Post-crisis Reconstruction: the National Dimension

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Many conferences have taken place on issues related to the recent financial crisis in emerging economies. This conference is particularly promising for its subject matter as well as for the way it is structured and the quality of the participants. Even if views still differ on both the nature of the crisis and its consequences, as well as the longer-term institutional and policy changes needed to foster an overall safer financial environment, a number of points can be made concerning what we have learned and about the successful responses to the crisis. However, the starting point should be that not much should be expected as a result of the efforts to reshape the so-called international financial architecture, and efforts should mostly concentrate on what should be done to make countries more resilient to contagion and panic effects.

First of all, we have learned a number of lessons that could be summarised in at least five points:

— Rigid exchange rate pegs directed at price stability or export promotion objectives carry an inherent risk of becoming unsustainable because financial imbalances — also associated with large fluctuations of the anchor currency — are perceived as persistent and rising. As this is, sooner or later, a rather likely event and as it is very difficult to determine the precise timing for giving up an exchange rate peg, (small) open economies seem not to have much choice between the extreme forms of fully flexible exchange rates and completely fixed ones supported by currency boards. In both cases, important conditions have to be met to avoid negative economic consequences, keeping inflation expectations under control in the first case and setting the exchange rate at a value that adequately reflects economic fundamentals in the second. It is as obvious, in this case as it is essential to make sure that fundamentals remain consistent with the chosen exchange rate parity. A strong and well-capitalised banking system is also necessary in order to meet adverse shocks.

— Complete liberalisation of short-term capital flows, with contemporaneous substantial restrictions to long-term foreign capital inflows (fixed direct and equity investment), produces a fundamental distortion that amplifies the risks of contagion and may lead to extreme pressure on a currency even in the presence of otherwise seemingly satisfactory macroeconomic fundamentals.

— The provision of adequate information on the size and composition of a country's foreign external position, including not only the level of official reserves but also information on the maturity of domestic banks' foreign indebtedness, is essential to maintain orderly market conditions. Transparency on capital flows and on the underlying stocks is necessary (though not sufficient) to produce timely responses when imbalances start to threaten.

— To restore confidence on the part of investors after a crisis requires both a return to a consistent and prudent macroeconomic policy setting and the recognition that growth prospects will not be jeopardised. This has important implications with respect to the stabilisation programmes put in place following a crisis, since it is clear that one size does not fit all. In particular, while an increase in short-term interest rates might often be the inevitable response to counter an extreme depreciation of the currency (and an especially necessary one if firms' balance sheets show a very high level of foreign currency indebtedness), the fiscal policy reaction very much depends on the state of public finances as well as on the need to offset possibly dramatic reductions in employment and the level of domestic demand.

— To avoid capital flows that may be excessive, given the riskiness of the underlying investments, the latter need to be properly priced. This leads to a need for revising the role and significance of capital adequacy standards such as those agreed in the 1988 Basel Accord. In particular, it should not be taken for granted that OECD membership is the most appropriate prerequisite for guaranteeing the lowest possible risk attached to short-term bank lending.

Considerable attention has been given to moral hazard as a possible element that might explain the building up of a systemic crisis. Without denying that this factor might at times play a non-negligible role, the stability of a modern dynamic financial system is not necessarily guaranteed. Quite apart from what might trigger a crisis, its diffusion depends, in fact, very much on the building up of self-fulfilling expectations, on the prominence of herd behaviour in conditions of partial and heterogeneous information, on "beauty contest" phenomena that are difficult to avoid. Therefore, even more important than how to prevent a crisis from taking place, the question might be how to act to reduce its impact and volatility in real economic conditions that might be associated with it. It should also be observed that, while the short-run consequences might be very severe, experience seems to indicate that only in very difficult times do crucial measures that make the domestic economies more crisis-resilient end up being taken. Clearly, the positive consequences of these measures crucially depend on the associated structural reforms not being withdrawn as the "good" times arrive.

