

General Discussion: Managing Financial Crises in Emerging Markets

Chairman: Jacob Frenkel

Mr. Frenkel: Thank you very much. Well, this has been a lively introduction. I remember during my own days at the IMF when Jeff Sachs came around, people in the IMF were a little bit schizophrenic. On the one hand, they wanted to ignore him. On the other hand, they couldn't. And it reminded us of the remark Sam Goldwyn, the film producer, made about a critic. He once said, "Don't pay attention to him; don't even ignore him." The truth of the matter is that we covered a vast area, starting from the exchange rate system, where we had two strong advocates for increasing flexibility of exchange rates against yesterday's remarks by Pedro Pou for a currency board and the remarks from Prime Minister Klaus about the differing goals of greater fixity of exchange rates for monetary union; and the point that the fiscal consequences should be taken into account. I would like to remind everyone that there is no exchange rate system that can protect us from bad policies. As a matter of fact, I believe the opposite is also true. The answer to bad policies does not rest in the choice of the exchange rate system. It may be barking up an important tree, but only one of them, when one defines the existing crisis as an exchange rate crisis alone. Therefore, the real question ties to the issues of yesterday about the fragility of the banking system: How does a crisis in the foreign exchange market get transformed into a corresponding crisis in the financial market? That is an issue that deserves consideration. I would also like to pay attention to the point that Jeff emphasized so much, that the transmission of information

is not working very well and, consequently, markets have not been working very well. As a matter of fact, Stan Fischer spoke yesterday about the issue of information. He stated there is an important distinction between providing information, understanding it, and internalizing it into a decisionmaking process. So the issue is not only the availability of information, but what is done with it. Is it being misinterpreted? Can Chairman Greenspan say, "Good morning," without being interpreted to have actually said "Bad night?" It reminds me of a story about communications. Just before Thanksgiving a producer ordered 500 turkeys. A week before Thanksgiving, he saw that the demand was slow and he sent a message to the producer saying, "Cut my order in half." Well, he got 500 turkeys cut in half. Let me open the floor for discussion. I have a very long list. The first one—Allen Sinai, please.

Mr. Sinai: I have a fundamental question for all of the panel: Whether to contain—and since we've had so much talk about Thailand, so this really does apply to Thailand and any other reverberation effects in Southeast Asia—whether to contain this shock, which I agree with Jeff, couldn't be called a crisis yet. But how you describe it is almost irrelevant since it could become a crisis; more relevant is whether to contain the shock and how to do so because of the effects on the private and banking sectors. That is one part of the question. The second part is: What is your concern and the degree of it on the effects of a big fall and a very fast one in the currencies on private sector indebtedness, the banks, the burden of debt, and how and whether that could evolve into a crisis by whatever your definition is.

Mr. Frenkel: For the benefit of time, we will collect questions and then allow the speakers to decide which questions they want to evade. Please, John.

Mr. Makin: Jacob's comment about cutting the turkeys in half reminded me of a question I wanted to ask Jeff. Certainly there is evidence of severe overvaluation of currencies in Southeast Asia. But my question is: How deep does the problem go? If the currencies have been maintained at disequilibrium levels for a long time, how

much excess capacity has built up in Asia, Southeast Asia, China? We certainly had an excess capacity in Japan in the late 1980s. In turn, that kind of goes to Allen's question: How far do we have to go here? Because if we built up a lot of excess capacity, and there is evidence that somebody is exporting a lot of deflation if we look at the behavior of goods prices globally, how big is that problem?

Mr. Frenkel: Thank you. For the benefit of the record, please identify yourself.

Mr. Shigehara: Yesterday when we discussed the causes for instability, the problem of the banking system, and so forth, we talked quite a lot about the need to be more flexible in exchange rate management to avoid financial crises. I think that, in looking at the recent crisis of Southeast Asian economies, there is something to be said about their exchange rate regime. Given the growing importance of the intra-Asian trade for these economies, I would have expected that greater viscosity of intra-Asian currency relationships would have been useful in minimizing the risk associated with variations of the dollar exchange rate. When the Japanese yen appreciated sharply against the U.S. dollar from 1993 to 1995, I advised my Southeast Asian colleagues to be cautious. I argued that the non-Japan Asian economies should attach greater importance to their currency relationship with the yen or to a basket of currencies in which the yen should have an important weight, rather than pegging their currencies to the dollar. In that period, these economies should probably have expected that in the end, the misalignment of the yen-dollar exchange rate would be reversed later and they should have to prepare for that reversal. If such an exchange rate regime had been in place, the yen's earlier appreciation and its recent weakening against the U.S. dollar would not have resulted in large swings in Southeast Asian countries' international competitiveness and changes in current account positions, which have been one important cause of recent financial and economic instability. One lesson I would have drawn from the recent experience of the Southeast Asian economies is that probably we might better think of three currency zones: the European Monetary Union, the dollar zone, and a currency zone for East Asian economies where probably the yen

