

Two crises and two Chinas

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“Happy families are all alike; every unhappy family is unhappy in its own way.”

Leo Tolstoy, Anna Karenina opening line.

1. Introduction

To paraphrase Tolstoy, every crisis is a crisis in its own way, but good comparisons often sharpen our understanding. This paper contrasts the approaches taken to the crises with Saddam Hussein and in East Asian financial markets. Since the East Asian crisis is the more general subject of this symposium, this presentation borrows some duality from the East. In the spirit of yin and yang, we address two topics, each with two parts. After addressing the two crises, we compare two Chinas, the one before the East Asian crisis, and the China of today (April 1998). We discuss China because it could set off a new round of competitive currency depreciation in Asia, because, as the world's most populous country, its relationship with the United States is likely to be crucial to U.S. security interests in Asia and worldwide, and because it has received relatively little attention in relation to the East Asian crisis.

We start by comparing the two crises.

2. A tale of two crises

Could we have ignored these crises? No. Both involve substantial externalities that deeply affect U.S. interests. Saddam Hussein's Iraq may store incredibly dangerous weapons of mass destruction including precedent-breaking biological weapons. It seems unlikely that Iraq possesses neither the banned weapons nor the facilities for pursuing them: even Saddam Hussein is not so callous as to let his people suffer great deprivation, as they have under sanctions, to keep inspectors away from innocent, albeit symbolic,

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buildings. Saddam has already shown a willingness to use chemical weapons on a limited basis. Past agreements require that such weapons be completely eliminated from Iraq's arsenal, and that such elimination be verified. The United States could not allow Saddam to prevent inspections, quite possibly continuing practices that threaten world safety, and to thumb his nose at the United States, the UN, and the international community. A U.S. response was necessary.

The East Asian financial crisis also required a response, though the threat was quite different in nature. No international accords were being threatened; the nations and leaders involved were not outlaws. But the crisis did threaten the economic health of Asia, and thereby quite likely that of the United States. Korea is Asia's third largest economy and the world's eleventh largest. Indonesia is the world's fourth most populous country. Taken together, the East Asian countries in crisis represented a significant proportion of the world's population. Even if the United States cared not a whit about the countries involved and their citizens, the crisis could and would have spread absent outside assistance. First, many U.S. banks have sizable loans to these countries, loans that were on the brink of default. Such defaults would ultimately be felt in the United States and could threaten the health of the U.S. banking system. Second, these economies are a major and increasingly important market for U.S. exports. U.S. exports to Asia have already begun to slow down. A sustained loss in exports would threaten U.S. jobs in the short run and ultimately the nation's long-term economic growth.

The externality argument for aiding these nations is similar to helping fight a fire in a neighbor's warehouse. Whatever we feel about the neighbor and his goods, we do not want his fire spreading to our warehouse, as it very well might. Alan Greenspan, in his testimony to the U.S. Congress, likened the East Asian crisis to storm clouds coming into our sight. Dark thunderclouds and lightning would already be overhead had we not helped lead an international rescue package for these countries.

Did we share the burden of the crises appropriately? With Iraq we had a practice run: this was our second major international crisis with that nation. During the 1991 Desert Storm operation, we marshaled substantial support from our allies in Europe, the Middle East and Asia, not only in political and logistical terms, but also in real economic terms. For example, the estimated cost of the operation was \$75 billion. Partly because the war was unexpectedly short, the financial contributions from our allies offered a one-time improvement in our current account balance. The current account deficit in 1991, at \$28.4 billion, was \$10 billion lower (in current dollars) than in any of the previous three and subsequent three years, according to the IMF's *International Financial Statistics*. In effect, we ran the military operation as an export activity.

The recent standoff with Iraq presents a far different story. Except for Britain, our traditional ally, and Kuwait, which had no good alternative, our effort to build an international coalition failed miserably. We stood alone. In any attack on Iraq, the United States would have borne virtually the entire burden, financially, militarily, and in cost to reputation. Ultimately, UN Secretary General Kofi Annan succeeded in his designated role as peacemaker. Iraq agreed to open the presidential palaces to inspection, but only with diplomats in tow, making it much less likely that illegal weapons will be discovered. Saddam diminished the invasiveness of inspections, gained greatly in world stature, and is already demanding reduced sanctions on Iraq.

