

## General Discussion: What Lessons Can Be Learned from Recent Financial Crises?

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*Chairman: E. Gerald Corrigan*

*Mr. Corrigan:* In light of Pedro Pou's comments, Stan Fischer, who had to leave, has asked me to read a note that he wanted to be part of the record of these discussions. I will do my best to read Stan's handwriting, but I think the gist of what it says is rather clear and I will read it as follows: "Pedro's question about how the Fund should operate in a case such as Argentina's has been discussed at some length with him and his predecessors. As of now, with Argentina in an IMF program, there would not be a big problem in increasing our lending to Argentina rapidly, if it were attacked (meaning if its currency or its financial system were attacked) and provided, of course, that the right policies are in place. In the case of Argentina, they are. For a country not in a program, it would take a bit longer to make such a loan because we would have to agree with the country on the policies needed to deal with the crisis. But we do have the ability to move very fast under the Emergency Financing Mechanism, if the country's policies are on track. Pedro says that the problem is that the Fund's board would have to agree to activate such a facility. He prefers a lender of last resort that would provide funding automatically, but I don't see how any agency could commit to providing sizable loans without having an agreement on policies—that is, a program. This means that if Argentina wants an automatic line of credit, it needs to be in a precautionary agreement in which it has the right to draw but does not expect to draw in normal circumstances. That is precisely where we are heading in our discussions with

Argentina. But unconditional lines of credit are not a good solution.” I also, Pedro, would like to make a point in the context of your comments. And that is: I think it should be said, perhaps a little more directly than you said it, that the Argentine banking system was far from exempt from problems in 1995, even though I think it is also fair to say that they perhaps were not as acute as cases we’ve seen in other countries. And you’ll get an opportunity in a minute to respond to all this, but let’s open the floor for a few minutes of discussion. Yes, Gavyn Davies.

**Mr. Davies:** I’d like to ask Urban Bäckström a question about the role of the fixed exchange rate in handling your crisis. Two things: First of all, do you think in retrospect that it would have been better to have floated the exchange rate earlier and eased domestic monetary policy earlier? And second, if a similar example, similar problem, hits a country in the future inside monetary union, what differences do you think that will make to the handling of the crisis?

**Mr. Bäckström:** What could have happened if we had floated in October instead of November? That is basically your question. There was a conflict between monetary stability and financial stability. No doubt about it. However, I think the main lesson goes back to the 1980s, where we should have seen the development of the bubble, we should have been warned of the massive increase in credit. And if we had pursued a stability-oriented policy back then, I think the crisis that we went through would have been much milder than it was. That basically answers your second question: What would have happened if we had been a member of monetary union? We would have pursued a low-inflation policy together with other countries and that would have, I would say, not driven us into the crisis that we later went through.

**Mr. Corrigan:** Mr. Becker.

**Mr. Becker:** I also would like to put a question to Urban Bäckström. We discussed this information problem this morning very intensely. When your crisis was developing, I think the authorities in Sweden were very well-informed on the development in the

different aspects and nothing happened I suppose because, as you mentioned, the political will was not there until the crisis itself came up. And I think that is the same as what Stan Fischer said, that government is only ready to act in the time of crisis. Now, having experienced the crisis yourself, what is the lesson you take out of that? Do you think in future times, the authorities will still be incapable of acting ahead of time? And second, do you have any lessons as far as indicators are concerned? Do you have specific indicators which might lead you to react faster or are you still unsure of what kind of figures you are looking at to start acting in this way or that way? Thank you.

**Mr. Corrigan:** Urban, please.

**Mr. Bäckström:** The question was: Did we see the problems but not act because of political reasons? No, I wouldn't say that because there was another climate back then. Martin Feldstein in his foreword of the book that I mentioned, *The Risk of Economic Crisis*, has part of the solution. He says that economists have been occupied by discussing the normal fluctuations of economies during the past twenty, thirty, forty years—something like that—but very little attention was devoted to the abnormal fluctuations of economies. And I think that is the reason. We didn't see it as a developing financial crisis; at least I didn't. I wasn't in government, but I didn't see it from the private-sector perspective either until the early 1990s.

**Mr. Corrigan:** Thank you.

**Mr. Bäckström:** Let me only add, we had to draw major conclusions from that, of course, especially in the central bank. We are trying to do that now.

**Mr. Corrigan:** Andrew. Questions have got to get shortened up, as do the answers.

**Mr. Crockett:** Thank you. Yoshio Suzuki makes a persuasive case that handling a financial crisis is complicated by being locked into a fixed exchange rate. The problem is that it is easy to get on to a

fixed exchange rate; it is much harder to have the exit strategy that Jacob talked about. When times are good, there is no pressure to introduce flexibility and there may even be a fear that flexibility will produce appreciation. When times are bad, you have the reputational problem that Pedro mentioned. I drew from Pedro's intervention that there would never be a right time. How does the panel think one can handle that question? You need an exit strategy, but I have never seen one adequately defined.

**Mr. Corrigan:** I don't know who wants to answer that. Pedro?

**Mr. Pou:** I wonder if I could comment on Stanley Fischer?

**Mr. Corrigan:** Before you do that, I want to hear from Jacob Frenkel. Jacob, let's get your question on the table here, because my hunch is that it is not unrelated.