would play a greater role in currency stability. So rather than just saying in general terms that you need to work out a greater flexible exchange rate arrangement as argued yesterday, I would have thought that some sort of currency zone might be quite useful in increasing financial stability in Asia, given the growing importance of intra-Asian trade. I would like to have the panel's view on this. Thanks.

Mr. Frenkel: Thank you. You used the word “cautious,” which reminds me of the word that Jean-Jacques Rey mentioned about the accommodation for a cautious lending into arrears. A key question is: What is the *operational* meaning of a “cautious” lending into arrears and what is the probability that the size of the arrears in this context will actually rise? Yes, please.

Mr. Mishkin: I just want to make two comments. One relates to an issue that Barry talked about, the similarities and dissimilarities between the Mexican and the Thai crises—if you call them crises. One of the issues that is not sufficiently emphasized in the Mexican case is that the banking problems were central to the collapse there. In particular, problems in the banking sector meant that the central bank and the government were between a rock and a hard place. When you have very severe problems in your bank balance sheets, it is very hard to defend your currency. In particular, if you do so and raise rates very dramatically, this sector is going to go down the tubes and you've got even bigger problems. A key in terms of thinking about these crises, and in particular, foreign exchange rate crises, is what is happening in the banking sector and more generally in the financial sector. The second issue relates to something that Jeff talked about. Particularly, he talked about the issue of the degree of depreciation or devaluation that we've seen in Southeast Asia and compared that to what had happened in Europe. The problem is that this is comparing apples and oranges. One of the things that I emphasized in my paper, and actually that he mentioned later, is that there is a very big difference in the financial structure in emerging-market countries and industrialized countries, particularly the degree of dollarization that Jeff talked about. One of the key dangers in terms of devaluation in emerging-market countries occurs if they have dollarized and have a lot of foreign currency-denominated

debt. I agree very strongly with Jeff that one of the key issues of prevention is that you do not want to have short-duration debt contracts. Furthermore, you don't want to have them denominated in foreign currencies because, not only does that make you more vulnerable to a financial crisis, but it also means that it is extremely hard to extricate yourself from financial crises. One of the questions that comes up is: What kind of lender-of-last-resort role can you perform as a central bank? If you are in a situation where you have this bad-debt structure, indeed you may be very limited. Clearly you are limited if you have a currency board. However, even if you do not have a currency board, you are also very limited. We want to be very careful of these issues and realize that at the center of these crises is what is going on in the financial sector. A tremendous amount of attention has to be put there.

Mr. Frenkel: Thank you. Morris Goldstein.

Mr. Goldstein: I just want to challenge Jeff Sachs on a couple of points. I agree with him that it's not the exchange rate movement by itself. That's not the crisis. But the crisis is in the financial sector. Larry Summers has recently offered the estimate that the ratio of nonperforming loans to GDP in Thailand may be as much as 20 percent. They've already put 12 percent of GDP in, before the rescue package. These are big numbers. What are you going to do about the financial sector problem? I agree there is a problem with the bailout. It is the one I mentioned yesterday. The large, uninsured creditors are not taking a big enough hit for that money. But to say that there isn't a real crisis there with what is going on in the finance houses and the banking sector, I think is incorrect. Second of all, the reason for IMF involvement is the traditional one of a balance of payments problem. Thailand had an 8 percent current account deficit. They need to get some money so that the deflation of the Thai economy is not excessive. That doesn't mean they need to get a Fund program for 500 percent of quota but the balance-of-payments problem certainly provides a rationale for some of that. It is the traditional one. How much do you wring out the economy to get the balance of payments correct? Third of all, I couldn't agree more on the need for an international banking standard. I've done a bit of work on that

proposal myself. But I think if you are going to have a standard, you need to have monitoring. The BIS doesn't have the troops to do that. You need to have the IMF or the World Bank involved. There is nobody else who can monitor that standard.