In the other case, rescuing the East Asian countries in financial crisis, we have done a far better job. The U.S. interest is well represented by the International Monetary Fund. We also participated directly in the rescue packages for the large economies in crisis, notably Korea and Indonesia. But there, our dollar contribution is only part of a far larger package. For Korea, for example, the total rescue package is a consortium of loans worth \$55 billion, of which the U.S. direct participation using the Exchange Stabilization Fund is \$5 billion. The balance comes from the IMF (\$21 billion), the World Bank (\$10 billion), the Asian Development Bank (\$4 billion), and other G7 countries plus Australia (\$15 billion). The official U.S. share of the funds in the IMF, the World Bank, and the ADB is 18.25 percent, but this is overstated: the United States is behind in its payments. Assuming that percentage, the total U.S. contribution is \$11.4 billion [$11.4 = 5 + 0.1825 \times (21 + 10 + 4)$]. In the Indonesian rescue package, the total loan is \$15 billion, of which the U.S. direct contribution is \$3 billion, and the indirect contribution through the IMF and the World Bank may be another \$2 billion. In fact, the international community is contributing a much higher percentage in Asia than when we spearheaded the rescue package for Mexico in 1995. (There, the U.S. direct contribution was \$20 billion, supplemented by an IMF loan of \$17.8 billion.) This time, we got more bang for our bucks.

Did we negotiate appropriately? In the case of Iraq, despite protests that we dictated the agreement, it was reached between Iraq and Kofi Annan, the eminent head of a neutral international organization who played the role of honest broker and mediator. We lost in terms of the nature of the agreement (agreeing to include diplomats in the inspection teams, to show respect in inspecting the so-called presidential palaces), and the framing of the negotiations. Saddam Hussein emerges as a possibly responsible world leader, someone who helped the world step back from the precipice.

To be fair, we would have risked a far worse outcome had we merely rained bombs and missiles on Iraq, since we had not laid out a convincing and coherent strategy to the world, to ourselves, or to Saddam Hussein. The appropriate justification for threatening an attack is not that Saddam Hussein is a very bad man, which assuredly he is. Rather, it is that the weapons he has and is seeking to develop, and his apparent willingness to consider using them, threaten the world both directly, and through their precedent value. The worst aspect of the Iraqi outcome is that biological weapons, abhorrent to the nations of the world as well as to any thinking citizen, have not been singled out as a salient threat meriting a salient response.

We argue that at the beginning we should have drawn a clear line between what was and was not acceptable, and been prepared to back our words with deeds. For example, we could have demanded to inspect some suspect buildings unconditionally, destroy the ones where we were refused, and then move on to the next set of buildings. This is a measured demand, but one that could be credibly backed up by our will and might, and by world opinion. In contrast, threatening that Saddam would have to leave office was clearly useless: we were unlikely to back up such a threat with an extended ground operation in Iraq in order to remove him.

East Asia, by contrast, has been a great success. There, our interests and those of the IMF are strongly aligned. In many of these countries, the tough restructuring imposed by the IMF causes substantial public protest, making the IMF often look like 'the bad guy'. We often sent our own representatives (the deputy secretary of the Treasury, a former vice

president) not only to capitalize on their expertise, but also to get credit for our contributions, and to show our support for the IMF's conditions. The IMF played as constructive a role as the United States could hope for from a multilateral institution. Alignment in basic objectives, and a well-conceived U.S. strategy, helped greatly.

Did we get what we wanted? In the case of Iraq, certainly not. Saddam is still in power, his prestige enhanced, his weapons continuing to elude UN inspectors. His position has significantly improved. If we find no trace of weapons this time, we would like to maintain the sanctions unless he can pass continuing and painstaking inspections that will deter the development, spread, and use of weapons of mass destruction. Implementing this policy looks unlikely. The United States has reaped a reputation as trigger happy – and we have sowed the seeds of dissent with some allies and some of our own citizens.

