

General Discussion: Exchange Rates and Financial Fragility

Chair: Andrew Crockett

Mr. Crockett: Thank you very much, Marty. We are running up a little bit against time, but I think we can take some time out of the coffee break and have something of a discussion here. First is Guillermo Ortiz.

Mr. Ortiz: First, I would like to thank Martin Feldstein for his good opinion regarding the possibilities of Latin and American central banking.

Second, the Bible teaches us that original sins can be redeemed; although, it is not an easy task. The alternative, dollarization, which Martin has already expanded on, requires preconditions that, in practice, I think, can only be met in Latin America—perhaps by Argentina. But, even Argentina has found that convertibility, which is a step prior to dollarization, is no panacea.

In addition to the conditions that were listed for dollarization, it requires a degree of domestic flexibility and discipline, which, in practice, is extremely difficult to achieve, as Argentina is finding out today, despite of the horrible memories about hyper inflation and the devastating effects that it has had.

Panama is not an entirely exciting example. Australia seems, of course, a much more promising one. What we are trying to do in at

least some countries in Latin America is to strengthen institutions and build credibility. Arminio told us yesterday about Brazil's move to inflation targets. We are trying to do pretty much the same thing in Mexico; although, there are a number of issues with inflation targeting for emerging markets which we have, of course, not discussed at this conference and which are complex and will probably merit a longer discussion.

In the case of Mexico, when these discussions of dollarization come about, what we tell them is that our NAFTA partners in North America—both Canada and the U.S.—have three strong characteristics. Both countries, for the first time in decades, have fiscal surpluses. They have strong financial systems. They have low inflation. So, let us converge to these three benchmarks. We will be moving in the right direction. And as we approach them, the whole discussion about the choice of an exchange rate regime becomes much less relevant.

Finally, about flexibility and hedging, I fully agree with Martin Feldstein's comment on exchange rate flexibility. Let me just give you another example about the advantages that it has had for Mexico. Prior to our floating exchange rate experience that began in 1995, (by the way, it was not really a policy choice to float) we had no reserves. Prior to that, the holdings of foreigners of unhedged short-term government and bank paper was in the order of \$40 billion. In other words, we had capital inflows that amounted to about \$40 billion. Since we began floating, on average, foreigners have held less than \$1 billion of unhedged government and bank short-term papers. So, instead of putting a tax on short-term capital inflows, I think that floating by itself is a strong deterrent for this kind of destabilizing problem.

Mr. Goldstein: I applaud Ricardo and Barry for making an effort in this paper to confront alternative interpretations of vulnerability with the facts. But, I must say, I find the interpretation of those tests less than persuasive, particularly as regards moral hazard. Let me just quickly mention one or two things and see if we can get their reaction.

They look at international capital flows and say they are small. And because they are small Ricardo and Barry argue that this implies a

small effect for moral hazard. But, if you take the view that the dominant source of moral hazard is national—not international, then that conclusion may not be warranted. Consider the case of Korea. If the chaebol are overextended and have very high leverage ratios, if they have very large implicit guarantees from the government, and if they make bad investment decisions that eventually lead to their collapses, would a small capital inflow tell us that moral hazard was not important? I don't think so. Because most of the sources of moral hazard are domestic, international capital flows are not going to tell us that much. In addition, the volume of international capital flows changes for many reasons (including dismantling of capital controls and changing expectations of profitability). Again, the volume of capital flows won't be able to tell much. In regard to the composition of capital flows, there are many things that change the split between securitized and non-securitized flows. Gross comparisons of bank loans, bonds, and equities won't indicate much. What we need is the difference between the actual composition and what it would otherwise be if there was no moral hazard. That is, of course, a harder test to conduct, but I think it is a better test.

Mr. Pardee: I am very serious. I think you should change the term that you are using of original sin because people from this room will understand it because you have defined it. But people outside of this room will misunderstand it very easily. I am serious because you have to deal with political elements that are involved in religion, and if you come up with these kinds of terms you will have a problem. Just think of the person who has to explain to Bill Clinton what this term means.

Mr. Berry: Like Scott, as a journalist, I would like to comment on language rather than economics. As a journalist, I am always looking for shorthand phrases to save space and carry meaning. Sometimes phrases, however, do not carry proper meaning. One phrase that I try always to avoid is “bailout.” It carries connotations of gifts, of squandering public money. You see this in the debate over the appropriateness of IMF actions in connection with crises in Washington and Congress. The authors use it both in the paper and in presentations and I think, like “original sin,” it is not a good phrase to use. Sure, in some cases, certainly investors, foreign investors have lost less money than

they would have if the IMF and the U.S. government and others had not made funds available to help in a transition. But when you loan money to a country like Thailand, which, as Marty said, started with an 8 percent current account deficit, and within a year or so has turned that into a substantial current account surplus at immense cost to the domestic economy and the people. That is not really a bailout.

