# The Devil's in the Details

## An Interview with Jeffrey Sachs

*Jeffery Sachs is one of the most influential international economists of his generation. He is the Galen L. Stone Professor of International Trade at Harvard University and is also the Director of the Harvard Institute for International Development. With considerable experience in designing and analysing macroeconomic policy, both in countries suffering from hyperinflation and those attempting to make the transition from command to market economies, Sachs has become an outspoken critic of the International Monetary Fund. He was interviewed by Christopher Ragan, Editor of* World Economic Affairs.

### Lessons from the 1997-98 Crises

**It is not surprising that different people draw different lessons from the experience of the past year. Some argue that recent events prove financial capital is too mobile and that financial markets require significant moderating influences by government. Others argue the contrary position, that the recent turbulence reflects only the power of markets to discipline poor economic policies, such as pegged exchange rates.**

**WEA: What is the main lesson you draw from the events of the past 18 months?**

**Sachs:** There is no doubt that, however bad the sins were of the emerging markets, the damage being done by the international financial markets is vastly greater. In other words, the financial panic under way is far greater than any alleged weaknesses of the emerging market economies and, as we saw from the failure of Long-Term Capital Management, these aren't just problems of emerging markets, these are problems of modern financial capitalism. I have been arguing for years that the international financial system is subject to self-fulfilling bouts of optimism and pessimism—that panics are extremely damaging and that we need the trip wires in the international system to handle them.

**WEA: There have been recent calls among the G7 finance ministers for enhanced monitoring and regulations in financial markets. Do you think this is a valuable effort? Is bad regulation at the heart of the recent turmoil?**

**Sachs:** I don't think that the issue is mainly the problems of regulation, although problems of regulation have played a role. Nor do I think that each attempt to take a crisis and give even more role to the IMF is likely to prove fruitful because the IMF has proven to be one of the failures in all of this—bad diagnosis, bad prescription and failed programmes. So I think we're going to have to think more broadly than just accepting the pleas from the IMF and US Treasury—we should give more power to the solutions that haven't worked up to this point.

**WEA: In explanations of the Asian crisis, we often hear about "Asian values", "crony capitalism", and the role of corruption. How important are such things to events in Asia?**

**Sachs:** I think there is plenty of evidence that corruption is very damaging to economies. I think it has done damage in Asia, I think it has done even more damage in Russia, but I don't think corruption is an adequate explanation of the crisis we are now experiencing. In formal statistical analysis that my colleagues and I have done at Harvard, we have found that the relative ratings of corruption in various economies in the world do very little to help explain which countries have been hit by crises. Rather, what we find to be a far better explanation is the level of short-term indebtedness of countries—especially in comparison to the level of foreign-exchange reserves that those countries have. Countries with high levels of short-term indebtedness relative to foreign-exchange reserves are the ones being hammered. When the short-term debt is very high, each of the creditors sees that if the other creditors demand immediate repayment there won't be enough assets to go around, and under those circumstances markets get very skittish and they often fall into outright panic. That is what we are seeing.

*The international financial system is subject to self-fulfilling bouts of optimism and pessimism.*

I think it is also extremely important to stress that the countries in crisis are often the most successful of the developing countries—not the worst of them. That may seem paradoxical but it is not paradoxical at all when you consider the fact that what we have is a crisis of countries that borrowed heavily. But the reason they were able to borrow heavily is that markets were willing to lend to them heavily and, in general, the reason that markets were willing to lend heavily is that the countries receiving these funds were deemed to have high growth potential. So these countries are success stories—not failure stories up until this crisis. This crisis can be viewed as a "crisis of success"—success enough to allow them to take on enough debt that they ended up getting in serious trouble.

**WEA: Your discussion about the importance of foreign-denominated debt and foreign-held debt suggests that pegged exchange rates may be important here as well. Are pegged exchange rates at the core of these problems?**

**Sachs:** Every country that has gotten into trouble has had a prolonged period of a pegged exchange rate, usually to the US dollar. Indonesia, Malaysia, Thailand, and South Korea were all effectively pegged to the US dollar. Brazil, Russia and many other countries being hit right now also tried to maintain pegged exchange rates to the dollar. The problem of pegged exchange rates works in two directions. First, when pegged exchange rates are announced it is basically an announcement by the central bank that the existing foreign-exchange reserves will serve as collateral, in effect, for loans that are made to the domestic banking system from international banks. So, if there are $20 billion of reserves and the exchange rate is pegged, the central bank is basically saying that it will use those $20 billion of reserves to facilitate a repayment of the short-term loans before a devaluation takes place. This creates a kind of moral hazard. It's like putting the money up front and encouraging large short-term capital inflows.