In East Asia, in contrast, things went well. The rescue packages helped to avoid disaster, at least for now, though severe pain continues. But the situation has surely turned around. As one indicator, Korea's stock market in the first quarter of 1998 rose 24.4 and 52.5 percent, respectively, in local currency and dollar terms.¹ It is clear that the timely rescue package has contained the pain mostly within the East Asian region, with U.S. and European economies flourishing, despite negative spillovers from Asia.

To be sure, some criticize the IMF and U.S. policies: the IMF conditions are too harsh, its assistance too meager. But the opposite criticisms, of laxness and excess generosity, are leveled as well, and there is some comfort in hitting the middle of the policy spectrum. Moreover, the criticisms are of our preferred policies, not, as with the Iraqi confrontation, that we had no coherent strategy, or that we allowed some international institution to deflect our interests. The most disturbing criticism is that we should not be bailing out international lenders and creditors who made poor investments. But once the crisis hit, the burning warehouse metaphor came into play: it was too late to stand aside.

It is important to note the success of our strategy. Making the bailouts painful helped to reduce, albeit not eliminate, concerns that other nations, international banks, and domestic lenders will draw the wrong lesson: that they can be lax and someone will bail them out if they fail. The United States, the IMF, and the rest of the international community may bail out a lax investor, but like a tough parent who worries about her child's future welfare, our rescue will be painful. Such measures may succeed in reducing moral hazard in borrowing countries more than among international investors, who get paid premiums for the risks they run.

Now, looking forward, it seems we should seek to design a system that charges risk-related premiums to international investors (or for that matter home-country investors), who wish to be eligible for future bailouts. Such a system will be challenging to design, since no markets can directly estimate the default risks of various nations. Nor can we easily segregate participating and nonparticipating creditors to facilitate paying off on insurance should a crisis occur.

The East Asian and Iraqi situations also offer interesting contrasts in handling domestic opinion in the U.S. With the East Asian financial crisis, little attempt was made to secure public support, for little would have been forthcoming. Neither East Asian nations nor the IMF are popular beneficiaries. Despite the lack of public support in spring 1998, the

¹ *Wall Street Journal*, Foreign Markets: Stock Market Indexes, April 2, 1998, p. C16.

Administration made some headway seeking approval for about \$18 billion in additional funding for the future IMF, from a reluctant, but possibly responsible Congress. (As this is written on tax day, the outcome is still in doubt.)

The most widely publicized effort to win domestic support for our Iraqi mission, the Ohio State forum with senior administration officials, backfired. Empty seats were numerous, as were Vietnam-era style denunciations of U.S. militaristic and racist policies.

What do we learn from comparing these two crises? There are several useful lessons.

First, the United States is the preeminent player in the world, in both military and financial matters. The end of the Cold War makes U.S. leadership in these matters more, not less, important. Many international crises entail large spillovers; they cannot and should not be ignored. It is entirely appropriate and indeed necessary for the United States to play a major role, if only to pursue its self interest.

Second, though a major player, the United States will rarely reap all or most of the spillover from defusing international crises. (The Mexico peso crisis in 1994–95 may be an exception: our neighborly location, the intertwining of our economies, and concerns about illegal immigration to the United States made us the overwhelming beneficiary.) Given the natural tendency for allies to seek a free ride, the big player, if there is one, will have to contribute a disproportionate share. This implies that our preeminence will frequently be a disadvantage. Arranging with the world community to precommit resources to deal with future crises will improve our position. The policy implication for the United States is clear: as much as possible, we should make burden-sharing arrangements in advance, having nations precommit resources based on some formula, relating say to GNP. Otherwise, it will be too late when crises hit. U.S. interests demand equity in burden sharing, rather than allowing the costs to fall where they may. The IMF is a good example of an international organization where the international community precommits its resources. Working through established international organizations may also provide us political cover.

