

Role of the Market in Maintaining Financial Stability: Finding Appropriate Adjustments*

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Six years after the East Asian financial crisis that started in Thailand, the role of the market in maintaining financial stability is still an issue under a great deal of debate. It is also an issue of enormously important current policy relevance. Asia is being told that exchange rates should be more flexible as reflected in the recent Group of Seven statement; "...we emphasize that more flexibility in exchange rates is desirable for major economies or economic areas to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."¹ This suggests that exchange rates should be more market determined, and it is alleged that this will promote smooth adjustments in the international financial system. However, with bad experiences of large financial volatilities prior to and during the crisis, economies in East Asia are still reluctant to allow the full play of market forces to determine exchange rates. Just as the large depreciation of currencies during the crisis brought economic havoc to the crisis affected economies through balance sheet effects, so the large appreciations which may result from market driven exchange rates are likely to create tremendous strains on the export-led economies of East Asia.

While the economies of East Asia are wary of the instabilities that may arise from currency markets, they are at the same time actively working to create another market. This is the Asian Bond Market, and this market is meant to increase financial stability in the region. The aim is to create an active and deep Asian Bond Market in order to be an effective source of long-term financing in the region. Prior to the crisis, most economies in the region with saving deficits had to rely on short-term foreign borrowing, and this, together with mismanagement by the domestic authorities, was a very important factor that led to the crisis. So the idea of the Asian Bond Market is to provide a means to lengthen the debt maturity structure of deficit economies in the future and lessen instabilities from volatile capital flows.

The very different perspectives concerning the two markets discussed above, i.e., associating currency

markets with great instabilities and the Asian Bond market with greater stability, should indicate that the role of so-called "markets" in maintaining financial stability is not a black or white issue. Even ignoring the fact that different people will have different opinions about whether a full play of market forces in a particular type of market will increase or decrease financial stability, a particular individual can also regard different markets as having different impacts on financial stability; some markets may be associated with greater instability while others with greater stability.

In addition, a market cannot be considered independently of the rules and regulations or policies that are imposed on activities in that market. So the question is not simply about comparing the situation where a market is free to operate without significant management by the authorities versus one where management and control of the market, such as price controls, are substantial. There is a whole range of degree of control that can be imposed on the market, and it may even be the case that the most effective functioning of a particular market for financial stability is neither at the extreme ends of fully free operation or rigid regulation and control of the market. Somewhere in the middle might be the best. On the other hand, if badly designed, the rules and regulations that are imposed on a market may actually have unintended incentive structures and lead to perverse consequences of instabilities and even crises.²

As an economist, I fully appreciate the crucial role of markets. Economists are taught about the magical role of markets and price signals in leading the economy to an efficient outcome (the invisible hand). Past failures of centrally planned economies illustrate the importance of markets even more. Of course, we also learn about such things as externalities and market failures, especially in a world of imperfect information and incomplete markets. And we also learn about how some markets can be rather unstable by nature, for example the hog cycle. The recent financial crises also illustrate that financial markets can be particularly volatile and risky,

* Paper presented at the APEC Finance and Development Program 2003 Annual Forum, held in Shanghai, People's Republic of China, October 15, 2003.

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especially if badly managed. Examples of inappropriate regulations leading to the creation of systemic risks and market failures can be found. For example, the provisioning requirements under the Basel Capital Accord call for less provisioning for short-term loans to non-OECD banks and private sector compared to that for long-term loans. This makes sense when viewed in the partial context of a single lender, as during the maturity of a short-term loan there is less time for adverse changes to the borrower or the economy of the borrow. However, this rule then leads to an explosion of short-term lending to emerging markets. Given that most emerging market authorities still have significant gaps in management capacities, the vast amount of short-term borrowing increases systemic risks to the whole economy. The recent crises show how painful the situation can get for both borrowers and lenders if these systemic risks become so large as to lead to a financial crisis. Thus, these types of situations where there could be hidden externalities and market failures need to be carefully studied, monitored and managed.

I think that financial markets are by nature more volatile than markets for real goods and services. This is because they tend to be more influenced by psychological factors compared to the latter markets. Even in goods markets, when psychology comes into play in a dominant way, such as in times of panic, instabilities can result, for example, hoarding in anticipation of shortages such as from an expected war.³ In financial markets, vast amount of trading go on everyday, especially with the development of information technology, but the fundamental anchors to the values in these markets tend to be so-called “long-term economic fundamentals,” whether of companies or of economies. These economic fundamentals are also less certain, and are open to various interpretations, so psychological factors also come into play in the judgment of economic fundamentals. How often has one heard an argument being used by analysts to explain increases in stock or currency prices at one point in time, and exactly the same argument used to explain declines in prices at another point in time.

