Commentary: Managing Financial Crises in Emerging Markets

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These crises that we are discussing—the Mexico crisis and the Thai crisis—can remind one of the sad gentleman who calls his doctor one day and says, "Doctor, so what's the news?" And the doctor, as you know, says, "Well, I have bad news for you and I have worse news. What do you want first?" "Doctor, why don't you tell me the bad news?" He says, "Well, your lab tests came back and they show you have 72 hours to live." The man says, "Oh, my god, Doc, what could be worse?" "Well, I've been trying to reach you for the last couple of days."

You get the feeling sometimes in Mexico, not only did they run out of reserves, but then the worse news was there was $28 billion of *tesobono* short-term liabilities that suddenly came to the front page of the *Wall Street Journal* on December 21, 1994—almost neglected beforehand. In the Thai case, not only was there a need for devaluation, but the worse news was learned afterward, all the while the Thais had been proclaiming proudly that they weren't running down their reserves. Even today you will find in the back page of *The Economist* magazine that their reserves are standing at $31 billion (a quite healthy sum). But these reserves had been run down in forward swaps and the forward market to a small number that we don't know of at this point. There hasn't been the even worse news that Thailand has *tesobono* liabilities as well. But who knows what we are going to find?

So, obviously, information is not working very well. That is part of what we have been discussing. But I also think the analysis of these crises has not been working all that well. I want to start with a comment that I made yesterday and now I have a chance to amplify it a little bit. The question is, what constitutes a crisis? Are we experiencing a crisis in Southeast Asia? What do we mean by that? How bad is it really? Does it require official intervention? I have my doubts and I want to raise those doubts.

I've given a little handout of some tables and if you could turn to Table 1. This is just the year-over-year change, August 20, 1997, over August 20, 1996. At the top panel's first half are the Southeast Asian countries, ostensibly in the middle of a deep currency crisis. On the bottom panel are the European currencies for which everything is going along fine. What you see, of course, is that Europe has depreciated significantly more than the Southeast Asian currencies during the past year. But it hasn't been a crisis. And it hasn't been a crisis because vis-à-vis Europe, we are in a world of floating exchange rates; vis-à-vis Southeast Asia, we were in a world, until recently, of pegged nominal exchange rates. The same market forces, in my view, have driven the dollar up relative to virtually all currencies in the world in the past year and vis-à-vis the yen in the past two years. For those countries that were pegged to the dollar, this was a kind of painful experience, because they had to gulp and let the dollar peg go. For those countries which were floating against the dollar, this has been quite a normal process, so the dollar strengthened. It strengthened because it was undervalued for a number of reasons in earlier years and because Japan and Europe turned out to have more difficult problems than had been foreseen. But, for whatever reason, I believe the evidence is fairly clear—and I believe it to be the case—that the Southeast Asian countries needed to get off the dollar hook, as the dollar strengthened significantly. And, if they had been floating, that would have happened smoothly. They weren't floating. They had a declared policy. That is what we are calling a crisis.

I don't believe this is a serious crisis. I think the most serious crisis is to get Prime Minister Mahathir to calm down, actually, and stop

Table 1
Currency Depreciation, Emerging Market and Developed Country Currencies
(August 20, 1997 versus year earlier)

Country	Depreciation vis-à-vis $US
Indonesia	18.1
Malaysia	11.6
Philippines	16.0
Singapore	7.1
South Korea	9.8
Thailand	23.7
Belgium	25.6
France	23.1
Germany	25.0
Italy	19.2
Japan	9.2
Spain	25.6
Sweden	22.4

Source: *The Economist*, August 23, 1997. Calculated as the year-over-year percentage increase in the domestic currency price of the U.S. dollar.

doing damage in his own country, which I think they are doing with interventions in the financial markets right now.

If you look at Table 2, you can see how far the currencies have actually declined. What I have done here is make a trivially simple index of weighted nominal and real exchange rates, simply using one-third for the dollar, one-third for the deutsche mark, and one-third for the yen, which is about right for Southeast Asia. What you can see in the case of Malaysia is a depreciation of all of 0.1 percent since the beginning of this crisis. Nothing! In real terms, it's also 0.1 percent. The movements in real weighted exchange rates are trivial

Table 2
Bilateral, Weighted, and Real Exchange Rate Depreciations in Asia
(Percent, year over year)

Country	Bilateral ($US)	Weighted, nominal	Weighted, real
Indonesia	18.1	6.4	3.4
Malaysia	11.6	.1	.1
Philippines	16.0	4.6	1.9
Singapore	7.1	-3.5	-3.1
South Korea	9.8	-1.1	-2.6
Thailand	23.7	11.5	8.5

Source: *The Economist*, August 23, 1997. The weighted exchange rate is calculated as a geometric weighted average of the U.S. dollar, deutsche mark, and yen, with equal weights. The real exchange rate is calculated adjusting for consumer price inflation, using equal weights of the U.S. dollar, deutsche mark, and yen.