*Countries with high levels of short-term indebtedness are the ones being hammered.*

The problem works in the other direction as well on the outflow side. When a pegged exchange rate becomes clearly seen by markets to be overvalued—as is the case in Brazil now, and was the case in Russia this summer and some of the East Asian economies last year—then the countries become sitting ducks for panic and collapse because the markets know that it is almost impossible to defend an exchange rate that is widely deemed to be overvalued. There is just too much opportunity to short the currency, and there is too much opportunity for domestic bank claimants to convert their bank deposits into foreign exchange. In other words, there are too many ways to attack the currency. The usual remedy—to defend the currency by raising interest rates sharply such as what Brazil is doing now and what Russia tried this summer—is almost guaranteed to fail because the super high interests rates that you use to defend the currency in the short term destroy the banking system. Everybody knows it, so nobody believes that that kind of a defence is really credible.

**WEA: You said that one of the most important problems was the amount of short-term foreign indebtedness. Is that really a problem if you have flexible exchange rates? Wouldn't the exchange rate gradually adjust to slow those capital flows?**

**Sachs:** Fixed exchange rates are part of the story, but the mix of short-term debt problems and fixed exchange rates is more complex and, I would say, to this point not fully understood. Some countries have hit the worst of the crises, even after they've abandoned the fixed exchange rates. In those countries the fixed exchange rates served as the prelude to the crisis in encouraging the capital inflow, but the panic occurred even after the fixed exchange rate was abandoned. This was the case, for example, in Mexico in 1994, where the fixed-exchange-rate system led to a sharp loss of reserves, the currency was floated, and *then* a panic ensued. And so the floating exchange rates came too late to insulate the economy from a full-fledged panic.

The point is that if you owe a lot of dollars in the short term, and if you have insufficient dollars in the short term available to repay those loans, then even under a flexible exchange-rate system you can be vulnerable to a very acute financial panic. But the likelihood is that you're going to get to such a panic under a pegged exchange-rate system. In contrast, a flexible exchange-rate system will allow many safeguards that do not guarantee the absence of crisis but make it much less likely. And in fact, as I said, the fixed-exchange-rate countries are the ones that have fallen into crisis—the flexible-rate countries, by and large, have escaped crisis.

**WEA: We are beginning to see some anti-market backlash to recent economic troubles—capital controls in Malaysia and a partial debt moratorium in Russia are only two examples. Is such a backlash to be expected? Is it a cause for concern?**

**Sachs:** I think that lots went wrong in the global management of the international market system, so naturally you would see some backlash. But what is a matter of concern, of course, is that the remedies can be worse than the disease. Poor prescriptions rather than good prescriptions can often follow a crisis. We saw in the midst of the Great Depression, for example, a reversion to protectionism that utterly destroyed the international economy and did great damage for decades. It was a reaction to the failures of the gold standard but it was not the right reaction. It was a panicked reaction that led to a spiralling of disaster. So, just because something goes wrong doesn't mean that any response to it is an appropriate response. That's why we really need to understand much more carefully what's happened, and then target the solutions to the weaknesses of the system.

**WEA: As this crisis becomes more widespread, are you concerned that there will be a return to isolationism and protectionism?**

**Sachs:** At this point, I am not of the view that we are about to descend into protectionism. The underlying pull of globalisation is incredibly powerful. Even countries very hard hit by crises, by and large, are still hoping to remain attached to the international economy. Even the current government in Russia, which has a lot of people from the pre-independence days, are claiming that Russia wants to stay engaged in the international system, wants to attract foreign investment, wants to maintain open trade. Whether they know how to do that and whether they do it is another matter, but I think one can see by their rhetoric, by their statement of intentions and by the actions around the world that, by and large, the goal is to remain attached. But that doesn't mean that full openness of financial flows is the best form of engagement, and that's the main point of the discussion right now. You can believe very much, as I do, in globalisation without thinking that unfettered flows of short-term capital is the appropriate form of that globalisation.

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**WEA: In your recent piece in *The Economist*, you argue that some types of control on the flow of capital may be appropriate. Other economists disagree. Can you summarise the source of the debate?**

**Sachs:** First of all, there are two kinds of capital controls and they tend to get mixed up in a lot of the discussion right now. There are controls on the *inflows* of capital—that is, restrictions on the ability of domestic firms to borrow from abroad and therefore to limit the amount of foreign capital coming into a country. And then there are restrictions on capital *outflows*—that is, locking up foreign money that has already come into the country or preventing domestic residents from taking their money out. Chile is an example of a country using the first kind of capital controls. It has long restricted short-term borrowing by its domestic banking system. Malaysia is an example of a country using the second kind of controls. It announced that holders of Malaysian equities could not take money out of the country for one year. I am in favour of the first kind of controls and against the second kind of controls. Other people have different views. But the first thing to do is to define our terms correctly.

