1985, to 79 in 1995, and then to 140 in 1998. The dollar-yen exchange rate is primarily a bilateral issue between the U.S. and Japan, and some Americans even argue that it is a Japanese problem because for the U.S. the dollar-yen exchange rate has much less importance than what it has for Japan.

However, I have to argue that at least in the past it was the U.S. who tended to use the exchange rate, together with the threat of protectionism, as a tool of bilateral bargaining.

Therefore, I would argue that, first of all, small and open economies in the region have to remain flexible in their exchange rate arrangement if there are disequilibria in their economy which cannot easily be cured. Equally important point is that the U.S. and Japan need to cooperate more seriously to achieve greater stability and predictability of the dollar-yen exchange rate. So-called “basket approach” may ameliorate the adverse effect of dollar-yen volatility, but the technical difficulty is significant and it will never eliminate the damage completely.

Treatment of Capital Flows

The most immediate cause of the East Asian crisis was the sudden and massive reversal of capital flow. It distinguished the East Asian crisis as a “capital-account crisis” as opposed to “current-account crisis” we often experienced in the past. Of course, in order to understand the whole process of the crisis we have to explore why, in the first place, there was such a massive inflow of capital, how the inflow distorted the internal macro-economic balance, and what has triggered the reversal. Yet we wouldn't be able to deny that if capital flows were better managed than they were the severity of the crisis could have been much less. In this respect I have to note that industrial countries, including policy makers, business, academia and media, were too reluctant and too slow to recognize the important relevance of the issue of capital flows. We should not forget easily the vicious accusation and the cynical mockery directed to Malaysian Prime Minister when he announced the capital embargo for his country in a desperate effort to protect it from speculative capital flows. While I recognize there are still many caveats against the smooth recovery of the Malaysian economy, I have to admit that Malaysia, after the imposition of capital control, has managed to survive the wave of contagion without the help form IMF and has recently succeeded in coming back to the international capital market.

What we need now is an international endorsement of a formula of properly sequenced capital liberalization together with a package of emergency capital control measures. Market-friendly measures such as additional reserve requirement or differentiated interest rate would certainly be a preferable approach. Also, industrial countries can provide valuable advice derived from their own experiences. After all, however, it is the capital importing country who has to ponder the balance between merits and demerits of capital control.

International Lender of Last Resort

When the crisis hit East Asian countries, the first symptom was the acute shortage of foreign currency liquidity. Official reserves were depleted as the result of futile intervention. Sharp depreciation of the local currency has enormously swollen the debt service burden of banks and business firms with unhedged foreign currency debt thus seriously damaging their balance-sheet. Currency crisis and banking crisis reinforced each other. Industries could not finance imports of vital materials, parts, and capital goods. Exporters could not obtain letters-of-credit facilities. Bankruptcies soared. In other words, the real sector of the economy crumbled.

When an economy encountered the onset of crisis as such the most needed dosage is the ample and quick injection of liquidity of foreign and local currencies. The national central bank is naturally expected to play the role of the lender of last resort in local currency. The more difficult question is who should provide foreign currency liquidity. In this respect, the Mexican currency crisis of December 20, 1994 was followed by an international rescue package of 50 billion dollars by January 31, 1995. The strong initiative taken by the U.S. made such quick action possible. Unfortunately, however, in the case of the East Asian crisis such a rescue package did not materialize. I have to argue that it will be unrealistic to expect that a Mexican-type rescue will be always available in future crises. If that is the case, the remaining alternative will be to establish a credit facility financed mainly by countries in the region which have a close tie of interdependence and thus a shared interest. Such facility could well be a regional vehicle of IMF, provided that regional members make majority contributions and hold majority voting rights to ensure a high degree of maneuverability which is the key for success of such facility. Considering 600 billion dollar official reserves held by countries in East Asia I believe that East Asia could be a fitting place to try such an idea.

Policy Coordination

Nobody could anticipate the onslaught of the East Asian crisis. In hindsight we can argue that there were plenty of signals which indicated growing risks and worsening distortions in many countries. Nevertheless, there was no collective sense of concern to prompt preventive or corrective measures. It is indeed a painful reflection for all East Asian countries. Lack of reliable informations and lack of transparency were certainly there. However, the major shortcoming was the lack of forum where countries, sharing common interest, were to conduct continuous surveillance over situations and policies among themselves and to exchange fair and frank advices with the aim to apply peer pressure. G-7 countries have long been endeavoring to establish a framework of mutual surveillance and policy coordination among themselves. The experience of the East Asian crisis, however, has revealed that G-7 type effort alone is not adequate. East Asia needs an additional forum to conduct dialogues more focused and more relevant to the situation in the region. Such forum could be established within IMF as a sub-group of its Board of Governors or Board of Executive Directors and participated also by international financial institutions and regional institutions. Hopefully, such forum could also be assigned to study on how best to devise appropriate exchange rate arrangements, to consolidate and improve settlement system, and to maintain healthy balance sheets of banks and business firms.

Role of IMF

Last but not least, how to improve the function of IMF is a particularly relevant issue when we discuss the reform of the international monetary system. Fifty years ago IMF was established as the guardian of the Bretton Woods regime. The mission was clear. It was to seek after exchange rate stability and balance of payment equilibrium. When the Bretton Woods regime collapsed and when the exchange rate fluctuation and the free flow of international capital became facts of life the original role of IMF became irrelevant. In hindsight, we should have had a fundamental reappraisal and redefinition of roles and responsibilities of IMF. However, under the pressure of urgency created by the series of events such as oil shocks, currency crises, demise of the Cold War structure, etc., roles and responsibilities of IMF have only evolved through incremental process without a clear-cut redefinition. Now IMF is functioning as a sort of all-purpose trouble shooter.

One may argue that it was an inevitable development under the rapidly changing circumstances. However, it is also true that there has been a growing sense of uneasiness about the lack of clear definition of IMF's role in the global economy. The uneasiness was intensified as the result of recent crises because of the mistakes made by IMF in its dealing with certain situations in crisis-hit countries. There are also criticism against the lack of transparency and accountability of that institution.

I have to jump to my own conclusion. I don't think it is a right moment to try to overhaul IMF because there is not even a sense of direction to which the exercise should move. Having said that, I believe it is important and also doable for major shareholders of the IMF to become more involved in the effort to improve the organization and functioning of IMF so that it can be closer to the situation of member countries and can provide more effective services for them.

Interest in the reform of international financial system has mounted several times in the past when the aftermath of a crisis was still around. However, the enthusiasm quickly evaporated as we somehow managed to survive the crisis. If we repeat the same mistake, I am afraid we will regret our negligence when the next crisis hits us.

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