

**CAPITAL ACCOUNT CRISES, LIQUIDITY ENHANCING MEASURES AND
MONETARY COOPERATION IN EAST ASIA**

by

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Authoritative studies on the financial crises in Mexico (1994-95) and Thailand (1997-98) have concluded that that these events are best seen in terms of two distinct stages: an initial devaluation which acted as an adverse signal triggering massive capital outflows and a subsequent post devaluation financial and economic collapse. This post devaluation contraction is incompatible with conventional wisdom which suggests that a devaluation should be the end of the crisis as the depreciated currency ought to stimulate the tradables sector and overall real economic activity. This in turn has contributed to the recent surge of interest in a new genre of currency crisis models which emphasises or attempts to rationalise the over-reaction or “overshooting” of markets and the degeneration of a currency crisis into an outright economic collapse (i.e. “the punishment far outweighs the crime”). Thus, referring to East Asia, the IMF has recently drawn attention to a “new breed of economic crisis” in a “globalised financial market”. These new generation models focus on the “capital account” in contrast to the first two model generations that focus on the “current account”. The Group of Seven (G-7) meeting in Tokyo in 2000 concurred with this analysis. In their declaration entitled “Strengthening the International Financial Architecture” they reportedly noted the need for IMF reforms so that “(i)n future the IMF would be better able to cope with *capital account crises*, such as the Asian crisis which broke just over three years ago” (emphasis added).

It has become commonplace to interpret the new genre of currency crisis models as taking a “bank centered” view of currency crises. While this is far too narrow a perspective and does not to adequate justice to the large milieu of new crisis models, it is not altogether surprising. After all, the high correlation between banking and currency crises (so-called “twin crises”) since the late 1980s and 1990s is a well documented fact, with the causation most often running from banking to currency

crises. What is more, these twin crises are far more pervasive in developing countries compared to developed ones.

There are two broad sub-classes of bank-based models, viz. those emphasising “insolvency” and those dealing with “illiquidity”. The insolvency models are somewhat varied in scope. A popular version draws motivation from the old style crisis models in the sense of focusing on - implicit - fiscal deficits and the consequent inconsistency of the underlying macroeconomic fundamentals with the pegged exchange rate regime. Fiscal deficits in turn result from the ballooning of implicit liabilities due to an actual or anticipated government bailout of the financial sector. In contrast, the *illiquidity* models emphasise bank runs or panics due to maturity and currency mismatches in the balance sheet of banks. In other words, insofar as the foreign currency revenues obtainable in the short term are less than the corresponding short term potential foreign currency obligations, the banks are, in effective, “internationally illiquid”. This sudden termination of bank finance forces the abandonment of potentially solvent investment projects.

Much ink has been spilt over the question of whether the East Asian crisis was due to insolvency or illiquidity. The importance of tackling this question cannot be underestimated as the consequences for economic policy will vary greatly depending on what the problem is perceived as being. On the one hand, in the case of a liquidity crisis, some form of coordination (via lender of last resort functionary, moratorium or standstill on debt, etc) will be able to avert sharp real losses. On the other hand, in the case where banks are insolvent, allowing them to continue operating without restructuring will magnify market distortions and the concomitant fiscal costs of bailout and rehabilitation. Whatever the reasons for the crisis and devaluation, the extent of the post devaluation collapse is exacerbated by the nominal appreciation of

external liabilities which are often foreign currency based and unhedged, slashing the net worth of individuals, corporations and the domestic financial systems at large. This so-called “balance sheet” effect leads to massive collateral damage and outright bankruptcies, which in turn aggravate domestic economic conditions and intensify capital outflows.

While managing a conventional current account crisis involves a judicious combination of *adjustment* and *financing*, dealing with a capital account crisis principally demands the restoration of “market confidence” and is a much more imprecise and complex undertaking. Accordingly, the emphasis is best placed on crisis *prevention* as opposed to *management* or *resolution*. In this regard, it is crucial that emerging and developing countries augment sound economic policies with appropriate financial safeguards to shield themselves from external shocks and adverse shifts in market confidence. Among the more important means of shielding against capital account shocks are those aimed at international liquidity enhancement.