Where psychological factors come into play, markets tend to be volatile. In fact, a whole field of research arose a couple of decades ago, the field of Behavioral Finance, because empirical evidences suggest that financial (stock) markets are more volatile than can be explained by the Efficient Market Theory (see Shiller 2002).⁴ This new field of research is quite useful for the study of phenomenon such as bubbles and the like.

Apart from volatilities arising from psychological factors, there could also be major instabilities if the market exhibits multiple equilibria and one is in the process of shifting from one equilibrium to another. In recent years, modeling markets with multiple equilibria seems to be a very popular game in graduate schools, and there are multiple equilibria models explaining all kinds of economic phenomena, including financial crises. I think that this explosion of interest in multiple equilibria models reflects a shifting of view from that which tends

to regard the economic system as being basically stable to one which sees potential instabilities in many aspects of economic life. If there are multiple equilibria, then given sufficiently large changes in the environment affecting the market, one can reach a point where the equilibrium shifts from one to another one far away. There will then be major instabilities as the market moves from one equilibrium to another. This is similar to situations captured by the so-called *catastrophe theory* in mathematics.⁵ The economic costs of the shift in equilibrium can be enormous. We can witness this from costs that economies that went through the financial crisis had to face, assuming that the crisis was indeed some form of a shift to a new equilibrium in a multiple equilibria situation.⁶

The view that the world is potentially very volatile, particular as it concerns financial markets, is not unrealistic. In fact, with all the talk about reforming the international financial architecture, it seems that very little effective measures have been carried out that have made financial markets less volatile and that reduced the risks of economies getting into financial crises.⁷ Economies continue to get into crises in a seemingly unending progression.

Finally, going back to where this note started, the need for currency flexibility (particularly in East Asia) in order to correct the current global financial imbalances. First, it has to be admitted that there are currently enormous imbalances in the system. East Asia, which already holds well above half of the world's foreign reserves is continuing to accumulate reserves at unprecedented rates. At the end of 2001, Japan's foreign reserves amounted to about US\$ 402 billion, while that for China was about US\$ 220 billion. By the end of September 2003, Japan's reserves had increased to about US\$ 605 billion with China having about US\$ 365 billion, and both continue to increase. In total, Japan and China have together about US\$ 1 trillion in combined reserves. Including the other East Asian economies, the region controls a combined total of well above US\$ 1.5 trillion, which is almost 60 percent of the world's foreign reserves. At the same time, the region is continuing to have a current account surplus of about US\$ 200 billion a year, so reserves will continue to accumulate as economies try to prevent their currencies from appreciating too much or to maintain their fixed exchange rates.

The current imbalance is not simply an imbalance in East Asia. It is part of a fundamental imbalance in the world's economic and financial system. The opposite side of the coin to the surpluses and reserve accumulations in East Asia is the vast amount of US\$ being pumped into the world financial system as a result of the huge US budget and current account deficit. East Asia is simply recycling back the US\$ by re-lending to the US (mainly), and this serves to maintain the dollar's value (or at least does not let it fall too much).

What makes matter worse is that in the current global financial architecture, there is really no fundamental anchor to the value of currencies.

Currencies are just paper, and not backed up by anything. Further, there are no clear rules as to how the system and economies should adjust if imbalances arise.⁸ In the old days of the Gold Standard, the link between domestic money supply and the reserves provided an element of automatic adjustment that could prevent extreme imbalances from arising. In the US\$-gold standard, the US\$ was fully guaranteed to be convertible into gold at a fixed exchange rate, and this provided the discipline for the US not to have huge deficits, otherwise there would simply be too much US\$ in circulation for it to be feasible to maintain the exchange guarantee with gold. Of course, like a bank, the system can only work with sufficient confidence in the system. If everyone wanted to actually change US\$ into gold the system would collapse, which was what precisely happened in the early 1970s.

Because currencies in the current system are simply paper, my view is that the current imbalances are not sustainable. Going on as before, more and more paper (US\$) will be pumped into the system. As long as people (or governments) are willing to hold these papers, and therefore back up their values, the system can go on. However, the situation will become more and more artificial, and eventually there will be a real danger that the whole thing will just collapse. Like a rubber band that is being stretched more and more, the longer we continue to stretch it, the limit will eventually be reached. And when it snaps there will be catastrophe, just like going over the edge in *catastrophe theory*, or moving to a new equilibrium in a situation with multiple equilibria.

