

General Discussion: Crises: The Price of Globalization?

Chair: Gordon Thiessen

Mr. Thiessen: Thank you very much, Charles. Well, you can see that there are huge dangers in allowing somebody to leave the central bank and go back into university. They start revealing the innermost secrets of central banking—like why do we accumulate reserves and why are we so interested in banking regulation of one sort or another?

Let's open up to questions.

Mr. Dugger: Charles, I thought your emphasis on the private sector conditions in the 1950s and 1990s is the right way to discuss this. This conference is about globalization. And if globalization has any impact at all, its impact is to steadily approve the noncompetitiveness of certain sectors that were developed and adopted by a country over a period of time. Globalization causes downsizing, causes restructuring.

In listening to people talking about globalization, when we look back to the 1990s, we tend to always look back and talk about it in terms of banking contractions and currency crises. But do we look enough at the real sectors on which those financial institutions and capital market arrangements depended? Did it turn out that the opening up of markets during the 1990s—opening up of economies—simply rendered large sectors noncompetitive—the Chaebol structure in

Korea; the real estate sectors in Thailand; and other sectors, such as Japan's agriculture, construction, small manufacturing, and retailing. Those sectors shrink. The institutions that lent to them shrink.

If we look at it that way, what does it tell us about what we should expect as trade and communications intensify in the coming decade? It seems to me that we need to be open to the possibility that financial crises are going to become more serious, that Andrew Crockett's job is going to become more complex because the information technology communications process is going to render at a faster rate. Sectors of economies that had previously been nurtured and protected will be rendered noncompetitive at a faster rate. This will generate financial sector problems and will generate currency capital market flows that are faster than we've seen in the past.

Mr. Thiessen: Can we accumulate some questions? I think Morris Goldstein is back there and then Roger Ferguson.

Mr. Goldstein: I wanted to ask Paul Krugman to elaborate a little bit on the case of Brazil, which I think actually is the most interesting case for other emerging economies—more interesting even than Australia. Brazil had a large devaluation, but they don't seem to have had the balance sheet effects and large-scale insolvencies that we saw in Asia.

Paul mentioned in his paper that Brazil didn't have a lot of dollar-denominated debt. My impression is that they did have it at one point but they hedged it. And the question is how did they do that? People say, "Brazil's mismatch wasn't so bad because everyone knew a devaluation was coming." Well, if everyone knew it was coming, it should have been very expensive to hedge it.

There is, of course, the Eichengreen/Hausmann view that global capital markets won't give you the kind of finance you need if you are an emerging market economy. Well, Brazil somehow got hedging finance. The question is how did they do it? How did they avoid the large-scale insolvencies and those nasty balance-sheet effects that were so dominant in Asian crisis countries? Also, Brazil has not had

a big upsurge in inflation, despite its history of hyperinflation. They have inflation targeting. They have Mr. Fraga. Could Paul tell us a little more about Brazil?

Mr. Ferguson: I would like to pick up a bit on what Charles Goodhart left us with, which is the whole question of institutional arrangements. I want to ask Paul if he senses that, perhaps, globalization might be a little self-correcting in the sense that it would create a greater move toward better practices in terms of transparency, corporate governance and banking supervision and regulation. Or is it more likely that the competition for funds will lead to a downward movement in all those areas and, in fact, we will continue to have crises that emerge from a lack of good institutional behavior.

Mr. Thiessen: Okay. Stan Fischer, do we just give you a question or right of rebuttal as well?

Mr. Fischer: I also noticed that Paul was concentrating on Asia and thought that the fact that the Latin American crisis countries recovered so much more quickly was interesting and will be interested in his comments on Morris' question. But I would like to say something about Argentina not being able to use fiscal policy at present. Whether fiscal policy is available in a recession is a matter of your previous fiscal policies. Brazil also was not able to use countercyclical fiscal policy in its crises, despite having a flexible exchange rate because the debt had reached a point at which they just had to tighten, even though people feared that it was recessionary to do that. Argentina put itself in the same position. So that's not really related to currency arrangements at all. And if Argentina had a floating exchange rate right now, it would also not have fiscal policy at its disposal in a counter-recessionary sense.