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Limiting short-term capital inflows is a prudential measure. It prevents your banks from getting into trouble. Banks have an uncanny ability to get themselves into trouble—not just foreign, Asian "crony" banks, but also American banks and European banks. It is part of the essence of banking. It seems that by using other people's money, by being extraordinarily leveraged, there is a propensity toward overly risky actions. And as a prudential standard I therefore favour limiting the ability of domestic banks to borrow short-term from abroad. And it is prudent for governments not to borrow short-term from abroad and also perhaps even to restrict the ability of corporate non-financial firms to borrow short-term from abroad, as Chile has done. I do not favour locking up foreign money that has already come into a country. I think that is an invitation to an abuse of policies by a national government. So being careful about what you borrow is one thing, but telling foreigners "you are going to keep your money in this country no matter what" is prone to all sorts of abusive actions by government.

**WEA: You also argue in the *The Economist* that since the real productive capacity in Asia is still in place and an overload of bad debt seems to be the real problem, the solution might involve large-scale debt write-downs. Do you think we will see the emergence of "Rubin" bonds any time soon?**

**Sachs:** There are three kinds of debts that we have to talk about. One is the debt of corporations, mainly to domestic banks in Asia. The second is the debt of banks, effectively to claimants on the banks. The third is the debt of these countries to foreign creditors—partly what the banks owe abroad and partly what the governments owe abroad. So, as always, it's a pretty complicated web of connection. The problems in Asia involve all three. Corporations are under water, in debt to their banks. The banks are under water in the sense that their assets are less than their liabilities to their depositors and foreign creditors. And the governments, either by implicitly or explicitly guaranteeing the bank capital, have borrowed from abroad and are increasingly under water, in debt to their foreign creditors.

*Banks have an uncanny ability to get themselves into trouble.*

We need actions on all three fronts although those actions have to be tailored to the specific circumstances of the country. What I was essentially arguing in *The Economist* had to do mostly with the first two forms of debt. I think that the corporate debt needs to be written down and converted to equity as you would do in a bankruptcy proceeding. But here you have hundreds of enterprises that need to go through this process, hundreds of big ones, not just one or two. So we need to find streamlined bankruptcy-style procedures that allow the balance sheets of the corporations to be cleaned up. That generally means cancelling a lot of the debts and handing over the ownership, at least in substantial part to the creditors. The banks would become part owners—they would then sell off those firms later on.

But the banks are in trouble as well because they owe a lot to their depositors and the holders of their certificates of deposits—to regular domestic bank depositors and to foreign investors in the banks. And their assets don't cover those liabilities. So to get the banking system working again there needs to be substantial re-capitalisation. That almost inevitably involves a huge infusion of public funds, just as it did in our Savings and Loan crisis. That fiscalises a lot of these losses.

Then the government ends up with the huge cost of all this. The question is whether that cost can and should be shared partly with the foreign creditors. The way the IMF intervened in the early days was basically to guarantee that the foreign creditors would come out whole. This, in my view, was one of the egregious actions of the IMF—that it stood by or encouraged a formal pronouncement of government guarantee on all of the foreign borrowings by the domestic banking sectors rather than allowing the private sector to work all of this out. So now we are in a situation where we have a lot of fiscal stress in Asia. At least in some of the countries we are going to have to think about how to reduce that debt burden over time. There are no proposals in place right now. In the short term the main thing to do is just to make sure that the press of short-term international debt repayments owed by governments don't overwhelm those governments. And so postponing repayments on those debts and providing new liquidity to the Asian governments is part of that story. We may have to revisit the overall scale of the debt down the road.

## The Role of International Institutions

**For years, economists and policy makers have spoken of a "Washington Consensus" regarding the best ways for developing economies to develop—emphasising the value of free markets, fiscal responsibility, low inflation, liberal trade, flexible exchange rates, and so on.**

**WEA: Do you see a movement away from this consensus over the past year? If so, what has caused the movement?**

*In the short term, the main thing to do is just to make sure that the press of short-term international debt repayments owed by governments don't overwhelm those governments.*

**Sachs:** I think the "Washington Consensus" has a lot of proper ideas in it. It is basically the idea that a world-wide market system is an attractive strategy for developing countries as well as for developed countries. But then come the details. We have been talking about some of them—fixed versus flexible exchange rates, capital controls on short-term capital movements or unfettered capital movements. The Washington Consensus never really reached that level of detail. It is also the case that for developing countries there are absolutely crucial issues that are not even recognised by the so-called Washington Consensus—problems of health in the tropical countries, problems of energy use, problems of agricultural productivity. A lot of science and technology questions that the international community does a quite miserable job in addressing. So the Washington Consensus was partially not a consensus on some key tactical issues. It was definitely much too limited in its scope in not addressing many of the most pressing problems facing the real state of development in the poorer countries.