Third, a nation can effectively negotiate on its own behalf. Even better, it can line up behind some international entity, such as the IMF in the East Asian crisis, with whose interests it is closely aligned. However, relinquishing control to an international institution whose interests are not its own, is unlikely to prove satisfactory. With Iraq, UN Secretary General Kofi Annan saw himself not merely as a mediator between the United States and Iraq, but as a representative of the UN, and therefore an independent actor. His primary goal was to avoid conflict, not to remove Iraq's weapons of mass destruction even at considerable cost, and certainly not to remove Saddam Hussein. U.S. interests and UN interests simply did not line up. Having boxed ourselves into a corner, we had to let an unaligned negotiator define the outcome.

Fourth, no nation will get what it wants if it gives away its threat position. With Iraq, we gave away the store at the outset. With our ships, planes, and missiles ready, Saddam felt the pressure, though we had neither an international alliance nor a well-justified strategy. Once we let the UN define the agenda and the objectives, the threat of military action was deflated. As an independent party, wearing a mantle of international respectability, Kofi Annan's overriding goal was to avoid conflict. Though Saddam had virtually no cards to play, he won laxer inspections, greater respectability, and a high likelihood of reduced sanctions.

In East Asia, by contrast, the IMF and the United States are dispatching their aid over time, requiring nations to meet further conditions to qualify for further assistance. The nations have responded and changed their behaviors, despite some wayward moments, particularly with Indonesia. Some no doubt welcomed an external party requiring them to make the painful changes that domestic politics would have prevented. The outcome might have been different had we given all the aid at the beginning, or even promised future payments at the beginning.

Our actions in Asia have made us a bit more likely to bail out other countries in crisis in future, but we have made it substantially more likely that nations will take steps to avoid such circumstances. We believe that greater transparency in the financial affairs of developing countries can help stave off adverse developments. Though we cannot yet know the results, the IMF has at least made its member countries promise greater transparency, and the United States has taken up the banner. In April 1998, just a few months after the crisis abated, Treasury Secretary Robert Rubin, working in conjunction with Federal Reserve Chairman Alan Greenspan, launched a major effort to move the nations of the world towards substantially greater transparency in the workings of their financial sectors. Potential changes in U.S. policy – for example, limiting or prohibiting financial operations flexibility in the United States for institutions that did not comply – would be a potential lever to effect change.

The United States did comparatively well in dealing with the East Asian crisis. It also learned important lessons, and adjusted its policies for the future. In comparison, China learned and is likely to change much more significantly, and that is the subject to which we now turn.

3. A tale of China before and during the East Asian financial crisis

As the East Asian financial crisis unfolded, no nation watched with greater anxiety than China. The countries in trouble are China's competitors in the world export market, and include many of its major trading partners. And some, notably Korea, have been seen as role models for China's own economic development.

In many ways China resembles Korea, the most significant nation in trouble. Both have gigantic corporations. (China had wanted to develop more, following the pattern of Korea's chaebols.) Both have massive problems with bad loans in their banking sectors. (Note that Japan, though unlikely to receive of U.S. or IMF assistance, also abounds in giant firms and massive bad bank loans.)

Despite these similarities, China's experience so far has been very different from that of its neighbors. Its currency, the yuan or RMB, has not been devalued. Its domestic financial system has not overtly collapsed. No major changes have been forced upon its economy. But all of these could occur. Therefore, we would now like to consider China's potential responses to the Asian crisis.

The East Asian crisis as an alarm bell for China. Obviously, the crisis and the massive devaluations in neighboring countries have started to exert tremendous pressure on China's exports. That is the bad news. The good news is that the East Asian crisis may have delivered two very welcome shocks to the Chinese leadership. These shocks are significant

enough to make it worth thinking of two Chinas: one that existed before the crisis, and one that will soon emerge.