This leads to a further observation. Perhaps too much emphasis has been given so far to the search for ("optimal"?) exchange rate mechanisms (in a menu that ranges from fully flexible to completely fixed exchange rate systems, including single currency areas). Correspondingly, we risk not giving sufficient attention to the fundamental necessity of enforcing coherent macroeconomic and structural policies and conditions that are needed to support any exchange rate system. Consider, for example, the proposal advanced by Eichengreen and Hausmann to look at the European countries' experience during their progress towards the EMU. To guarantee capital flows towards emerging economies, they claim, a necessary condition is to reduce interest rate volatility (and the burden associated with the connected risk premium). The European experience is therefore interesting, as the drive towards monetary union would seem to have led towards a substantial reduction of interest rates "in the continent's chronically high interest rate countries, making it easier to cut budget deficits and stimulate growth". It nonetheless has to be observed that the reduction in the level and volatility of interest rates in these European countries (i.e. the interest rate convergence among the countries participating in EMU) was a condition for their taking part in monetary union rather than a consequence of such a decision. The convergence was only made possible by substantial progress improving economic structures and public sector finances that led to a remarkable reduction in inflation rates and fiscal deficits, and to a period of sufficiently stable exchange rate conditions. On the other hand, considering the proposal of "dollarisation" recently advanced, for example, in the case of Argentina, there is a risk that the country might be negatively affected by fluctuations in US interest rates and in the effective exchange rate of the dollar, especially if the product and labour markets are not flexible enough. Also in the case of an exchange rate bilaterally fixed with respect to a single foreign currency, even in a currency board arrangement, such risks are obviously present. Such an arrangement might be modified, however, and to avoid real and perceived competitiveness losses consideration might, for example, be given to linking the national currency to a basket of a small number of important currencies rather than to a single one.

Responses to financial crisis are obviously different depending both on the origin of the crisis and the initial conditions of the economies involved. However, even if we are still far from the possibility of expressing a final appraisal, in a number of countries the exit from the 1997-98 crisis seems to point in a positive direction. In Southeast Asia, the V-shaped recovery, as in the case of Korea, is very much the result of a proper mix of policies and structural reforms in the corporate and financial sectors, as well as some positive developments in the labour market. In Brazil, the macroeconomic adjustment is, eventually, likely to bear fruit. Even if the crisis has had dramatic effects in many countries, the counterfactual question of whether it would have been (politically) possible to adopt proper policies in the absence of pressure from a critical situation is very difficult to answer. Other experiences of advanced economies seem to suggest that even if in good times structural reforms would certainly be much less costly, it is most often the case that only a crisis will induce the necessary policy changes. What is important is that these not jeopardise the growth prospects of the real economy. Reducing the regulatory burden in the corporate sector, and at the same time increasing transparency and improving the governance system, therefore have to go hand in hand with healthier and more efficient banking and financial systems. The Korean experience of 1998-99 is important as it shows that a wide range of structural reforms may have a significant impact in restoring the confidence lost during a crisis. Even if confidence might be an elusive concept, as Krugman and Stiglitz have recently forcefully observed, this does not mean that we should not pay attention to it, as it plays a crucial role in investment decisions. Even if a comprehensive effort towards structural reforms may not be, by itself, a guarantee towards rapid recovery from a crisis, especially if not accompanied by supporting macroeconomic conditions and policies, it is certainly a very important element to ensure its sustainability. The best response against a financial crisis, then, is likely to be that of building stability-oriented institutions while, at the same time, ensuring that market relations have a transparent and efficient environment. This might not be sufficient to prevent a crisis from occurring, and perhaps even spreading to the global economy, but it would help significantly in dampening its effects.

The need to provide better information on the state of an economy is often mentioned as a prerequisite for a proper assessment of sovereign risks. Transparency should not only be applied to produce appropriate statistics of real and financial transactions with the rest of the world, but a more thorough assessment of real economic developments and prospects also appears to be needed. Proposals have been made to give to an institution such as the IMF the role of "formally" judging the progress and the failures of the various countries. An enhancement of the role played by private rating agencies has also been examined, even if much evidence has been accumulated on their lagging behaviour, and associated destabilising effects, in the evaluation of country risks. While the possibility of producing (peer-examined) reviews of emerging economies along the lines of the country surveys that are part of the OECD surveillance process might well be considered, it is mostly the responsibility of the countries themselves to provide the information and analysis that is currently lacking. There should be an especially strong incentive, in fact, for countries with strong fundamentals, consistent policies and solid institutions — from which stable growth prospects appear to follow with high probability — to provide market participants with the elements necessary for discriminating properly among different risks.