If you ask why the difference between the responses in Latin America and Asia, a large part of it has to do with the health of the financial and corporate financing sectors and with their size. The Brazilian and Argentinean banking system are much smaller as a share of GDP than those in Asia. That's probably a result of past hyperinflations. But it does mean that the cost of financial crises is

lessened and that firms have figured out other ways of financing themselves. The problems were bigger in Asia.

Finally, I think we must be careful in saying “we” haven’t done so well in two out of three, or two out of four cases. The “we” has to be interpreted pretty broadly. The countries that got on with fixing their financial sectors and dealing with their corporate debt problems more quickly, who were the Koreans, did better. And this was something that surprised me when the Malaysians imposed capital controls; they continued dealing seriously with their underlying problems. Those who, for whatever reason, have not been able to attack these problems as quickly are still catching up or still recovering very slowly. So, it is a matter of the strength of domestic policy responses as well as what can be done through the international system. And that reinforces one of the lessons that continues to be drawn—if you want to be globalized, you’d better be very careful about the type of financial system you construct, how you supervise it, and build a strong system and watch how corporations finance themselves.

Mr. Thiessen: Next on my list is Jacob Frenkel.

Mr. Frenkel: I think Paul Krugman is right by speaking about those three phases, but I would actually refer to them as three factors. In other words, one can perfectly lend with currency mismatch story but must realize that the currency mismatch reflects the fact that somehow there was not enough incentive to hedge. And maybe there was not enough incentive to hedge because there was a belief that somebody will bail out. So, the moral hazard issue, which is the policy factor, comes into the currency mismatch as one of an integrated system.

Let me say a few remarks about Charles Goodhart’s remarks—the Laffer Curve remark concerning monetary policy. If all that it means is that there is an optimal monetary policy, too tight and too loose are bad outcomes, then obviously we understand it. But I think that the example of Sweden, the 400 percent interest rate, is really not a very strong one. I would not qualify Sweden’s policy at the time as a monetary policy, but rather a futile short-term attempt to deal with an

exchange rate. It's really not the kind of thing that we talk about when we speak about too loose versus too tight. So, the question is, if a central banker needs to decide, recognizing that there will always be an error, should he or she err by being too loose or too tight? Here the question is the cost of Type 1 versus Type 2 errors. And in many cases, those that come from the legacy of high inflation, it would be advisable to undertake a strategy that allows for an error than to err on the too tight.

I found Charles Goodhart's description of sterilized intervention to be much too tolerant to it. And it is much too tolerant because the issue is not theoretical whether there is a scenario under which sterilized intervention can help, but rather a practical. I can say that somebody who had to defend an exchange rate band to prevent an appreciation and sterilize the capital inflow, I would not wish it to any central banker to do. And not because it is difficult, but rather because it is futile. I think that as you have increasing capital flows, the ability to sterilize, even for a limited period, and that limited period gets shorter and shorter, is pretty limited. And I think that as Alan Greenspan spoke this morning, it is not an ideological issue by now. It is really a pragmatic issue. And the pragmatic issue is, don't adopt for the short-run policies that are not sustainable for the long run because the long run is closer to us than what we believe.

Concerning the reserves of central banks, I think that the whole notion of reserves of central banks really needs to be revisited. The concepts were designed in the Bretton Woods era in a world in which pegged exchange rates were the tasks of central banks and in an era in which capital flows were the exception rather than the rule. And, indeed, in the new era, there is a valid question to ask about it.

And I have one final remark. The distinction between capital controls on the one hand and bank regulation on the other is much more than semantics. Even though both may generate the same impact on capital flows and things of that type, they still emanate and reflect different considerations. Bank regulations, if they are appropriately designed, reflect prudential considerations, which are relevant for the economy. And capital controls, which are typically motivated by

discriminatory efforts and inability to do the other things, even though occasionally they may have similar results.

Mr. Thiessen: One last question there, and then we'll give the presenters a chance to respond.