First, China may well rethink its industrial policy strategy. Back in 1996, the China State Council, a national cabinet, released the *White Book on Industrial Policy*, detailing which industries it intended to support as strategic industries. Industry policies imply, among other things, that government will direct resources into industries for reasons other than maximizing economic returns. Equally troubling, the government intended to organize industrial groupings, or conglomerates of firms, by administrative decree. In the discussion surrounding the industrial policy document, the Korean chaebols (known in Japan as keiretsu) were explicitly cited as a model for China to follow. The current turmoil in Korea has shocked the Chinese leaders into rethinking this plan. It is now clear that chaebols tend to over-leverage themselves, frequently because one firm in the group, or its bank, is coerced into making bad investments in an allied firm. If the crisis can persuade the Chinese leaders to give up on the chaebol model, it could prevent much future pain for the Chinese economy.

Second, the East Asian crisis has delivered China a wake-up call on its financial sector problems. For more than a decade, China has been talking about reforming its financial sector, cleaning up its bad loan problems. Some progress has been made, but far from enough; reform is painfully slow. It has not seemed urgent, and it is tied to complex problems of reforming state-owned enterprises.

The East Asian crisis has dramatically changed this picture. The Chinese now see clearly that a domestic banking sector plagued with bad loans is a time bomb. An initial currency crisis, like a rapid depreciation of the exchange rate, can quickly become a pervasive domestic financial crisis, ruining both commercial and investment banks.

By contrast, if the nation's banking sector is secure, even a major currency depreciation will not create the problems Thailand, Indonesia, and Korea have just experienced. Moreover, a solid banking sector may well prevent a currency crisis. So the current crisis may be a subtle but significant blessing if it helps to strengthen the Chinese leaders' political will to revamp the financial system. We emphasize political will, rather than mere technical know-how.

By April 1998, as this is written, China has already been spurred toward reform. Two changes are particularly worth mentioning. First, new reform measures were introduced in February to restructure the central banking system. Under the old system, the People's Bank, which is China's central bank, had about 30 branches, one in the capital city of each province. These branches often faced great pressure from the provincial and local governments to loosen credit controls in order to help regional manufacturing concerns, particularly state-owned enterprises. The new system will resemble the U.S. Federal Reserve System with a total of about a dozen district banks. The idea is that if the central bank district is larger than any given province, bank officials should be less subject to political pressures from provincial or local leaders. The second action is the announced plan to close many loss-making investment companies. Most are government owned, centrally or locally; many have engaged in massive real estate speculation and other risky investments, with unfortunate results.

The currencies of Hong Kong and China. China's response to the current financial crisis must include Hong Kong, its international financial outpost, and part of China since July 1,

1997. Maintaining Hong Kong's economic and financial stability is an overriding objective for China. The financially savvy Zhu Rongji, elevated to his position as China's premier in mid-March 1998, surprised a group of visiting American economists a year ago by defending China's massive foreign-exchange reserves: 8 month's worth of imports as opposed to the rule-of-thumb 2 months. Zhu observed then that these reserves would 'help keep Hong Kong stable'. Is he both seer and premier?

Much is well with Hong Kong (HK), but its dollar, pegged at 7.8 to the U.S. dollar, has faced intense speculative attack, driven by its neighbors devaluations. Hong Kong exports, including Chinese goods, have become much less competitive, which presents a dilemma. Absent devaluation, defending HK's dollar will become increasingly difficult. On the other hand, the level of the HK dollar symbolizes both the management ability of HK's post-Britain government, and the confidence of Hong Kong citizens in Beijing. In both Beijing and the Hong Kong Special Administrative Region, to abandon the peg would be taboo.

China has its own currency, the yuan or RMB, which is not fully convertible and is subject to a tightly managed float. Just how tightly is revealed in Fig. 1: the yuan to dollar ratio has barely changed over the past 3 years. (The yuan actually appreciated about one percent a year over the period.) The fabled Japanese yen, shown for contrast, has fluctuated widely. The year experienced a net depreciation of roughly 20 percent over this period, during which the U.S. dollar appreciated by somewhat over 12 percent against all currencies on a trade-weighted basis. Most observers believe that the yuan will not be devalued. Moreover, early in 1998 Chinese leaders reportedly told U.S. Deputy Secretary of the Treasury Larry Summers, and IMF Managing Director Michel Camdessus, that China will not devalue any time soon. And remarkably, at roughly the same time, Zhu Rongji, the communist leader, discussed with Merton Miller, the free market Nobel Laureate, how China might sell derivative instruments on the yuan both to reassure currency markets about its value, and to profit by removing uncertainties about devaluation.

