Comment on "How Can Future Currency Crises Be Prevented or Better Managed?" by Stephany Griffith-Jones

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What Are the Problems that Need Fixing?

This paper provides a useful evaluation of procedures already suggested by others for better preventing and managing currency crises in emerging economies. It then turns to some inventive and welcome new suggestions for official involvement, and in so doing clearly moves the debate forward. Before turning to three of Stephany Griffith-Jones' specific suggestions, let me spend a few minutes on identifying three aspects of crises which might justifiably worry policymakers. Since all new policy measures will be costly in some regard, either in their formation or their implementation, it is important that their benefits be perceived to outweigh their costs. Moreover, solutions implying new procedures on the part of the official sector should ideally be devised to deal with those aspects of crises which are judged most troublesome.

A first possibility is concern that a country with liquidity problems will be faced with an overshooting problem. As capital, both domestic and foreign, leaves the country, interest rates may rise "excessively" and the value of the currency may fall "excessively", with potentially damaging international and domestic effects.

Turning to the first of these, what is the likelihood that overshooting problems in the case of a single country would cause systemic problems for the international financial system? One new factor reducing the likelihood of such an outcome is that most of the capital inflow into emerging markets in recent years has been provided by non-banks. This is completely different from the 1980s when the safety of the international banking system was at stake. Contagion is of course more likely, but we must remember that contagion is not systemic risk, and that even if a number of smaller countries experienced problems, it is not clear that the further reverberations would have costs sufficient to warrant grand solutions. Yet it is worth underlining that, if a liquidity crisis were thought to have systemic implications, this would certainly tilt the bias in the direction of the official sector doing something other than relying solely on what has been called "the market solution".

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In contrast, it is quite likely that the interest rate and exchange rate overshooting could be so great as to seriously harm the economic prospects of the country under attack. The international official community would wish to avoid this if it could. That is to say, the official sector would wish to intervene if the costs of doing so (especially moral hazard) were not greater than the perceived benefits. Yet it is not clear that market failure of this sort should normally be presumed. Indeed, I would like normally to put the burden of proof in the opposite direction, particularly given that the more people are involved in securities markets, the greater is the likelihood of market efficiency and price setting consistent with fundamentals. Note too that for countries with balance of payments (trade) problems, higher interest rates and a lower exchange rate (forced by the market) are not necessarily part of the problem. They may indeed be part of the solution.

One factor that seriously aggravates the danger of overshooting is a weak domestic financial system. Given such weakness, the domestic monetary authorities cannot respond in a timely way with adequate interest rate increases, and the currency may thus be viewed as seriously vulnerable on the downside. Moreover, sharply higher interest rates may eventually be forced upon the authorities by the markets with very serious domestic implications. While the obvious preventive measure is to strengthen the domestic financial system, if the system is weak when a crisis hits, the resulting domestic damage may be grave. This raises the issue of what procedures might be put in place to help a country in such circumstances.

A second problem that new procedures might deal with is the seizure of assets and attempts to pursue sovereign countries through the courts. Those suggesting "officially sanctioned" standstills seem to see this as a major problem. The history of the last fifteen years makes me doubt this, though it is clear that this problem is more likely to be consequential given a myriad of unorganised security lenders (as at present) than given a smaller number of bank creditors (as in the past). A helpful factor is that, in fact, most sovereign countries do not have assets abroad of any significant worth.

A third problem raised in the context of recent liquidity crises, but not directly caused by them, may be the need to reduce (rather than restructure) sovereign debt. The Griffith-Jones paper only mentions this in passing, but better ways to approach debt reduction are what may be quintessentially "new" in recent discussions. Sachs' suggestions, based on the reasoning underlying Chapter 9 and 11 of the US Bankruptcy Law, do explicitly include procedures for more orderly debt restructuring and possible debt reduction. To me, the need for better and faster procedures to deal with "debt overhang" problems is self-evident. It is now well over a decade since the debt crisis broke and its resolution has been glacial.

Yet to identify a problem is not to identify a solution, since all solutions have costs as well as benefits. Let me now turn more specifically to the proposals in Griffith-Jones' paper. She recommends three things:

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Some Specific Solutions to the Identified Problems

There should be controls over (or at least fuller disclosure of) capital inflows into emerging economies with control being exercised from both the debtor side and the creditor side (regulation).