Mr. Lieberman: My question deals with what I think to be Krugman's lack of attention to one of the factors I consider among the most important behind the instability in East Asia—namely the absence of a well-functioning, objective, apolitical legal system. Consider the case of Korea. Any investor who ever looked at Korean companies understood perfectly well that they were outrageously deep in debt. Elsewhere, such companies would have failed. And yet, Korean companies were able to attract foreign capital and raise fresh funds any time they needed to do so, because we knew the government stood behind them. They would not be permitted to fail. But when that belief came into question—when we began to doubt that the Korean government would be able to bail them out—only then did money flee. Taiwan held up quite well, in comparison. Consider Africa, which is at another extreme. The legal system there is extremely weak and government is also deeply involved with companies, but government itself is often very weak. African companies just can't attract capital. They didn't suffer from a new bout of financial instability, since very little money went there in the first place. It was just too risky. Russia is another example where the absence of a well functioning legal system caused investors to rush for the exits when the government moved to default. The cascading effect of capital flight reflected fear that institutions would not protect investors. Contracts were rewritten, governments defaulted, enforcement of property rights became questionable. These were pivotal in provoking capital flight and they've received insufficient attention. I'd like to hear Paul Krugman discuss this subject.

Mr. Thiessen: Okay. Paul?

Mr. Krugman: I can't respond to everything. Let me take a few points. I want to react to something that Charles said about the Malaysian controls being easy because Malaysia has a current

account surplus. They didn't start there. In fact, if you look on the eve of the crisis of those four Asian crisis countries, South Korea and Indonesia were running current account deficits that were somewhat smaller as a share of GDP than the current account deficit that the United States is running today. And Malaysia and Thailand were the ones that were running very large account deficits. So, it was not a broad picture. The extraordinary thing about this crisis is that I don't think there has ever been a swing in current accounts as a share of GDP as large as occurred in this crisis. We had basically countries moving from current account deficits of 4 percent to GDP to current account surpluses of 13 percent to GDP in the space of two years. And Malaysia's current account surplus is one of those enormous swings. The whole point is, it would have been a very different story if the question was, how do we get people to continue supporting our current account deficit? The question that actually arose in the crisis was how do we keep people from forcing massive capital export that requires us to run huge account surpluses? And that doesn't necessarily bear on the question of whether Malaysia's policies have anything to do with its success, but it is worth bearing in mind.

Regarding Brazil, I'm a little hesitant because I don't feel that I understand what happened in Brazil well enough. And, particularly, I don't think I understand the lead up to the policies that had been put in place for the previous twenty years well enough. My quick summary of what I think I understand, but someone can tell me wrong, is that, in a way, Brazil got off so lightly precisely because it had not succeeded as much before. It had a financial system that had not expanded. It had a smaller banking system. It was not as highly leveraged. And, therefore, much of the foreign currency debt was official, not private. In a way, Brazil looked a little bit more like one of those pre-modern globalization economies and, therefore, was less vulnerable to the modern, high-speed financial meltdown. What was important, I think, about the Brazilian lesson was that it showed that the fears that inflation returns at the drop of a hat were exaggerated. It showed that even countries with a very bad inflationary history are less vulnerable to that. And there is something of a mystery. If I look at all of the scenarios, in every case there has been far less inflation than anyone expected, including Indonesia. Of course, that's also

happening here. And sometimes I think the Martians have a stable price ray beamed on the Earth right now. I don't know what's going on, but it certainly says that the great fear is that if you waiver even slightly in your defense of your currency, hyperinflation will be back in a month. Israel is another case where the inflationary consequences of decline in the currency were far less than anyone thought would happen. For whatever reason, it seems to be a more friendly world for stable prices.

I want to say something about fiscal policy. I agree that, by and large, the lack of ability to use fiscal policy has something to do with fiscal irresponsibility in the past. It is important to realize, however, that, by and large, the countries that we say have no room for fiscal policy do not have debt to GDP ratios that are spectacularly high. Brazil, on the eve of crisis, had a debt to GDP ratio of about 50 percent. And the reason why the deficits were so large was the extremely high rates of interest that the government of Brazil found itself obliged to pay on what was short-term debt that had to be constantly rolled over. So, in some sense, the lack of any ability to pursue fiscal policy because of large deficits was itself a product of lack of confidence, not so much of objective build up of foreign debt. I haven't redone the calculation, but I believe that if Brazil had been able to pay real interest rates on its debt—not noticeably higher, just a couple of percentage points higher than those paid in the United States—Brazil in 1999 would have met the Maastricht criteria. Its budget would have been good enough for it to adopt the euro. You really have to be careful when we talk about these things.