Mr. Frenkel: Thank you. I am sure that the IMF's First Deputy Managing Director, Stanley Fischer, agrees with you. Andrew Crockett.

Mr. Crockett: While thanking Jeff for his plug, which was not a paid political announcement, I have to agree more with Morris than with Jeff. But my question relates to exchange rate flexibility. I certainly agree that the lack of exchange rate flexibility is a very important part of the crises that we've seen. However, for most of the time that the Southeast Asian, and indeed other, currencies were pegged, they were under strong upward pressure, not downward pressure. And presumably had they had more flexibility, they would have had a more appreciated exchange rate and a weaker commercial balance. My question to Jeff, and indeed to the others, is: At what stage does the flexibility become necessary and would it be a concern to him if flexibility at an earlier stage had led to a more appreciated rate and a weaker current account?

Mr. Frenkel: Thank you. David Hale.

Mr. Hale: I'd like to reinforce Morris' point on the role of the banking system. I think the sequence of events that led to the Thai crisis actually began last autumn with a series of private-sector reports from brokerage houses, analyzing the Thai banking system and projecting that over the following year, nonperforming loans would be 20 percent or 25 percent of GNP. There were clear movements, I think, in capital flows tied to these reports and disclosures. Finally, I'd like to ask Barry Eichengreen: We've had, in the modern period, very diverse exchange rate systems in developing countries. We've had pegs. We've had floating rates. And in recent years, we've had more currency boards. Do you think that because of these events, we are now moving toward a kind of bipolar system in developing countries of just currency boards and floating rates? Or will the kind of pegs we had recently in Asia be revived in the next few years?

Mr. Frenkel: Thank you. Scott Pardee.

Mr. Pardee: A lot of people are saying that the private sector has to do a better job in analyzing these situations, but I'd like to point out three problems in that. One is there are severe conflicts of interest. If you go to any of these countries and you want to get a mandate to underwrite bonds or stocks, you have to write good reports or they won't invite you back. So the investors themselves have realized that they can't rely on the reports of many of the people in the business community. So they have to get their independent analysts, which sometimes is expensive. The second thing is that the fund managers have to consider the availability of funds. They are committed to placing a lot of money, say, in Latin America. Then, if Latin America is a problem, where do they go with their funds? They can't go back into Treasury bills necessarily. Then, finally, there has been this criticism of the hedge funds and so forth. But the big money is still local.

Mr. Frenkel: The discussion about the rivalry between institutions of who should be the police reminds me of one of the remarks by Mayor Daley during the 1968 Chicago convention. As you may recall, there was a big disorder and Mayor Daley went to the microphone and said, "The role of the police is not to *create* disorder. Its role is to *preserve* it." Ted Truman.

Mr. Truman: Thank you. One comment: I think Barry was a little unfair to Jean-Jacques Rey's report, and maybe Jean-Jacques was a little less defensive than he should have been. But that report actually did worry a lot about the question of fighting the last war and looking forward. There was actually a long segment in it on financial stability in domestic markets, partly for the reasons that Rick Mishkin cited, because people who looked deeply into the Mexican problem and saw that although the attention was focused on the *tesobonos*, even without the *tesobonos* there would have been a crisis. It would have been a domestic banking crisis for the reasons that Rick has pointed out. One question for Jeff on his question of restrictions on dollarization and access of banks to external markets: On the face of it this makes some sense, but we also tend to argue

that domestic markets are aided by the presence of foreign banks because they have external lenders of last resort, they bring expertise, and so forth and so on. But foreign banks operating in these markets often do so by bringing in funds from abroad. So, are you going to have two standards? Foreign banks will have one standard, and they will be able to bring all the money in from abroad that they want because they have an external lender of last resort and supervisory structure, but domestic banks are going to have a different standard. It seems to me, anyhow, that is a very tough call to make, and it leads to a suggestion that it's not quite so easy to implement the recommendations you advocate. Thank you.

Mr. Frenkel: Thank you. Václav Klaus.

