Linda Goldberg and Thomas Klitgaard

Overview of the Volume

The goal of this special issue of the *Economic Policy Review* is to draw some lessons from the recent crises in Asian and other emerging markets that may benefit future decision making in the international economy. The articles in the volume, written by economists from the International Research Function and banking specialists from the Emerging Markets and International Affairs Group, are not intended to address all issues relevant to currency and banking crises. Instead, the authors use detailed data and the rigorous tools of economic theory and econometrics to explore select topics: the mechanisms for transmission of crises across countries, the role of banks in emerging markets, the price and quantity responses observed in the trade flows of the crisis countries, and the impact of emerging market crises on the aggregate and sectoral activities of industrialized countries.

In the opening article of the volume, Paolo Pesenti and Cédric Tille summarize the prevailing views on the causes of currency crises. The first generation of economic models to address these causes attributed currency instability to poor or incompatible macroeconomic policies. In this view, large or persistent fiscal deficits can be in conflict with a fixed exchange rate regime if investors anticipate that the government will ultimately resort to printing money to pay off its past debts. The second generation of models linked currency instability to self-fulfilling private sector expectations of future macroeconomic problems. If investors view a future depreciation as likely, capital outflows and lower output will cause a devaluation that validates the initial investor concern.

Pesenti and Tille then proceed to argue that both the first- and the second-generation models are inadequate for understanding the complexities of the Asian crisis. Specifically, the models overlook two factors that figured importantly in the 1990s: the role of the banking and financial sectors and the international transmission of crises. The authors incorporate these factors in a more synthetic view of the Asian crisis that suggests that policy weaknesses *and* self-fulfilling investor expectations were at play in the crisis. Consider, for example, a country in which a poorly supervised banking system raises investor expectations of future government spending to cover bad loans. Even though the current fiscal deficit may be small, market expectations shift toward larger future fiscal deficits, putting immediate pressure on the country's exchange rate.

A closer look at the role of the banking and financial sectors in emerging economies is provided by the second article in the volume, by B. Gerard Dages, Linda Goldberg, and Daniel Kinney. The authors begin by acknowledging the important and sometimes heated debate in emerging markets about the appropriate structure and ownership of local banking systems. Many economists maintain that opening the financial sectors of emerging market countries to foreign ownership boosts funding for domestic projects and improves the quality and pricing of financial services. Others contend, however, that foreign-owned financial institutions will destabilize domestic bank credit and crowd local institutions out of the most lucrative domestic markets.

Pursuing the theme of foreign participation, the authors observe that in the Asian countries hit hardest by the financial crisis, foreign-owned banks had few direct roles in the local economies. Yet the fact that emerging markets as a group have increasingly been opening their financial sectors to foreign

bank participation leads the authors to suggest that the experiences of these countries may provide some relevant crisis-management lessons for the future.

With this in mind, Dages, Goldberg, and Kinney narrow their focus to Argentina and Mexico—two countries with a significant foreign bank presence—and compare the behavior of foreign banks with that of domestic banks over the course of the 1990s. The authors find that foreign banks in these countries showed stronger and less volatile loan growth than domestic banks, and that diversity in bank ownership helped produce greater stability in times of crisis. Although the authors emphasize that individual bank health, rather than bank ownership per se, emerges as the most important factor in determining the growth, volatility, and cyclicality of bank credit in Argentina and Mexico, they see the effects of foreign bank participation in the financial systems of these countries as essentially positive.

A close examination of the export and import performance of the Asia crisis economies is provided in the article by Matthew Higgins and Thomas Klitgaard. The authors begin by observing that the swing from large inflows of capital in these countries to large outflows required a corresponding improvement in each country's current account balance. A review of imports and exports in dollar terms reveals that almost all of the improvement in the current accounts stemmed from lower imports.

As the authors note, however, this finding does not imply that the export activities of the crisis countries were unaffected. By breaking down the trade flows into their dollar price and volume components, the authors show that large adjustments occurred in both the import and the export trade volumes of Asian economies. Import volumes fell with the collapse of domestic demand in the wake of the crisis. At the same time, export volumes rose because demand in areas outside of Asia continued to show strong growth. The reason that dollar exports appear flat in the data is that the increase in export volume was offset by the decline in export prices in dollar terms. A similar decline in import prices accentuated the decline in imports in dollar terms.

In their examination of the price component of trade flows, Higgins and Klitgaard attach considerable significance to the fact that dollar import and export prices fell together, with both tracking world prices. This pattern leads the authors to conclude that exchange-rate-induced price changes did not play a large direct role in the improvement of the crisis countries' current account balances.

In the fourth article in the volume, Eric van Wincoop and Kei-Mu Yi analyze the effects of the Asian currency crisis on noncrisis countries. While most earlier studies of such effects focus on how currency devaluation and economic recession in the crisis countries influence trade balances with other nations, this article explores the sharp outflows of capital that originally prompted the devaluation of the Asian currencies.

Tracking the capital flows out of Asia, the authors find that most of the capital was moved through the world banking system. More than half of the outflows went first to offshore center banks and then to banks in Europe. Although subsequent movements are more difficult to trace, van Wincoop and Yi argue that much of the capital eventually reached the United States.

The authors then assess the effects of this reallocation of capital from Asia to the United States. The flow of capital into this country contributed to lower interest rates and hence encouraged domestic demand growth. On the supply side, the appreciation of the dollar against the Asian currencies lowered the cost of imported intermediate goods, generating a positive effect on the economy similar to the effect of lower oil prices. The rise in the dollar also led, of course, to a deterioration in the U.S. trade balance. Taking all three of these effects into consideration, the authors calculate that the overall effect of the Asian crisis on the U.S. economy was small but positive. As van Wincoop and Yi observe, a narrower inquiry into the trade balance effects of the crisis would, by contrast, have underscored the negative effects of the crisis on U.S. producers.

Calculating the costs and benefits of the Asian financial crisis for an industrialized country such as the United States also involves consideration of the impact of trade adjustments on particular local industries. The final article of the volume, by James Harrigan, examines how the large devaluations experienced by Korea, Malaysia, Thailand, and Indonesia affected the traded goods industries in the United States. The author contends that U.S. exporters were largely unhurt by the devaluations. Although export sales to Asia dropped, strong domestic demand and continued exports to other foreign markets kept the crisis from significantly reducing the growth of shipments by U.S. industries.

On the import side, the drop in the price of goods produced in Asia did not, with the major exception of steel, lead to a surge in imports. This unexpected outcome holds an important lesson about the direct distributional consequences of an emerging market crisis. Because U.S. firms for the most part did not compete directly with Asian imports, they did not lose domestic sales to these goods. Instead, Harrigan concludes, the U.S. economy may have realized a net benefit from the Asian crisis, since the crisis lowered the costs of imported inputs without eroding the position of most U.S. industries relative to their major foreign competitors.