Regarding the point that was made about institutional arrangements, where we developed institutional arrangements, I guess my impression is certainly we will learn something, things will get better. But a lot of this doesn't seem to be obvious institutional flaws. And the changing world seems to outrun the institutional arrangements that we have. Charles was talking to you about the pre-World War I history of repeated financial crises. That was a long-standing period of globalization, at least a forty-year period of large-scale international capital flows, and they never got it right. And I don't know that we can count on ourselves getting it right any time soon either.

Mr. Thiessen: Charles?

Mr. Goodhart: I would like to start where Paul left off, which is, I think, the interesting issue that Stan raised about what the interrelationships are between fiscal policies and particularly fixed currency board or dollarization-type currency arrangements. I think this is a very interesting issue and needs further work because the founders of the euro obviously thought there was a link. Why otherwise are the Maastricht fiscal criteria there? And I think that that is a fascinating further question, which is not yet, I think, resolved.

Rob Dugger asked whether the Asian economies were uncompetitive at the start of the crisis.

Notice the remarkable speed in which the current accounts turned around, as Paul indicated. They were a bit uncompetitive, largely because they were linked to the dollar. But I don't think dramatically so in any sense nor do I see globalization as causing any greater problems than we've had in the past about adjustments to the structure of your real economy and shifts in what you produce.

I obviously managed to rile Jacob, which was rather fun. He said that there's no sort of surprise if monetary policy can be too tight. The point that I was trying to make is that monetary policy can be too tight for actually stabilizing your exchange rate in the sense that you can drive interest rates up to a point at which the effect on your exchange rate is counterproductive, not just on total events in general. And I think that that is a point that has not yet received general appreciation.

Intervention is a much more difficult one and here I have to admit that I'm a heretic, particularly a heretic among central bankers. I mean, it is now generally believed that intervention is a terribly weak reed and all the rest of it. I'm not sure that I entirely agree. Sure, you've got to be lucky and you've got to time it right, but what was the ECB doing sitting on all those reserves? If the euro is so wildly undervalued at the moment, why doesn't it actually use some for the benefit of the euro area taxpayer? I mean, after all, if the euro is so undervalued, you could actually buy a few dollars and you could

make a profit for the euro taxpayer. It's not necessarily the case that intervention is always at the expense of the taxpayer. If you do it right, it can be extremely profitable, indeed. But I recognize that I'm a heretic and you can burn me at the stake afterwards, Jacob, if you want.

And also, I agree that there is a difference in principle between regulation and exchange controls, and if we can achieve it by doing the nicer one through better regulation, yes, let's do it that way rather than through exchange controls.

Mr. Thiessen: Thank you very much, Charles. I must say, as somebody who comes from a country where all but seven of the last fifty years we've been on a floating exchange rate, I still find that my colleagues and I, when we look at the circumstances surrounding the Asian crises, are inclined to put a lot of emphasis on those fixed exchange rates. And I must say that I'm still of the view that floating exchange rates are likely to be beneficial. But I hope, Paul, that they're not just adopted because they are a kind of a funny form of capital controls. But you really do adopt them because of your concern of responding to asymmetric shocks. And you get in the process the advantage that they do respond when you get sharp capital flows in or out. But I think what we really do have to do is make floating exchange rates more attractive to a lot of countries. And some of the work that is going on internationally to increase the degree of transparency—codes, principles, and all of that—can help. We need to help some of those countries cope with those dragons of speculators, hedge funds, and all the rest of it. We do have to realize that for a lot of developing countries, it's a kind of scary notion thinking that your exchange rate can be moved around very sharply by those groups. And so that is something that we need to focus on if we are going to encourage the use of floating exchange rates.