Mr. Klaus: Well, I will be very brief because I had the privilege to speak much longer yesterday. First, I would like to say that I am very happy that the discussion moved from yesterday to today, because yesterday several times, I had the feeling to stand up and protest against so much belief in regulation and policies and international institutions and not enough trust in the market forces. So I am very glad that the shift occurred this morning. As almost the only elected politician in this room, I must confess one thing. On the discussion about the IMF today, I don't want to criticize anything easily or cheaply, but I must say that at no moment in the Czech financial crisis this spring, did it come to my mind to call Washington, D.C. or to call anyone in the IMF. Really, believe me, never at any moment in that whole critical period before the crisis, during the crisis, or after the crisis. I am sorry to say that. And, even after the crisis, we lost some currency reserves so we wanted to augment them again. Of course, we asked a consortium of private banks to give us some loans. We didn't ask international financial institutions. Second, I'm sure flexibility of exchange rates is important, and I mentioned it very often. But, my experience with the widening of the bands is that it doesn't help. We used to have almost totally fixed exchange rates until February 1996 when we widened the bands to 7½ percent both ways. With the exception of three days after the introduction of the new exchange rate regime and three days after the parliamentary election last June, in all days from February

1996 to the moment of the crisis, the Czech koruna was 4 percent to 5 percent on the appreciation side of the band. Again, a difficult problem. And my last comment: there was this morning a pertinent talk about information. I would prefer to discuss not the lack of information, but the lack of analysis.

Mr. Frenkel: Thank you very much. Our time is up. One is always amazed when one hears this. Were all of these mistakes done by one body? Was it all done in one context? This reminds me of the story about the student who gave his homework to the teacher. The teacher looked at it and saw many mistakes. And the teacher said, "My goodness, how can one person make so many mistakes in one homework assignment?" And the student answered the teacher, "My father helped me." So, ladies and gentlemen, there are international organizations, there are private economists, there are policymakers, and there are the markets. So, there is enough blame to share around. We have three speakers; each one asked for five minutes and the way I'll allocate it, arbitrarily, is to give Barry Eichengreen, three minutes; Jean-Jacques Rey, one minute; and Jeff Sachs, two minutes. And this is not a dictatorial reaction, but a fully agreed-upon consensus among these people on the podium. At the end of the road, you will see they are credible in their pre-commitment. That is the incentive system. Please, Barry.

Mr. Eichengreen: I will use my three minutes to concentrate on the big issues. The biggest one of all, of course, is: Was Thailand a crisis and did it require multilateral intervention? I may be becoming a company man too quickly, but I do think that the interaction of the banking system problems and the currency market problems created scope for multiple equilibria. The more the currency depreciated, the more the problems created by the existence of foreign-currency-denominated liabilities in the financial system worsened, requiring more domestic credit creation to deal with them, worsening the potential exchange rate position, and ultimately giving rise to an unnecessarily high adjustment cost. You put that together with the possibility of contagion, which I do not think we should underestimate, and you have good grounds for intervention.

There were a series of questions from participants about what measures should now be taken to contain the crisis. I think that may have been a veiled reference to this debate over the use of capital controls. I strongly believe that controls on outflows after the fact are a bad idea. The arguments for slowing down inflows before the fact are much stronger. I think exchange rate flexibility henceforth will be important for containing the effects. I think yen-pegging in Asia is a bad idea, for the same reason dollar-pegging was a bad idea. I think common basket pegs for East Asian currencies are a bad idea. I think central bank cooperation in Asia is useful, but it will be counterproductive if it increases the pressure for the adoption of some kind of common basket peg.

Jeff Sachs emphasized the importance of market-led reform and a market-based procedure for debt workouts. All I can say is, "Amen, Brother." But the coordination problems we must surmount to get to that point are very, very severe. We would like to see new provisions in bond covenants to facilitate that. This is not going to happen without G-10 leadership. And if G-10 leadership is not in the cards because the markets are skeptical about these kinds of reforms, the only game in town is the IMF. That's really the bottom line of my paper.

David Hale asked, "Are we moving toward a bipolar exchange rate system where developing countries either adopt currency boards or float?" I used to think that; now I think we are moving to a unipolar system where virtually every developing country will adopt more exchange rate flexibility. I think the fashion for currency boards is over. I'm not convinced by, for example, David's earlier arguments about the merits of a currency board for Mexico.