In this light it is notable that the East Asian economies have gradually been strengthening their international liquidity positions by replenishing and accumulating reserves as well as by lengthening the average maturity of their external indebtedness. This, along with the introduction of relatively greater flexibility in the exchange rate regimes (save Malaysia which has chosen to peg its currency firmly to the US dollar), may have eased their near term vulnerability to the destabilising effects of volatile capital flows.

From a government’s perception, an obvious advantage associated with international reserves is that they may be used rapidly and without conditions. This may also appear to be the case with financing from private capital markets. However, it does not necessarily mean that liquidity in East Asia is now adequate to avoid future

crises. Moreover, as the economies of the region continue to recover from the 1997-98 crisis, imports will rise and current account surpluses will tend to fall; the rate of accumulation of international reserves may therefore also decline. In any case, an important limitation of such a reserve-hoarding policy is that it involves high fiscal costs as the country effectively swaps high yielding domestic assets for lower yielding foreign ones. In addition, since the size of international reserve holdings has been found to be a theoretically and statistically significant determinant of creditworthiness, depleting them as a way of cushioning the effect of capital outflows on the exchange rate may make matters worse by inducing further capital outflows. If capital outflows reflect a perception within private capital markets that a country is illiquid, reducing international reserves and therefore curbing liquidity further is hardly likely to be an effective strategy. In other words, the reversibility that makes reserve depletion credible in the context of current account deficits is often absent in the context of capital outflows.

Provision of external financing may, for these reasons, be seen by some as a “public good” and as being appropriately supplied by the IMF so as to solve the first-mover problem, whereby no single creditor or investor is ready to extend the first offer of funds to a crisis economy. The Fund’s response has been to create the Contingent Credit Line (CCL). There are, however, some fundamental drawbacks of such an IMF-based precautionary line of credit. Why should countries sacrifice any degree of sovereignty over national policy and subject themselves to strict conditionality when all they receive in return is an option on a drawing? Since, in many cases, countries fail to implement conditionality for one reason or another, a situation could arise where a country complies with a significant proportion of conditionality and yet is ineligible to draw in the event of experiencing contagion

from a crisis. Of most concern though has been the possibility that by negotiating a CCL a country sends out a negative signal to private capital markets that it is vulnerable to a crisis. The range of *ex ante* conditionality may paint a bleak picture of what is wrong. This may have an adverse effect on capital flows and may contribute to causing the very crisis that the CCL is intended to help avoid. Moreover, there must remain some doubt about whether the facility would be adequately financed. Contagion from crisis has turned out to be more of a *regional* than a *global* phenomenon. And advanced economies may therefore remain reluctant to provide finance when they may perceive the CCL as conferring few benefits on them.

Are there other ways in which contingent credit lines could be established outside the IMF? Some emerging economies including Argentina, Mexico, and South Africa have arranged private lines of credit with international banks. Nonetheless, there are a number of problems with such privately contracted credit lines. First, there may be high opportunity costs involved insofar as the individual countries have to commit certain assets/revenue streams as collateral. Second, calling on these lines of credit when needed could lead to a hike in the country's international risk premium. Third, while negotiating lines of credit with a country, the financial institutions could undermine the effectiveness of these commitments and their net exposures to that country via other channels (through various corporate risk management techniques). Foreign banks themselves could be a source of contagious transmission of crises. For instance, in response to a crisis in one country, multinational banks might attempt to liquidate positions in other regional economies to which they are exposed either to enhance overall liquidity or reduce (perceived) portfolio risks.

In view of the limitations of these private contingent lines, and in recognition of the fact that financial stability has the characteristics of a regional public good,

selected East Asian economies have recently agreed to create a network of bilateral currency swaps and repurchase agreements as a “firewall” against future financial crises. This has since come to be termed the Chiang Mai Initiative (CMI) following an agreement in Chiang-Mai, Thailand on May 6, 2000.