Most observers believe that China cannot devalue the yuan, since if it does, the HK dollar will have to follow. Their argument relates to the contagion of concern. If investors, particularly international currency speculators, believe that a yuan devaluation implies a reduced resolve to defend the HK currency peg, then the yuan would become virtually impossible to defend.² We believe these observers are wrong, both in that China might well devalue, and if it did, the HK dollar could maintain its value.

First, consider a possible effect of a yuan devaluation on Hong Kong. The HK and mainland economies are tied together in a manner not present between say Thailand and Malaysia, or Indonesia and Korea. Most of Hong Kong's exports are manufactured primarily or completely in China. If China can regain competitiveness, Hong Kong will as well. China could help Hong Kong directly by subsidizing goods flowing through the territory, with tax subsidies, tariff rebates, etc. This would work economically, but fail politically. It would violate World Trade Organization rules, and cloud China's hopes of joining that organization soon.

²Peter Passell, Devalue the Yuan? China Doesn't Seem About to Do That, *New York Times*, February 26, 1998, p. D2.

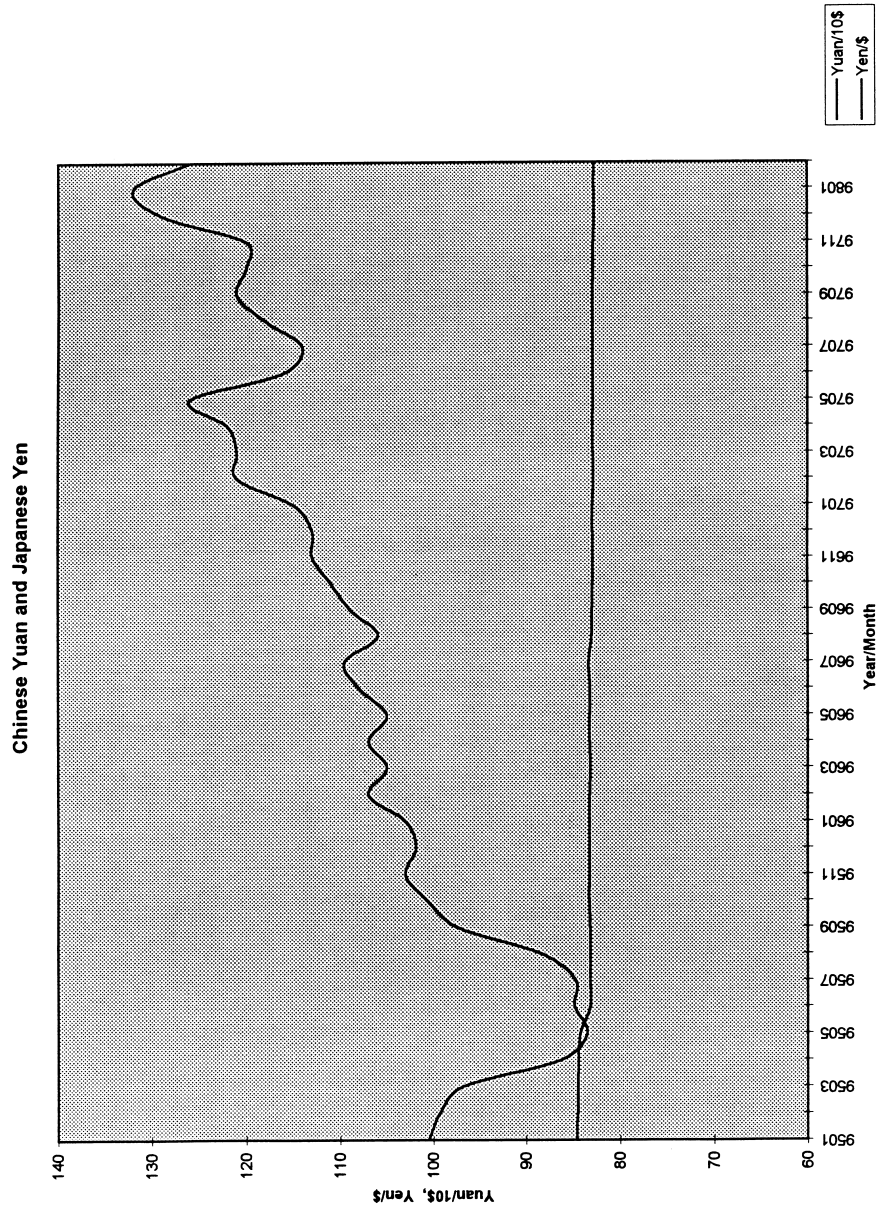


Fig. 1.

A more direct route to Chinese and HK competitiveness would be to simply keep the HK dollar fixed but let the yuan fall in value. Hong Kong, with its enormous flow through of Chinese goods, would become more competitive immediately. The devaluation would violate no international law. China could merely adjust the weights on its managed float, managing less and floating more. This is quite different from artificially engineering a devaluation. It is simply letting supply and demand play a greater role – as the IMF and United States have long requested of China.

Given China's self-interest – to recover export competitiveness for itself and for Hong Kong, and to maintain the Hong Kong currency peg – devaluation of the yuan is an intriguing alternative. We do not expect China to devalue soon: it has said it would not. But we do not rule out the possibility of a drifting devaluation by spring 1999, when attention to the East Asian crisis will have subsided, and when China's 'no-devaluation' promise will be stale. (Moreover, Zhu Rongji never sold those derivatives.)

Two policy actions have helped prevent the flames of the East Asian crisis from spreading to China. First, China decisively reformed its exchange rate in early 1994, putting in place a significant devaluation. That helped China build up massive foreign-exchange reserves. Second, paradoxically, it delayed its reform of implementing capital account convertibility. China introduced convertibility on current accounts in early 1994, and intended to have capital accounts fully convertible by the Millennium. The East Asian crisis might well put such plans on hold. Full convertibility has lost some appeal.