How to proceed? Well, clearly, simply demanding that some economy (China?) or group of economies adopt more flexible and market based exchange rates is not really addressing the fundamental problem with the current global financial system. One might turn around and put the burden of adjustment on the economy that has been pumping out more and more paper (the US), as getting rid of over-expenditure in the US will certainly be reflected in less surpluses in East Asia.⁹

The problem is that the imbalances inherent in the current situation are already very large, as witnessed by the rapid accumulation of reserves in Japan and China, i.e., the elastic band is already significantly stretched. Because the current global financial system has no clear rules for adjustments, imbalances have therefore been allowed to build up. With current imbalances, unleashing the full force of the currency markets in the hope of bringing about a smooth transition to a new equilibrium is just wishful thinking. Given the inherently volatile nature of currency markets, and the existing imbalances, unleashing the full force of the currency markets is most likely to bring about chaos and economic crises.

Economies in East Asia are also competitive with each other, so any sustainable currency movements will require coordinated efforts. I believe that it is now quite essential for East Asian economies to discuss and

implement concrete exchange rate coordination mechanisms, and implicitly reserves management strategies, in order to bring about a smooth adjustment to the current imbalances in the global financial system *as a group*. Going on in a business as usual fashion is very dangerous as was earlier indicated. Given that most of the world's reserves are controlled by East Asian economies, it should be East Asia that makes pronouncements about how the world's financial system should be evolving. Decisions on how these huge financial resources are managed have the potential to stabilize or greatly destabilize the global financial system. It is therefore imperative that a serious dialogue be initiated within the region. Finding appropriate adjustments to the current imbalances should be the next major task of the ASEAN+3 group.

In the long-run, of course, economies need to seriously think about *real* reforms of the international financial architecture. On this, East Asian economies must also have a great deal of input, given the amount of resources under their control. The role of the US\$ will need to be re-examined, together with the significant reliance by East Asian economies on the US market as an important engine of growth, as this imposes important constraints on exchange rate adjustments. The EU's attention is currently occupied by its eastward expansion. Over the next few years, the US may also become more and more diverted by the north-south integration of the Free Trade Area of the Americas (FTAA). Therefore, East Asia needs to actively work toward greater economic integration in the region. Progress is happening every year, and East Asian Leaders appear to realize the importance of pushing ahead on this front. This is very important, as a sustainable adjustment of the kind of imbalances that East Asia has with the US at present will surely require much less reliance on the US market for the region's growth compared to the situation at present.

ENDNOTES

- 1 Statement of G7 Finance Ministers and Central Bank Governors, Dubai, September 20, 2003.
- 2 Auerbach, Nancy Neiman, and Thomas D. Willett. 2003. The political economy of perverse financial liberalization: example from the Asian crisis. Paper presented at the Conference of Korea and the World Economy, University of Washington, August 1-2.
- 3 Of course, there are special types of markets where cycles rather than stability may be the norm, such as the example of the hog cycle alluded to earlier.
- 4 Shiller, Robert J. 2002. *From Efficient Market Theory to Behavioral Finance*. Cowles Foundation Discussion Paper No. 1385. New Haven, Conn.: Yale University.

- ⁵ See Thom, Ren. 1972. *Stabilité Structurale et Morphogénèse*. Reading, Mass: Benjamin (English Translation by D.H. Fowler. 1975. *Structural Stability and Morphogenesis*. Reading, Mass: Benjamin). For a more accessible introduction, see Saunders, P.T. 1980. *An Introduction to Catastrophe Theory*. Cambridge, U.K.: Cambridge University Press.
- ⁶ For a simple but illuminating model of a financial crisis similar to the recent Asian crisis, see Krugman, Paul. 1999. "Analytical Afterthoughts on the Asian Crisis." September, available at <<http://web.mit.edu/krugman/www/MINICRIS.htm>>.
- ⁷ Professor Stiglitz is a particularly vocal critique of this, see Stiglitz, Joseph. 2003a. "The Painful Reality the IMF Ignores." *The Guardian*, Thursday, October 2.
- ⁸ This is particularly true with respect to the US.
- ⁹ See Stiglitz, Joseph. 2003b. "China is Right to Go Its Own Way." Project Syndicate. Reproduced in *The Nation*, Bangkok, October 8, 2003.