There is clearly a need for more disclosure by debtors of timely and relevant information, in particular macro-data and data on the size and maturity of liabilities. Markets need information to price risk correctly and to avoid problems of "self-fulfilling expectations". Yet to go from disclosure to regulation (particularly of creditors) is a big jump. Griffith-Jones suggests that, if there is to be an International Lender of Last Resort (ILOLR) then regulation (particularly of creditors) is needed. She is led to this conclusion by the analogy that provision of a domestic lender of last resort facility implies complementary regulation to minimise the cost to the public purse. Yet this argument is not compelling for two reasons. First, there should be no certainty that an ILOLR will always lend and, short of that assumption, there will still be a great incentive for self-regulation and less need for the official sector to do it. Second, if the ILOLR is to lend only to "solvent" countries, analogous to a domestic lender of last resort, then the taxpayer will not be exposed. Mexico will not prove to be a bail-out if the Mexicans repay. I agree, however, that the ILOLR could always make a mistake in assessing solvency, at which point the taxpayers of the creditor countries would be exposed.

Turning briefly to the specifics of Griffith-Jones recommendation, I have three points. First, the whole thrust of her approach assumes it is "foreign" holders of securities who are the problem. In fact, domestic holders of assets may be the first to head for the exits. This regulatory/control path would, moreover, lead into exchange controls very quickly if both foreign and domestic holders of government debt must be dealt with. Second, focusing rules on current account deficits may lead to tardy policy reactions if such deficits are lagged effects of underlying problems (e.g. an overvalued exchange rate). Measuring the size of an "unsustainable" current account deficit is also an inherently difficult task. Third, the suggestion that we need regulation and supervision of securities flows because they are less well "overseen" than bank loans ignores the fact that it was bank loans that got us into the debt crisis of the 1980s. In sum, supervision and regulation have benefits in some circumstances, but they are no panacea.

There should be an ILOLR lending on Bagehot's terms (unlimited loans to solvent debtors) with terms ideally arranged before a crisis hits.

The suggestion that the Fund pre-negotiate "conditionality", using the promise of immediately available funding later if a crisis should occur, is interesting, but I see certain problems. Would news that the Fund had prepared a crisis package actually catalyse such a crisis? This is a real danger in that many "threatened" crises never happen, as noted in the Wyplosz-Eichengreen paper. Would countries ever

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bind themselves to conditionality they did not want (because otherwise they would do it anyway), to help deal with a crisis that was not already there? Similar to the problem of identifying "unsustainable" current account deficits, there is also no agreement as to when fiscal deficits are "too big" or monetary policies "too expansionary". This ambiguity will clearly hamper pre-crisis agreements.

Second, the suggestion that the ILOLR facility should be designed for "the less stable but smaller emerging markets" brings us back to the need to specify clearly the nature of the problem being addressed. Problems in small emerging markets have far less likelihood of developing into systemic problems. On the other hand, as Peter Kenen's paper notes, we should remember that the Fund was not set up to deal with systemic risk but rather to help out member countries with temporary balance of payments financing needs.

There should be, as an "absolutely last resort", recourse to some more formal work-out procedures for sovereign countries akin to Chapter 9 and 11 of the US Bankruptcy Code.

Let me raise a number of problems whilst reiterating my personal belief that finding a better way forward in this area justifies the further, serious attention paid to it in Griffith-Jones' paper:

1. The use of IMF Article VIII 2(b) to support such formal procedures is not legally sufficient. New Articles or an international treaty would be required, and this could take years to negotiate.
2. At the "standstill" stage, if creditors could be prevented from having recourse to the courts, they could still sell assets, leading to overshooting. Thus, if overshooting is the big problem arising from securitisation, it is not obvious that more formal procedures will help significantly. Some questioning of market participants as to possible market responses in altered circumstances might be illuminating.
3. As for "new money", it is not at all clear how security holders could be forced to lend more. There could then still be need for official liquidity support and exposure.
4. As for new "debt reduction" procedures, they would be better than what we currently have if they could be applied in a more timely way, and if they assured that all creditors were treated fairly subject to the various levels of risk they had been paid to assume. In this context, the issue of institutional participation needs serious reflection. One important question is whether the IMF, as a preferred creditor, could be given responsibility for deciding when bankruptcy could be declared, thus imposing costs on others.

Finally, should we be talking publicly about all this? I think the answer is yes. As Stephany Griffith-Jones rightly says, the very fact that investors know a bail-out is not automatic means they will be more prudent than otherwise. This almost always represents a step forward.

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