Mr. Fraga: Guillermo already said most of the things I was thinking, so I will just say a couple of my own. One, I do think that there is no doubt about the need to go a little deeper and ask the question as to why there is an original sin situation. What can be done about it? It is intriguing to think about dollarization as a shortcut. But then you have to go back to the old optimum currency area and revisit all those arguments. Reread Barry's *Golden Fetters* book and other historical research. I think having gone through this thought process for not only Brazil but looking at other countries, that while dollarization may be useful for some countries that fit the optimum currency area conditions, it certainly does not present a shortcut to virtue for most countries.

Mr. Mussa: I wanted to compliment the authors. I think the most valuable thing in this paper is its emphasis on the fact that the economic situation, particularly with regard to exchange rate regimes and related matters, facing emerging market countries is simply very different from the situation facing industrial countries. Carrying over a lot of the analogies from industrial countries' experience is quite dangerous, often inappropriate. I noticed that Marty said, "Well, if you float the exchange rate then you no longer need to raise interest rates to defend the exchange rate." It is not so. When the Mexican peso comes under severe downward pressure because of broader emerging market difficulties, the Banco de Mexico cannot just sit there and let the currency fall. It needs to react to those pressures by raising domestic interest rates. Similarly, when emerging market countries exit from defact or desure pegs, they did not have the option that the Bank of England did to cut interest rates and for Norm and Lamont to sing in the shower after he let the exchange rate go. That is not the situation that confronts these countries in those circumstances or in others, and it is important in thinking about their policies and policy regimes to recognize those differences.

Mr. Chandross: I would like to make three comments. First, with regard to Thailand and South Korea, one of the main issues was a lack of transparency, both in terms of the fact that the reserves were being squandered through the forward market or through processes that did not make them available to the central banks when they were needed.

Second, the fact that a lot of those institutions that put capital into the country, particularly Thailand, had very little information or did not take much effort to find out where the money was going. I think it makes a big difference whether a bank was lending the money to a company that was in the export business or lending the money to a company that was building an office building for which demand for space was very questionable.

Third, with regard to Marty Feldstein's point about backup lines of credit, in fact, these can actually be a perverse entity because when questions arise about a country and there are concerns about getting your money out, in many cases the international banks that provided the backup lines are the same banks that are providing trade lines and other short-term capital. And because they know they are going to have to honor the backup lines, it provides them with an incentive to withdraw their lending through other mechanisms, therefore, making a potential crisis worse rather than less of a problem.

Mr. Visco: It seems to me that inflexibility on the nominal side must have as a counterpart a high degree of flexibility somewhere else on the real side. This is an argument that is already important in Europe after the euro launch and this example seems appropriate but not in the way that has been used by Barry and Ricardo. They are right that interest rates have fallen in the chronically high interest rate countries such as Ireland, Italy, Portugal, and Spain. But they add that this has made it easier to cut budget deficits and stimulate growth. It seems to me that the reverse has happened. Those countries that had some "original sins" have been able to achieve price stability and put order on fiscal side. This has helped convergence in interest rates and, at the end, has produced the possibility for the successful launching of the euro. So, there is nothing else you can do other than act with pain on the issues that have caused the original sin.

Mr. Sherwin: I did not like the paper. I thought it was defeatist in some respects. It strikes me that original sin is mostly a product of, or a euphemism for, weak policies or a lack of policy credibility. I have no doubt that the source of those weaknesses is related closely to very complex domestic political considerations, which can be a real handicap for some emerging economies. But weak policies should not be regarded as inevitable. There is a reward for good governance. There is a price to be paid for weak governance. I don't think that the "original sin" referred to in this paper amounts to anything more complex than that.

Barry Eichengreen worries about the lengthy time lags required to build credibility. He speaks of a twenty-year lag which is clearly too long to wait for the benefits of credibility. But I see nothing inevitable about such lags. Indeed, I am reminded of our own case where New Zealand spent ten years messing up its economy with abominable policies. After that had precipitated the inevitable crisis that, in turn, sparked the necessary policy reforms, it was just months rather than years before foreign investors began to back those reforms. Very substantial backing came in the form of purchases of domestic currency bonds and also in the form of a very vigorous euro currency market in New Zealand dollars.

If we had more time, I would talk about the weakness of banking systems in emerging economies, and the value that can be derived by inviting foreign banks to participate in the domestic banking system. By inviting in sound foreign banks, countries can speed up the process of building credibility. They get added balance sheet strength in the local financial sector, better risk assessment, some protection against political manipulation and corruption, as well as valuable diversification of fiscal and systemic risk—and all in a short period of time.