right now. This does not mean that there aren't people who are going to lose a lot of money having bet on the stability of the dollar. So there are crises for a lot of individuals to be sure. I don't want to deny the real pain that is being felt by banks that borrowed in dollars and lent to real estate and by those who gambled on a nominal peg's being sustained. What I do want to say is that the drama that we are talking about is no big drama in terms of the size of movements, in terms of the kind of correction that is needed. We don't have a rampant, self-fulfilling run from these currencies. We don't have panic in these currencies. We don't have flight from the baht. We don't have speculative attacks on the ringgit. What we have is the dollar strengthening and these currencies, which depend heavily on the yen and heavily on Europe for their trade, responding to the sharp cross exchange rate, plus the fact that, as Barry noted, there had been moderate real appreciation in the previous five years. I would put the combination of moderate real appreciation plus significant cross-rate movement of the dollar plus the fact that these currencies had unwisely pegged to the U.S. dollar as what we are calling the crisis right now.

Again, yes, people will lose money, banks will close, real estate developments will fold in Thailand. But these currencies need to depreciate to get their export growth on track. They are all export-led economies. Nothing should be done, in my view, to stop the depreciation of these currencies. Moreover, the big damage that is being done right now is that tight monetary policy is being introduced to try to prevent the normal depreciation that ought to be taking place.

We see it all over the place where the Harvard Institute for International Development is involved, whether it is the Philippines or Indonesia or other countries we are watching; the reaction of the policymakers is to raise interest rates. The advice of the international community to tighten up monetary policy significantly to try to hold the nominal exchange rates does not make sense, in my view. What these countries need fundamentally is the underlying base of long-term growth, which is going to come from realistic, nominal exchange rates. I should add, by the way, that markets haven't worked very well in the last couple years, in that the attention of the money market managers to underlying real exchange rate movements has been much too low. I know that by talking to a lot of you and a lot of them over the past couple of years. Countries cannot borrow unless they can repay with net exports. And countries cannot repay with net exports unless their export base is competitive. That means keeping real exchange rates at realistic levels. To be whispering in the ears of finance ministers that the most important thing in the world for them is to keep their nominal exchange rate to the dollar peg, because that is the way a lot of money is going to be shoveled in, is very bad advice. It is bad advice to be giving and it is bad advice to be receiving.

What these countries need to hear more than anything is that their long-term health, and therefore, the short-term health of your money inflows, depend on real export competitiveness in the long term. That means flexible exchange rate arrangements, not stable U.S. dollar exchange rate arrangements.

That is the first point. I don't see a crisis. I see mistakes, but I don't see a crisis. I still don't see the case for, as I will explain a little bit more later, for the International Monetary Fund (IMF) emergency package for Thailand. I don't understand what it is supposed to be doing in particular. What Thailand needed was a depreciated currency. This was clear for two years. A lot of people, including myself, said it to the Thai government. What we also said repeatedly was, "Don't do the Mexico thing. Look, if you are going to face the problems of the markets, don't spend down your reserves because the thing that is worse than overvalued currencies is overvalued currencies and no reserves at the end." And they went ahead and did exactly that. Fortunately they don't face, as I'll come back to, the specific problems that Mexico faced on December 21 after the devaluation. They don't have the *tesobono* overhang. Therefore, I think the case for official intervention is very weak in this particular circumstance.

I have also distributed a talk I gave at the Bank for International Settlements (BIS) at the end of December 1995. I feel it is more true today than it even was then. The point was that our ability to prevent these crises ex ante is much greater than we are exercising right now. It is not the interventions ex post that are going to be most important, but the prevention of the crises. Some very basic things that were true in December 1995 are still true today. I just want to list five of these and then go to the post-crisis management issue.

The first point, in my view, was that strictly pegged exchange rates raise the risk of financial crises and therefore should be used only in very specific circumstances. That is what we have just seen again in what is called the Southeast Asian crisis, but really is simply a problem of pegged exchange rates.

Second, the central bank should discourage the dollarization of accounts in the domestic banking system. Similarly, governments should avoid the dollarization of their own short-term debts. Most of these emerging markets have very weak balance sheet problems because, as Rick Mishkin reminded us yesterday, they have banks that have complicated currency structures, lots of dollar liabilities, and lots of dollar assets. The problem is that the regulatory controls that are in place where the net open position on foreign exchange is limited doesn't work, for a simple reason: A lot of the dollar assets of the banks in these countries are in domestic real estate loans. So these dollar assets cannot resist real depreciation. When it comes, you get bankruptcies even if it looks like the net open position is limited. I think there is a strong case that banking sectors, because of leverage and their role in payments and settlements, are different from other financial markets. And the extent of dollarization should be limited by regulation. It comes down to what Chairman Greenspan said in the opening remarks, "In normal fiat money systems, central banks can act as a lender of last resort, because they print the money." But in the emerging markets, that is not true, because a lot of the liabilities in the banking system are dollar-denominated. You don't want to get into a situation where your own central bank cannot be a lender of last resort.