Then comes another problem—the organisation of the International Monetary Fund and the World Bank. Because of the weight that the US government has given to them, those institutions have had a paramount, and I would say domineering, role within developing countries. I have negotiated for 15 years with the IMF. I find it to be a deeply flawed institution—not sensitive to local conditions, and not technically up to the task in many cases. And I've worried very much about giving so much responsibility and power to a quite secretive institution.

**WEA: Some economists argue that the IMF is an unnecessary institution, which maybe even does more harm than good. Their basic argument is that the IMF's willingness to assemble rescue packages simply encourages bad economic policies in the first place— policies that could not persist without the existence of the IMF. Do you share that view? If not, what do you see as the IMF's main role?**

**Sachs:** I think the IMF should exist because I think we do have problems of co-ordination in the international financial system. I think there are shared goals in the international system, such as convertibility of currencies for international trade, where the IMF has played a very constructive role. I think also there are occasions when emergency financing makes sense.

But I don't think the IMF has been effective. It hasn't been effective in diagnosing the nature of international markets, and it hasn't been effective in its form of giving advice. So I think it has done a lot of damage in the ongoing crisis. It think it essentially failed in Russia and I think it has done a poor to mediocre job throughout Africa where it has been deeply involved for 15 years.

Rather than scrapping the institution, however, I would like to give it one more chance to undertake a quite fundamental reform in its mission. I think it should have much less power. I think it should have much less dominance in developing countries, and I think it should have a re-defined mission. That means settling properly issues of exchange-rate policy, getting some international agreement on the scope for capital controls, limiting the ability of the IMF to dictate measures to developing countries when those measures are suspect, increasing the transparency of the institution, and giving countries more freedom to formulate their own policies.

I also think there is a way to approach many of these crises other than through IMF bailout loans. For years I have recommended orderly workout mechanisms instead of IMF bailouts as a proper way to proceed. So, instead of putting in fresh money from the IMF, help the existing creditors to see their collective interest in rolling over debt or in giving a standstill to developing countries. This, in essence, is what happened in South Korea at the end of December 1997 after the IMF approach of promising large amounts of funds had failed. So there are some good examples of orderly workout approaches that are in contra-distinction to the IMF bailout approach.

**WEA: Are your criticisms directed more at the way the IMF functions, or more at the policies the IMF pushes?**


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**Sachs:** I think the criticisms involve both aspects—the way it functions and what it recommends. I see a link in the long term, but perhaps not in the short-term necessarily. A better functioning institution is more likely to come up with the right policy approaches. If you are secretive, if you are a monopoly power, if you are backed by the US Treasury whether you do right or wrong, if you never admit mistakes, it is very hard for an institution like that to hit on the right policy and to change course when it is on the wrong policy. And so I think that the secretiveness, the aggressiveness, the arrogance of the institution definitely allowed it to go down the wrong path in the Asian crisis. This means that process and outcome are related. That, after all, is very much what we believe about any system of government—that the process actually affects the quality of the outcomes.

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## The Global Economic Outlook

**Some people have argued that today's economic situation is very similar to that in the late 1920s, just before the onset of the Great Depression. Indeed, looking at the recent economic developments, it is hard to avoid the conclusion that the world is headed toward recession.**

**WEA: Do you also see some dangerous similarities in the current world situation and that existing in the late 1920s?**

**Sachs:** I think there is a fundamental difference between now and 1929. In 1929 all major economies were on the gold standard. When a panic occurred and there was a flight from national currencies to gold there was a scramble for a limited stock of gold, which meant that the whole world was engulfed in a monetary contraction. Now, fortunately, we don't have a global gold standard. What we have is a set of emerging markets that are on a dollar standard. For them, that is like the gold standard. And as the flight to dollars takes place out of those countries they are essentially facing the same kind of crisis that the gold-standard countries faced from 1929 to 1933. But for the major countries of the world, we are not bound by any artificial straightjacket like gold, and for that reason I think that we have the wherewithal to escape a global contraction. If the Federal Reserve, the Bundesbank, and the central banks in the other G7 countries push monetary policy into an expansionary mode right now, and if the emerging markets let their currencies float, then I think we have a good chance of avoiding anything like the calamities of the 1920s and 1930s.