China before and after the crisis. Beijing, and indeed the world community, worried that the East Asian crisis could spread to a somewhat fragile China. Thus far that disaster appears to have been averted: China's currency has not moved, its stock market has not crashed, its banks have not closed. Still, the crisis has transformed that nation. In thinking, and already in many areas of policy, changes are evident. Sweeping attempts are being made to diminish political influences on economic decisions within firms, industrial groupings, regions, and the nation at large. No longer is China pursuing an industrial policy fostering interlinked corporate groupings equivalent to Korean chaebols or Japanese keiretsu. Banking reforms, in particular to insulate central bank operations from provincial politics, are being pushed. Zhu Rongji, reputedly a brilliant financial thinker, has been made premier. Sound learning by China, a future economic powerhouse, may be the brightest ray of hope to emerge from the East Asian crisis.

4. Conclusion

The United States did well in confronting the East Asian financial crisis. Working in conjunction with the IMF, and thus securing financial support from other major nations, it doused an economic conflagration. China, a neighboring tinderbox that escaped the flames this time, has learned how to insulate itself through economic and financial arrangements. The bailouts by the IMF and the United States have been sufficiently stringent to deter future lax behavior by other nations, and sufficiently long-term to deter backsliding by current aid recipients.

The Clinton administration, viewing a short-term horizon, has been celebrating the outcome with Iraq. But Saddam remains in power. His reputation is enhanced, his weapons

of mass destruction less likely to be detected, and his sanctions on a downward course. When the United States went its own way with Iraq, but failed to define clear and justifiable goals for its military threat, it not only lost standing in the world, but also allowed the UN Secretary General, whose interests diverge from those of the United States, to play a central negotiating role. The United States did not get the results it most desired.

International crises, by their very nature, are rarely anticipated. But by putting policies and structures in place, the United States can make it more likely both that crises will be dealt with effectively, and that other affected nations will contribute their fair share. In this spirit, the Iraqi crisis was dealt with poorly, the East Asian financial crisis very well.