In broad terms, the CMI is aimed at providing countries facing the possibility of a liquidity shortage with additional short-term hard currencies. The CMI extends and expands upon the little known ASEAN Swap Arrangement (ASA) and encompasses all ASEAN countries as well as China, Japan and Korea (i.e. ASEAN Plus Three or APT). The ASA was established in the 1970s to provide short term swap facilities to members facing temporary liquidity or balance of payments problems. In 1977, there were only five ASEAN signatories - Indonesia, Malaysia, Philippines, Singapore and Thailand - each contributing about US\$ 40 million. This facility was increased to US\$200 million in 1978. At the Fourth ASEAN Finance Ministers Meeting in Brunei Darussalam (March 24-45, 2000), the Ministers agreed to expand the ASA to include the remaining ASEAN members, Brunei Darussalam, Cambodia, Lao PDR, Myanmar and Vietnam. In keeping with this expansion, the ASA was enlarged to US\$ 1 billion with effect from November 17, 2000. There are also a series of repurchase agreements (repos) that allow ASEAN members with collateral such as US Treasury bills to swap them for hard currency (usually US dollars) and then repurchase them at a later date. The expanded ASA is to be made available for two years and is renewable upon mutual agreement of the members. Each member is allowed to draw a maximum of twice its commitment from the facility for a period of up to six months with the possibility of a further extension of not more than six months.

This expansion of the ASA is the first step in putting into effect the CMI, which envisages that hard currency lines of credit will be made available to members. In addition to the expansion of the ASA among Southeast Asian countries, the three ASEAN Dialogue partners (China, Japan and Korea) have simultaneously been in discussions aimed at establishing a series of bilateral swap arrangement (BSA) amongst themselves. Japan has recently signed BSAs totalling US\$6 billion with Malaysia, Thailand and Korea, and is planning to add ones with China and the Philippines. BSAs among other members of the APT are expected in the near future. While the maximum amount of withdrawal under each of the BSAs will be determined by negotiations between the two countries concerned, in the spirit of regional partnership, there is planned to be full coordination and consultation among all members when deciding on disbursements.

While the basic idea behind the CMI is clear, the details still need to be clarified. Journalistic accounts suggest that 10 percent of the funds will be available automatically while the rest will be subject to IMF conditionality. Other details of the new swap arrangements, such as the type of collateral that may be required for hard currency loans, the interest rate to be charged, and the number of withdrawals that can be made, are not yet known. However, economic analysis helps to identify some broad principles that need to be incorporated in the initiative.

First, the resources need to be capable of being disbursed quickly. Speed is of the essence in a crisis. Second, the credit lines need to be “sufficiently large” so as to generate confidence in private capital markets and to repel speculative attacks. It also needs to involve sufficient countries to avoid potential problems of co-variance and to allow the pooling of risks. Nonetheless, it remains an open issue as to what is meant by “sufficiently large”. It is unclear as to whether the existing swaps are ample to

tackle future capital reversals. Indeed, during the East Asian crisis of 1997-98, the ASA was not even activated as the financing levels available through these channels were considered grossly insufficient in the face of the massive capital withdrawals experienced by the regional economies. It is for this reason that one component of monetary regionalism has been an expansion of the scheme to include capital-rich North Asian economies like Japan. Third, the rate of interest needs to be “sufficiently high” so as to guard against moral hazard, i.e. an increased readiness of creditors and debtors to court risks (The need to charge prohibitively high interest rates is, of course, the classic rule for a lender of last resort proposed by Walter Bagehot.). Countries need to be discouraged from using such credit lines as a matter of course. Fourth, access to such liquidity needs to be separated from the detailed negotiation of conditionality which would prejudice quick dispersal; links to IMF conditionality may be some cause of concern. However, given the part played in the East Asian crisis by weak and inefficient domestic financial structures, inadequate prudential standards and supervision, there is a strong argument for making access to the credit lines associated with the CMI conditional upon compliance with some minimum set of financial standards. This would encourage countries to push ahead with reforms to their domestic financial systems.

A credible system of regional swaps based on these principles would have two key attractions. Not only would it enable participants to avoid the severe output losses that are associated with extreme shortages of liquidity, but also, by creating confidence that such extreme shortages will not occur, the incidence of crises could be reduced. Of course, confidence would be undermined if the swap arrangements were used to try and defend disequilibrium real exchange rates and the CMI should not, therefore, be a mechanism for inappropriate currency pegging in the region. Again,

the history of bilateral swaps in the context of the Bretton Woods system demonstrates that they are an ineffective means of defending seriously misaligned currencies.

While we will have to wait and see if and how monetary and financial cooperation in Asia progresses, to the extent that such regional arrangements may help reinvigorate interests in strengthening the international financial architecture, they could act as “stepping stones” towards multilateral reforms rather than “stumbling blocs”. Regional arrangements ought to promote greater commitment to and national ownership of programs and conditionality, a point that is universally recognised as being of considerable importance.