**Mr. Frenkel:** That is right. The first remark concerns Pedro Pou's characterization of the 1995 crisis: I think you are perfectly right that it was a liquidity crisis rather than a solvency crisis. But still the fact of the matter is that it highlights one of the limitations of a currency board system. It does not provide an automatic mechanism for a lender of last resort, and you really had to work very hard to find some imaginative ways to provide liquidity. I am not sure that this solution is indeed resolving all the difficulties of the currency board. But I also want to remark about the ex ante role that you see for the international community and I, with Stanley Fischer, think it is very dangerous, especially with respect to the moral hazard problem. I think there is additional danger that once you create that avenue for an ex ante role, you really discourage the development of markets, the development of private instruments, and you probably limit your country's access to international capital markets, given that you are going to depend so heavily on that international role. And finally, something that the panelists did not mention but it came up in other conferences: One of the lessons learned from those banking crises is that if you see one, the implementation of the remedy had better be swift. And if you delay it, then you lose credibility and the too-big-to-fail syndrome comes in. Thank you.

**Mr. Corrigan:** Pedro, could you respond succinctly to these various observations?

**Mr. Pou:** First, I would like to respond to Andrew Crockett's comments on exit rules from convertibility and the need to introduce flexibility in a currency board. However, what we have found in Argentina is that once the currency board regime was established and obtained credibility, the economy developed a very large degree of price flexibility that allowed external shocks to be accommodated. Therefore, I don't see the need to think about changes in the regime or establishing exit rules. The main argument against the fixed exchange rate is the need to accommodate real shocks in the absence of price flexibility. The danger is that without price flexibility or exchange rate flexibility, adjustment must come through unemployment. What we find now in Argentina is that nominal prices are flexible downward. This price flexibility is increasing over time as the regime becomes more and more credible. Second, with respect to Jacob Frenkel's question on the limitations of a currency board to act as a lender of last resort, I would say that these limitations are true, but are no different from the limitations of any monetary regime that puts a high priority on price stability or any kind of nominal stability. So, I don't think that the fact we have adopted a currency board gives us less flexibility, compared with an alternative that has the same objective of price stability. I would like now to answer the question about the ex ante role of the IMF and the question of moral hazard. I knew that this topic was going to be controversial, and I was prepared for this response. So I was happy to know that Stanley Fischer was leaving, but I didn't expect that he would read my mind and leave a note with his comments! First of all, I would like to state categorically that my comment does not reflect the IMF's role in the 1995 crisis in Argentina. The Fund acted very rapidly to put in place a facility and to help Argentina to surmount the crisis. My comment was more general, since I was supposed to be talking about the lessons we learned. One lesson that I learned, or I think I learned, is that if an ex ante commitment had existed, maybe we would not have had the crisis at all. As I said, countries that have limited access to international funds have to have a high-liquidity policy. That high-liquidity policy has a very direct

tradeoff with respect to domestic credit. One possibility of reducing this tradeoff is obtaining from the capital market the necessary liquidity against domestic assets. That is what we have done in the repo facility, and my comment was that there are limitations in going further with these facilities. I don't see any reason why, if the private market is willing to offer such a facility, the international organizations should not do so. Maybe Jacob will give the obvious answer. If the private market does it, why should government institutions? The fact is that the private markets do not provide the exact kind of liquidity assistance that is needed, and that is where the international organizations can play a role. I recognize the moral hazard problem, and that is probably what Stanley could read in my mind. However, I said that if the IMF were to take such a pre-emptive role then, of course, it should take all the responsibilities that come with a lender-of-last-resort policy, that is, regulation and supervision. That means that a country that enters into such a facility will have to be subject to (1) an IMF program that is previously agreed, and (2) specific regulations and supervision of the financial system.

**Mr. Corrigan:** I guess my reaction to all this is I would not encourage anybody in the audience to expect to wake up tomorrow morning and see these mechanisms in place. Again, I think there is an issue, Pedro, beyond the moral hazard that we saw in the Thailand case. That is, unless the Fund is on board with what a country is doing, you just aren't going to see a lot of people standing in line with their checkbooks in hand, either private or public. Somehow or other you have to square that circle. I know there are some frustrated prospective questioners. Does anybody have a quick one?

**Mr. Chandross:** This is for Mr. Suzuki. You talked about the bad loan situation in Japan, and yet we don't see any progress being made in developing a more comprehensive set of measures to deal with it. Is that likely to be an issue this year? Or is it just going to drag out at a very slow pace?

**Mr. Suzuki:** Writing off the bad loans has been in progress and is still proceeding steadily. According to the announcement of the Treasury, the peak is already over. But, the macroeconomy is so

weak that some people are concerned about a final resolution of bad loans. So in that sense, I said that a bad loan problem still existed. No one knows what will happen, but it is not so serious at present. But if the macroeconomy would get weaker and weaker, then a bad loan problem might trigger the instability of the system again. But otherwise, I think the most serious phase is already over.

**Mr. Corrigan:** Thank you. I started off this morning by saying that in the area of financial crises and disturbances, what you see is not always what you get. Over the past twelve to fifteen years, we have had significant financial disturbances of one kind or another in industrial countries, in developing countries, in emerging-market countries, and in transition countries. We have had disturbances involving banks, nonbanks, and other types of financial institutions. We have seen this phenomenon in countries that have well-established systems of deposit insurance and lenders of last resort. We have also seen it in countries that have neither. We have all come through this, I think, with a feeling that we have dodged most of the big bullets; but at the same time, all of us have a deep, nagging sense of unease growing out of the fact that the process has involved a degree and a magnitude of official intervention that leaves us all uncomfortable. I think that would be an understatement. Our discussion this morning—and, Tom (Hoenig), your conference more generally—is going to help us all see the way clear to the approaches, the policies, and the practices that hopefully will leave us a little better off in the future than we have been in the past. So to our speakers this morning and Tom, to you, thank you all very much.