I disagreed with what Pedro Pou said yesterday about Argentina. Argentina got itself into a situation where a central bank cannot be a lender of last resort, and now it is asking the world community to be a lender of last resort. I think it is better maybe for Argentina; given historical circumstances, it was the right way. But don't give the advice to the others. The others should keep their systems from getting dollarized in the banking system, so their central banks can be lenders of last resort. And that is one of the big risks right now. It can be attended to, but it is hardly part of our policy discussion in IMF programs, for example.

Third, as a corollary to the first and second points, currency board arrangements should be avoided except in the case of very small, very open economies. Even then, central banks should maintain some scope for lender-of-last-resort actions and should arrange international lines of credit in advance in order to be able to respond to future banking crises.

Fourth, the liberalization of controls on capital inflows should be managed gradually to avoid a boom-bust cycle. This is quite clear. There is a lot to be said about that, but not in fifteen minutes. The main problem is banks that are liberalized, that borrow dollars, and that lend for real estate—this over and over again is what this crisis has proved to be about. In many, many countries that have gone through financial market liberalization, you cannot have dollar liabilities—especially short term—on lent whether in dollars or in local currencies for nontraded goods in economies highly dependent on export-led growth, because you tend to get overvaluation, and then when the real depreciation comes, the bank balance sheets get into a lot of trouble.

The fifth point, which has been partly remedied since the time I gave this talk but not fully, is BIS prudential standards for commercial banks are not sufficient in developing countries. More stringent capital-asset ratios should be encouraged, as well as rigorous minimum capital levels for banks. I should add, and I will add in a moment, the role of the BIS should be greatly increased throughout the world, particularly in the emerging markets. I am delighted there is new membership in the BIS of the emerging-market countries. But there is a lot more to be done.

When should there be official intervention? In my view, the main case is when there are multiple equilibria and you want to get out of the bad ones—not simply when mistakes have been made. When there are banking panics, financing panics, extreme expectational panics, these cases arise. I think they arose with Mexico when Mexico could not roll over its short-term paper. So the problem in Mexico wasn't mainly the devaluation. The problem was that, because it had been mismanaged so badly, they could not roll over short-term paper. It was quite clear from analysis that it was not a solvency problem, so there was a case for intervention.

In Thailand, I don't see the multiple equilibria problem. I don't see the markets going awry. I don't see a financing problem. I just see mistakes and people that regret that they made a lot of real estate investments. But I don't see the case for emergency intervention on that basis.

Multiple equilibria is one kind of case for intervention. The second is when you have extreme coordination problems, which you have in debt workout situations.

How do you intervene in these cases? One part is through standards and through regulation and oversight. There is a strong case for the BIS expanding its oversight role and even auditing role in banking sectors in emerging markets. I could elaborate. Maybe we will have more chance to discuss it, but I think there is a real opportunity there. I don't think that responsibility belongs with the IMF particularly. It belongs with the central banks and with the BIS. There are a lot of reasons why it should not be with the IMF.

Let me finally say a word about the role of the IMF itself, one of my pet hobby horses I admit, but I can't resist. First, the IMF has gone a little bit from inaction to maybe hyperactivity. I don't see the case for this emergency package in this particular case.

Second, I happen to believe that we look at the IMF as the failsafe to go in and clean up the country. The amount of technical errors in IMF programs is significant. They are large. If there is a real informational problem with the IMF, part of it is that we don't scrutinize the IMF itself because everything the IMF does is secret. The IMF wants to distribute lots of information to the world, but what it doesn't do is to distribute its own advice, its own actions, or to have ex post reviews. I raise this because many very important cases are being mishandled in my view. The IMF, this year, pushed Bulgaria (with all that's now known about this), pushed Bulgaria to a currency board where not only is there a fixed exchange rate, it is in the law! You don't put your exchange rate in the law, with all due respect.

So, why is it that this advice goes? Because the IMF says, "You do this or you are out of the international community." There is no court of appeal in this case. There is just your IMF staff. It is bad policy and it was a real mistake, in my view. It is going to be a problem. I have my concerns about giving more and more power to an institution that has what, in the European context, is called a democratic deficit or a review deficit or a postmortem deficit. I think it is a serious problem that is not really addressed in a serious way.

Finally, I would say, in almost all of these kinds of interventions there are ways to do it that are probably more market-oriented than we are doing it right now. In my own thinking and writing about orderly market workout, what I try to stress is analogous to the quasi-market mechanisms that allow for debtor and possession finance and allow debtors to tap financial markets even when they are financially strained through, for instance, Chapter 9 and Chapter 11 of the U.S. bankruptcy code. Almost everything I've said about that has been misunderstood, because I am not arguing for an international bankruptcy procedure. What I have been trying to suggest is that rather than viewing workouts as the IMF mission's going in and declaring what the country should do and insisting on the conditionality, there are more market-tested ways to get finance to countries that need it in the midst of financial workouts.