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Book Review

Book Review: Capital Flows and Crises

Aussenwirtschaft

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Buchbesprechungen--Book Reviews

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pg. 111

Buchbesprechungen – Book Reviews

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Barry Eichengreen (2003):

Capital Flows and Crises

The MIT Press, Cambridge (MA), xiii + 377 pages, ISBN 0-262-05067-6

USD 35.-/GBP 23.50 (cloth.)

In this volume BARRY EICHENGREEN discusses many of the major issues related to international capital flows and crises. The breadth of coverage illustrates EICHENGREEN's immense intellectual capacity – not just in terms of content but also with respect to method: there are historical, institutional, econometric and theoretical, though not formal, accounts. Although all chapters have been published previously, this is far from a loosely connected collection of essays. Instead, the papers were chosen – from a much larger set of EICHENGREEN's contributions to this topic – to form a consistent entity.

The book is divided into four parts: historical background, capital account liberalisation, crises and policy implications. There are eleven chapters in total. In the introductory *first chapter* EICHENGREEN not just summarises the major issues covered in the book, but also explains how the chapters (and hence the original papers) relate to each other. What emerges is a wide but focused research agenda spanning a decade of his work. In *Chapter 2* EICHENGREEN surveys 'a century of capital flows', differentiating between four major lending booms: 1880–1913, the decade after the first World War, the period after the first oil price shock until the beginning of the debt crisis, and the 1990s. Clearly, surges in capital flows leading to economic crises are nothing new. But this does not imply that all crises are alike. Each episode took place in a specific historical and institutional context, and both structure and destination of capital flows have changed significantly over the course of the century.

In *Chapters 3* and *4* EICHENGREEN examines the case for capital account liberalisation in detail. The existing literature is inconclusive and in stark contrast to the policy consensus of the 1990s. EICHENGREEN concludes that "the lack of empirical substantiation of its [the policy consensus] fundamental tenets is worrisome" (p. 68) and then re-examines the link between capital flows and growth econometrically in *Chapter 4*. There is no evidence that the link is conditional on the stage of financial development. There is some evidence, though, of a positive link for countries with a stronger legal system and fewer macroeconomic imbalances. Eichengreen interprets these findings as an indication that "the sequencing of reforms shapes the effects of capital account liberalisation" (p. 94).

Chapters 5–9 provide detailed accounts of the more recent crises. *Chapters 5* and *6*, written in the aftermath of the EMS crises, feature two well-known empirical papers on the causes of post-war exchange rate crises and the extent to which contagion played a role. The evidence on the determinants of crises (*Chapter 5*) is rather mixed: "excessively expansionary" (p. 149) policies tend to raise the likelihood of a crisis, but there is also evidence of self-fulfilling attacks. The evidence in *Chapter 6* is highly suggestive of contagion, but rests on the strong assumption that all other factors have been controlled for. To deal with this criticism, EICHENGREEN and his co-authors test two channels through which currency crises might be transmitted: the trade and macroeconomic channels. The evidence on the trade channel is strong, but there is no indication that macroeconomic 'similarity' has played a role. The remaining three crisis accounts are narrative. *Chapter 7* draws comparisons between the 1890 Baring and 1994 Mexican crises. *Chapters 8* and *9* provide detailed accounts of the EMS and Asian crises and reveal EICHENGREEN at his

best, as he links the events not only to the theoretical currency crisis literature but also to the specific economic, political and institutional background in the countries involved.

The *final two chapters* discuss the policy implications. Are international capital flows an engine of growth or a source of crisis? EICHENGREEN describes his own position as the “messy middle” (p. 290): capital flows have proved to be beneficial for developed countries, but emerging markets need to strengthen their economic and institutional environment before liberalising capital accounts. He offers the following sequential policy recommendation to governments in emerging economies: liberalise and decontrol domestic financial markets first; then liberalise foreign direct investment before stock and bond markets; liberalise offshore bank borrowing last; rely on market-friendly instruments to limit capital flows; and align institutions and policies to the capital account regime (international standards of financial regulation and supervision; stable fiscal and monetary policies; appropriate exchange rate regimes). At the international level, he calls for emerging economies not to be pushed into premature capital account liberalisation, but instead to be pressured into reforming their financial sectors, economic policies and institutions first.

This volume is highly relevant, interesting and thought-provoking. Many of the issues raised are well-known, but even the slightly older papers included have aged well. Particularly impressive is the way they are strung together and put into context. Due to the clarity of EICHENGREEN’s writing most parts are accessible to non-specialists and students, making this book a valuable addition to many reading lists.

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