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Comment Leonard K. Cheng

A factor widely considered critical to the East Asian financial crisis in 1997–98 is its enormous short-term foreign debt. This paper examines the extent to which the “capital inflow” problem was induced by the “sterilization” policy or equivalently tight monetary policy pursued by the East Asian governments. It goes on to test whether sterilization was effective in limiting the growth of monetary aggregates during the decade before the East Asian financial crisis. The questions raised in this paper are both interesting and timely.

An inflow of capital (as measured by the foreign asset in the monetary base, abbreviated as FA) will put downward pressure on the domestic interest rate, other things being equal. The effect of any sterilization policy is to keep the domestic interest rates in the East Asian economies higher than otherwise, thus inducing an additional amount of capital inflow. I agree with this logic, but I also think the time dimension should be explicitly recognized.

In one example, capital flows in, the interest rate falls in response, sterilization policy kicks in, and the aggregate money supply drops, thus pushing up the interest rate. In another example, sterilization policy kicks in as soon as capital flows in, and the movement of the interest rate depends on the extent of sterilization. The interest rate will fall by an amount that is smaller than that without sterilization if sterilization serves to offset the capital inflow only partially. In contrast, if sterilization serves to more than offset the capital inflow, then the interest rate will rise. Which of these examples fits the quarterly data better? Do the responses of the monetary aggregates and interest rates to an innovation in FA as summarized in figure 6.6 of the paper imply that sterilization was more than offsetting the capital inflow? Or were both responses the results of an increase in demand

for money that was met by partial sterilization of the induced capital inflow and an increase in the domestic interest rate?

From the point of view of the East Asian economies faced with the potential of a speculative boom, is it desirable to let the domestic interest rate fall farther to the world level? Is capital control an appropriate response? The authors did not set out to answer these questions, but the theory of distortions may be able to shed some light on them.

The authors point out that a central bank “typically exchanges high-yielding domestic assets for low-yielding foreign assets” in the open-market operations. Given the financial costs involved, central banks often turn to other policy tools to control the growth of monetary aggregates, the most common of which was raising the commercial banks’ reserve requirements. While both of these measures make domestic bank lending more costly, they do not make direct foreign borrowing more expensive, thus causing a diversion to foreign borrowing and additional capital inflow.

If excessive capital inflow is considered undesirable, then the optimal policy suggested by the theory of distortions is one that acts directly on the inflow (such as a capital inflow tax as levied by some Latin American countries). Measures such as open market operations and reserve requirements are necessarily suboptimal because they deal with the symptoms rather than tackling the root problem directly. In this sense, perhaps one can even say that the capital inflow problem empirically ascertained in this paper was the result of inappropriate policy responses.

Comment Mahani Zainal-Abidin

This paper provided a succinct and perceptive summary of the pattern of capital inflow into East Asia during the 1986–97 period and of the policy responses undertaken to minimize its adverse effects, such as an excessive rise in aggregate demand, a rapid monetary expansion, and rising inflationary pressures. The measures employed to manage large capital inflows include capital controls, trade liberalization, greater monetary flexibility, fiscal contraction, and monetary instruments. The frequently used monetary measures comprise open market sales of domestic securities (a conventional form of sterilized intervention), increase in reserve requirements, shifting of government deposits from commercial banks to central banks, increase in discount rates, moral suasion, and credit controls.

The paper set out the hypothesis that effective sterilization not only limits the growth of monetary aggregates but also raises the level of domestic