# Comment on "Financial Crisis: Towards an Alternative Approach," by Ariel Buira

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Mr. Buira's basic thesis is that the IMF is ill-suited to deal with a crisis of confidence. This is for two reasons: (i) the IMF equates financial crisis with a balance of payments crisis and uses similar prescriptions, and (ii) the IMF first lets the crisis emerge and then introduces adjustment programmes. Therefore, he proposes an alternative approach to deal with a crisis of confidence. This approach has two components. First, investors must be aware of the impact of their actions. This would mean that if a sudden massive reversal of capital flows were to cause a crisis, the authorities of the country in consultation and supervision of the Fund, could force creditors to take certain losses through a bankruptcy type procedure, or impose certain limitations on transfers. Second, an alternative approach to dealing with financial crisis would aim at preventing a speculative attack from developing into a full-fledged crisis by the timely provision of sufficient financial support to sustain confidence coupled, if appropriate, with a policy reform package.

Mr. Buira's analysis makes eminent sense. I will focus my comments in two areas. First, the IMF has changed over the years. For example, much of the balance of payments difficulties in the 1970s could be attributed to structural factors rather than expansionary demand policies. The IMF, therefore, introduced the Structural Adjustment Facility (and Extended Structural Adjustment Facility). Further changes have been made in IMF policies, and IMF programmes now cover financial sector restructuring, strengthening of corporate governance, and other reform measures. Second, the timely provision of funds from the IMF to preempt a crisis, rather than react to the crisis, is a good idea. However, without policy reforms and "conditionality" such actions cannot be effective. The Philippines, after three decades of IMF programmes, recently graduated from the IMF programmes and has a precautionary facility in place.

Mr. Buira also emphasises the need for a prudent approach in dealing with capital flows. Large surges in private capital inflows can complicate macroeconomic management by leading to economic overheating. Also, volatility and reversals in private capital could be destabilising. In fact, this is an important lesson emerging from the East Asian financial crisis.



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Let me now build further on Mr. Buira's analysis by applying it to the East Asian financial crisis.

## Root Causes of the East Asian Financial Crisis

All currency crises tend to be different. But, now a consensus is emerging on the root causes of the East Asian financial crisis. First, the root causes of the crisis in East Asia were structural – weaknesses in the financial and corporate sectors, compounded by policy mistakes in managing private capital inflows and global financial integration. Macroeconomic fundamentals were relatively less important contributory factors. In fact, the region had the strongest fundamentals among the developing regions. Second, the problems in East Asia were not due to fiscal profligacy, but to excessive borrowing by the private sector mainly in the form of short-term capital. Government policies that permitted the borrowing were also, of course, at fault. There was a sudden investor confidence and foreign capital flows reversed in 1997.

The first implication of the differences in the root causes of the crisis is that in the East Asian case, various macroeconomic austerity measures of the IMF had to be complemented by structural measures, including measures to deal with private sector debt and coordination between diversified creditors and debtors. In fact, macroeconomic austerity is only one component of the IMF-led rescue packages to the Republic of Korea, Thailand, and Indonesia. IMF-led rescue packages also seek to: (i) accelerate banking and capital market reform; (ii) promote efficiency in trade and industrial sectors including trade finance; (iii) promote good governance and corporate management; and (iv) mitigate the social costs of adjustment.

Second, structural problems are more difficult to resolve for the following reasons: (a) a set of fully articulated structural reforms is difficult to design in the middle of a financial crisis; (b) the required political and economic consensus might be difficult to achieve; (c) the structural reform agenda will take time to implement, and the results may take even more time; and (d) progress in implementing structural issues will be more difficult to observe and assess.

## Asian Development Bank's Assistance to the Affected Countries

The Asian Development Bank (ADB) has argued, from the very beginning, that the East Asian crisis was a different type of crisis and required a different set of prescriptions. There is now an evolving consensus on this view. Accordingly, the ADB joined the IMF-led rescue packages for Thailand, Indonesia, and Korea and committed over $9 billion emergency assistance


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to support structural reforms and capacity building efforts, and to mitigate the costs of structural reforms.