Finally, on the point raised by Ted Truman, I was not criticizing the G-10 report, which indeed points out the danger of fighting the last fire; rather I was criticizing some spokesmen for the markets, who invoke the idea that the locus of the sources of danger will change over time as a justification for no reform.

Mr. Frenkel: Thank you very much. Jean-Jacques Rey.

Mr. Rey: Just 20 seconds to say that I was surprised to hear that there was no confidence crisis justifying a reaction on the part of monetary policy in Thailand. I think that is news to me. Thank you.

Mr. Frenkel: Thank you. You have exported 30 seconds to Jeff Sachs.

Mr. Sachs: Your arithmetic is bad. It's 40 seconds, Jacob.

Mr. Frenkel: You have just wasted it.

Mr. Sachs: All right. Better to be right about the math, though. First point, on policy: What is the priority now in East Asia? It is to let the currencies go to realistic values, so that the underpinnings of long-term growth are right. If what you mean by policy intervention is that the IMF is going to come in and say, "Let's stabilize the baht with an emergency package and keep real interest rates relatively high," you're not going to do any benefit for the banking sector through a chronically higher real interest rate policy. Indeed, the underlying recovery of the economy as a whole, not necessarily the real estate sector, but of the economy as a whole, is going to come through export-led growth again. This is not Japan. That is what is in the minds of everybody who is so worried about this is that you are going to have six years of chronic recession or, if not chronic recession, slow growth. These countries are not in Japan's situation because naturally their underlying trend growth rate is significantly higher than Japan's. They are not mature economies; they still are fast-growing, export-led growth economies. This crisis won't be as profound, because Japan is a country whose underlying growth, as we heard yesterday, is maybe 3 percent per year right now in the aggregate. These countries are still going to manage 5 percent or 6 percent growth per year with realistic exchange rate policies and world markets being in normal condition. So, I don't see the analogy there. I think what is lurking in people's minds is that everything is going to hell all of a sudden, that the bubble has burst, and that it is many years of trouble. But these countries have a lot of growth in them and they have a lot of spring in them. So I don't really see that fundamental risk or analogy as being correct. Is this a case for

currency zones? No, because trade doesn't flow on the basis of regions. We know that the problem is in fact that, for instance, the Southeast Asian countries trade not only with Japan and each other but with Europe and the United States. So their exchange rates have to be not just pegged to the yen, but realistic in terms of cross-rates of all of the major countries in the world. So I don't see this as a case for a yen zone, particularly. Final point (and I probably won't even exhaust my time) therefore, is: There are a lot of real crises in the world that are not these. The idea that the IMF is suddenly responding to crisis rapidly is an optical illusion. We are working in Malawi; we are working in Burkina Faso; we are working in the Democratic Republic of Congo. You want real crisis? That's real, extreme crisis. But it might take two years for an IMF program in a place like that, and it may take five years for the HIPC Initiative to reduce the debt. Now there is this all-of-a-sudden mood to move right in and the weak, poor countries in the world don't get the proper attention to this moment. And it can take years for them to get their case analyzed. Then when it is analyzed, it can be analyzed in a very particularly biased or unhelpful way, as I said, with no court of appeal. So I don't believe that we are doing better on crisis response. We have to keep clear what is the crisis. Is it that some people are going to lose some money because markets moved in a way or not? Or is it because there are real underlying coordination problems that are not being resolved? I think that a lot of those latter problems aren't being worked out. I heard, for instance, that maybe there will be another case for orderly workouts. There are forty countries in default right now in the world. There are emergency cases for orderly workouts. It is just that those countries are poor countries off the radar screen, and it might take ten years to work them out. That is crisis, in my view. So there is a case for solving those problems much, much sooner. They don't come to the front headlines. Therefore, we also have to define what we mean by real crisis. Of course, when a lot of money is at stake, that brings it in a sense, but when a lot of people's lives are at stake, especially the poorest people, that is also real crisis. You have those crises all over the world right now.

Mr. Frenkel: Thank you very much. Henry Kissinger once said

that one does not introduce a new world order as an emergency measure. And the question is: How do we transform that concept to an emergency situation and yet, looking ahead, pass it into a new order? Let me invite the next speaker and discussant, and in the meanwhile, thank the speakers and the discussants with appreciation. Thank you.