Mr. Makin: This conference is about finding an approach to credible policy rules. I think the previous papers give us a guide in answering the question of whether we should have floating rates or dollarization. Dollarization amounts to giving up control over the money supply and floating rates amounts to giving up control over the price of money. If a country is not part of an optimal currency area with

the United States, it seems to me that it is impossible to have credible policy rules under a dollarization regime because of the time inconsistency problem. If you are really going to have credible policy rules, you have got to have an optimal currency area. So, by default, I think it is far more credible to give up control over the price of money and let the currency float.

Mr. Crockett: With apologies to those who wanted to speak, I will give a minute or so each to the presenters and discussants. Of course, we will by doing this save time for the general discussion at the end of the morning, which means the comments that you are bursting to make can be made then. So, I will ask if they can very briefly respond to any of the main points that have been made but at length. First are Barry and Ricardo.

Mr. Hausmann: I will be brief in answering Marty. We have discussed floating regimes with inflation targeting. Marty said that the problem is large current account deficits, overvalued exchange rates, mismatches, short-term dollar liabilities, and insolvent banks. Let us take the issue of current account sustainability and overvalued exchange rates. If a country was to float and adopt inflation targeting, what could its central bank do when faced with such conditions? After all, we have been talking about inflation targeting for two days and nobody mentioned the current account. Is it supposed to raise interest rates and, thus, appreciate the currency even further? Should it lower interest rates and cause an even larger increase in domestic demand and inflationary pressures? Would inflation targeting have led to smaller current account deficits and real appreciation in Mexico before the Tequila crisis and in Thailand? Has it avoided large deficits, strong currency misalignments among the major currencies? So, if large current account deficits and overvalued currencies is central to the story, I do not see how floating and inflation targeting is a solution.

Will floating do something about the currency mismatches in external borrowing? According to the BIS cross-border lending takes place in very few currencies. In fact, it only reports data for ten currencies and once you leave the first four currencies, volumes drop dramatically. Are we to believe that the reason why ten countries borrow

abroad in their own currency and 160 do not is due to the fact that 160 countries do not know how to run a central bank?

I think that Guillermo Ortiz and Arminio Fraga are great and that they would find it surprisingly easy to run the central bank of any G-7 country. The difference is not in the quality of the policy-makers but in the nature of the constraints they face. One such constraint is original sin. Many of the countries that suffer from it have no particularly noteworthy history of inflation. The proposition that the problem will go away through greater central bank credibility is a very strong assumption. I can think of several alternative explanations, which we discuss in the paper, which could account for original sin through mechanisms that are unlikely to go away so easily.

Mr. Eichengreen: Those people in the room who believe the ability to borrow in your own currency can be gained overnight tend to come from, what we can euphemistically call, the advanced industrial countries. And the voices we have heard, maybe mine notwithstanding to the contrary, who believe this is a long and laborious process to complete, tend to come from the emerging markets. If the emerging market perspective is correct, and it will take some years to complete the process, you have to force the banks, the regulation to close their foreign positions. If you force the banks to close their foreign positions, they pass on the currency risk to the corporates and you get a credit risk problem.

Then, to respond to Marty, you probably have to slap on Chilean-style holding period taxes or other measures to limit the ability of the corporates to take on this foreign risk. And then maybe at the end of the day you get into a problem where the banking system is not intermediating and the corporate sector is not able to obtain credit through other channels. Representatives from Mexico and other countries who can speak to this problem I think will be available at the break.

I am more skeptical about building reserves than Marty is. I owe to Steven Grindle the comment what you end up doing is paying more for the short-term borrowing than you earn on the reserves. Why was it worth while to borrow short-term and then end up losing money in the

first place? Marty alluded to maybe you could put these reserves into high-risk assets and there is clearly a down side to that as well.

Finally, I have enjoyed debating with Marty the merits of EMU for the last decade and look forward a decade of debating dollarization.

Mr. Feldstein: That is an optimistic forecast, Barry, because it tells us that we won't have dollarization for the next decade.

I would just emphasize that I think the issue of the inability to borrow in other currencies is an overstated problem. Countries do not need foreign borrowing to support domestic investment in any large amount. As I said, 80 to 90 percent of domestic investment is financed by domestic savings, and of the remaining 10 to 20 percent, a significant part comes from equity investment. So, much of the foreign capital is not needed for domestic real capital accumulation but is part of a speculative activity. It is not even necessarily net borrowing from the rest of the world. It is money coming in in one form and going out in another. So, the answer is really banking supervision not dollarization. My chairman tells me I should limit my time so I will stop there.

Mr. Crockett: Thank you very much, Marty. I think we had an excellent discussion supported by a first-class paper and discussion. I would like to thank everybody on the panel for their contributions to that.