*Thailand.* The ADB pledged $1.85 billion focused on financial and social sectors. A $300 million Financial Sector Programme Loan was approved on 19 December 1998. A $500 million Social Sector Programme Loan and a $1.0 billion Export Financing Facility was approved more recently. The latter was organised with 10 international commercial banks.

*Indonesia.* The ADB has pledged $3.5 billion over the next three years of which $1.5 to $1.8 billion will be new money. A $1.5 billion Financial Governance Reforms Sector Programme Loan is at an advanced stage of preparation. A Social Protection Sector Development Loan is also being prepared.

*Korea.* A $4.015 billion Financial Sector Programme Loan was approved last December.

Finally, the East Asian crisis has highlighted that contagion tends to be the most serious among neighbouring countries. There may, therefore, be a need to complement individual country and global surveillance with regional efforts. Such an effort will involve peer surveillance and an unique perspective stemming from an in-depth knowledge of local conditions. Under the Manila Framework, and as requested by the ASEAN finance ministers, the Bank is considering the establishment of a regional monitoring mechanism.

## Lessons from the East Asian Crisis

Since the Latin American debt crisis of the early 1980s, the incidence of financial crisis around the world has tended to increase. The costs of such crisis have also increased. These trends are expected to continue in the future as integration of financial markets increases. Globalisation also magnifies the benefits of good policies and the costs of bad policies. It, therefore, places a premium on economic reforms. The non-affected countries should not be complacent.

In terms of macroeconomic responses, a consensus appears to be emerging that responsible fiscal management, supported by monetary sterilisation and some nominal exchange rate flexibility, is an appropriate response to surges in private capital. The Bretton Woods system of pegged exchange rates was successful in maintaining low interest rates globally in an environment where capital mobility was low. That situation does not prevail any more, because most industrialised and developing countries have liberalised exchange controls and regulations on repatriation of profits and interest, and have removed discrimination against investors.

The banking system plays a dominant role in the allocation of capital in



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developing countries, and the health of this system largely determines whether a developing country will be able to exploit the benefits of financial integration and avoid its pitfalls. In many Asian developing countries, since the early 1990s, the financial sector has been partially liberalised and deregulated. However, the banking sector is still very weak and fragile, because institutional development has lagged behind. The poor health of the banking sector needs to be addressed urgently so that vulnerability to globalisation is reduced. Actions are required for: (i) reforming the institutional structure in areas such as the regulatory and supervisory framework, transparency and disclosure of information, accounting systems, market infrastructure, and risk management; (ii) human resource development in various areas such as regulation, supervision and accounting; and (iii) overall governance of the sector to avoid, among others, insider trading and moral hazard types of lending to speculative and corporate sectors. These reforms will take time to implement; hence actions should be initiated now to prepare banks for globalisation. Competition should also be promoted in countries where this is a problem.

Actions should also be initiated to develop well-functioning capital markets to reduce the risks of potential instability in an integrated world. Actions are required in three areas: (i) market infrastructure (where the consequences include high transaction costs, frequent delays in settlement, and outright failed trades); (ii) protection of property rights (in particular those of minority shareholders); and (iii) disclosure of market and company information and control of abusive market practices.

Countries must be prudent in capital account liberalisation. Capital account liberalisation must be sequenced properly. The preconditions for successful liberalisation are: a sound macroeconomic framework consistent with the choice of exchange rate regimes, a strong and well-regulated domestic financial sector, and a strong autonomous central bank. Prudence in capital account means neither a return to pervasive capital controls nor a rush to immediate liberalisation. The role of temporary controls on short-term capital is still very much debatable. An ongoing ADB/World Bank study suggests that such controls could be effective in the short run, but not in the long run.


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