**WEA: But given the Bundesbank's current fixation on avoiding inflation do you think such a co-ordinated cut in interest rates is likely to occur?**

**Sachs:** The Bundesbank always leans, I think, excessively in the direction of monetary constriction. That has been its mantra for all of its existence. But it is also pretty clear that the Bundesbank has started to hear the message from other central banks, from the new left-of-centre government in Germany, and from the international markets. Just yesterday (October 5) the head of the Bundesbank acknowledged that if things get worse there is no taboo against considering further action—even monetary action. So I believe that there is some light there—although one is never sure.

**WEA: How important is Japan in the global economic outlook? Is it even more important than its size suggests?**

**Sachs:** Japan is very important because it is a lynch pin of the Asian economic system. Japan and Asia are in a spiralling decline. Japan's weakness hurts Asia, Asia's weakness hurts Japan, and both are part of the overall credit implosion right now. But Japan is a creditor country and it has a way to get out of this—through a lot of monetary expansion, through credits (both grants and loans) to the East Asian economies, and through more aggressive action of the Bank of Japan to buy up bad debts from within the Japanese banking system. So I would like to see a much more aggressive monetary policy in Japan. People say "how can it be more aggressive if the interest rates are close to zero?" The answer is that the quantity of money can be increased through the kinds of measures I just enumerated, and I think there is scope for considerable action there. What that will do is weaken the yen further—which has been one of the things resisted both by Washington and Japan. But it seems to me that trying to cure the Japanese affliction without a weaker yen is like trying to fight in a boxing match with both arms tied behind your back.

## The Role of the United States

**As the world economy heads toward recession, and pressure mounts on the US Federal Reserve to do something, the United States finds itself in the uncomfortable position of having its domestic economic interests possibly diverging from its global interests.**

**WEA: In your view, should the United States have a set of global economic objectives that are independent from its domestic objectives?**

**Sachs:** I think in the longer term we could focus more on the US objectives if fewer of the major emerging markets were not pegged to the US dollar. So, if one followed the line that I recommend and saw countries like Brazil floating against the dollar, we would not have to ease monetary policy as much as we should now, because other countries would have full independence of their monetary positions. But we are living in a world in which for many years other countries have been pegged to the dollar. The consequences of that will depend on what the United States does, and I would definitely lean toward monetary ease to help that process.

The conflict between internal and international balance, as it might be said, is not so extreme right now, though, because the US economy is softening. The pressures that we are feeling from the international markets are causing the froth to definitely go out of the US economy, and even to slow down growth to levels that look a little bit shaky in some forecasts for 1999. In short, I think under these circumstances we would have to tilt toward the international setting anyway, but fortunately the conflict between domestic and international considerations is not so strong right now. In the future, in the kind of environment that I would like to see—more flexibility in exchange rates around the world—the scope for more independence of monetary policy on our part would be greater.

*The United States has profound responsibilities—they are enlightened self-interest responsibilities.*

**WEA: Do you think the United States has responsibilities internationally, in terms of economic matters? And if so, what are they?**

**Sachs:** We have profound responsibilities—they are enlightened self-interest responsibilities. In the short term we will not be a healthy, stable economy in a world of crisis; in the long term we will not be a safe and prosperous economy in a world of economic decay or collapse. So in the short term we have a major role to play in helping to preserve international financial stability, to help maintain macroeconomic balance, and help maintain economic growth. In the long term, we and the very few other high-income countries have a profound job to do to help—better than we have in the past—to make sure that the benefits of modern technology and modern science really do get transmitted to the poor countries of the world. We are going to face a world of growing stresses—remarkable increases in population, and unprecedented environmental strains. And unless the world is moving in a similar direction, in which prosperity is shared with the poorer countries, it is going to be a far more difficult and less pleasant world for our children in the United States. And for those reasons—given our power, our technological and scientific pre-eminence, our wealth—it behooves us to take the lead in helping to spread the benefits of economic development.

**WEA: Are you optimistic about how current difficulties are going to be worked out over the next couple of years?**

**Sachs:** I think we can avoid the worst. For some countries, things will get worse. For other countries, we have probably seen the bottom and we will soon start to see a recovery. I don't envision a global collapse. I don't even envision a global recession right now. I do envision a lot of discomfort and pain for Latin America in the coming year. I hope, and see at least some glimmerings of signs, that the bottom has been reached in Asia and a recovery could begin in 1999.

**WEA: Thank you very much for this interview.** ◆