

Commentary: Crises: The Price of Globalization?

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Paul opens his paper by suggesting that the good old days were calmer. But that depends on how far back you go. The interwar period was hardly a haven of tranquility, and the 19th and early 20th century were interspersed by twin banking and currency crises, quite similar to those of recent years.

So, perhaps, the really unusual period historically was the decades between 1945 and 1973, which, in retrospect, seem both calm and prosperous. Several special features characterized this period. I would select three: first, a stable system of pegged exchange rates, the Bretton Woods system; second, widespread controls over capital flows; and third, quite strict limitations on the kind of business that commercial banks could do. These three features were, of course, interlinked. Paul puts most emphasis on the importance of exchange controls in limiting capital flows. I would place equal weight on the importance of exchange controls as a necessary concomitant to maintaining domestic restrictions on commercial banking. Remove exchange controls and banking can just go offshore, unless liberalized domestically.

There were, of course, some financial crises in the 1950s and 1960s, but they mainly stemmed from laxity in public sector finances. And the IMF, under the guidance of Jacques Polak, soon developed a common and successful (Western Hemisphere) model

and approach to deal with those. But the financial crises of recent years have more often arisen from private sector financial laxity, especially a property investment cum banking boom. As research work at the World Bank has shown, one of the best indicators of a banking crisis is prior deregulation and liberalization of that country's banking system.

As Paul notes, none of that implies that we either could, or should, go back to the status quo ante 1973. The benefits of an open economy are just far too great. A free trade system brings with it a need for free capital flows, and free capital flows bring a need for a liberalized domestic financial system.

But we do not yet have a standard or a successful model of how to handle the resulting private sector crises. For example, the situation is even more complex than Paul suggests. Paul correctly argues that when domestic banks and firms have large short-term foreign currency debts, that country is at risk from a downward spiral of devaluation and default, the bad equilibrium in his Figure 2. And he correctly argues against monetary loosening, but excessive domestic monetary tightening could be just as bad.

Let me give two examples. The first one is Hong Kong in October 1997. It reacted to the speculative attack, brought on by Taiwanese devaluation, by allowing overnight rates to go to some 120 percent, and appeared to threaten banks with withdrawal of access to the discount window. All that frightened the horses. No one wants to invest in a country that cuts off its nose to spite its face. The attacks on Hong Kong eased after it adjusted its system, via the September 1998 measures, to reduce the extent to which interest rates jumped in response to currency outflows. The second example is Sweden in the 1992 ERM crises. It pushed overall interest rates to 500 percent. Such levels are neither politically nor economically credible and can actually be counterproductive. There is a kind of Laffer curve for monetary policy also. The problem is that none of us knows quite where the curve may peak.

One suggestion to improve matters, which receives virtually

universal support, is to develop domestic bond and securitized mortgage markets in emerging countries so they do not have to rely so much on bank borrowing, especially foreign currency borrowing. Paul pays rather more attention to a much more contentious solution to the problem of currency crises, which is the adoption of rigidly fixed currencies, currency boards, or further the adoption of a common currency, dollarization, or euros. The main problems that I see with that are political rather than economic, though there remain plenty of economic problems.

Almost all countries have their own single currency. Regional and sectoral adjustment problems still abound within such national systems—think of the UK now with services in a strong boom, but the tradeable goods sector stagnant. But within countries there are a variety of mechanisms, both economic and political, for easing such pressures and pains. Paul mentions the case of Argentina with its Currency Board where neither monetary nor fiscal instruments are usable to ease the pain if asymmetric/adverse shocks occur. If the pain gets too great, with the threshold depending on history and politics as much as economics, radical politicians will arise who will promise to free the people from their monetary chains. And remember that, in currency issues above all, the grass is always greener on the other side.

So, if you cannot abolish currency crises by abolishing separate currencies, what else can you do? Well, as Paul notes, for a variety of reasons, floating is safer than a pegged but adjustable system.

For the rest, Paul has explored a number of palliatives—official intervention, exchange controls, perhaps of a limited extent, and enhanced regulation. Like Paul, I believe that official intervention can sometimes work in a basically free market system. If sterilized intervention does not work, then why do countries seek to build up foreign exchange reserves, and why are countries with large reserves seen as less fragile? One of the research exercises that I am undertaking is a study of Hong Kong's equity market intervention in August 1998. This was, I believe, an example of a well-executed, successful, and, above all, luckily timed intervention.

The use of exchange controls is even more contentious. Certainly in Malaysia, where I visited the Bank Negara recently, they believe that their application there was successful. My response was that the more successful they are in the individual case, the more dangerous they could be to the system as a whole. Malaysia was, to some extent, a special case because it could rapidly transform its prior deficit to a current account surplus, in part, by cutting back on huge, even grandiose (public sector) investment schemes. And, thereafter, it did not have to rely on further capital inflows to finance a current account deficit.

One of the slightly surprising aspects of Paul's paper is that there is hardly any mention of speculators, hedge funds, or highly leveraged institutions—the demons according to Asian mythology. But where Paul's paper does coincide with Asian views is in seeing a strictly limited set of markets, such as the off-shore currency market, and of institutional flows, such as short-term bank lending, as being responsible for most of the turbulence. Rather than talking about exchange controls generically, would it be better to examine ways in which such a limited set of financial flows can be kept under better control? In particular, could such mechanisms for limiting volatile short-term capital flows be subsumed under the general heading of banking and financial regulation rather than as direct controls? We are conditioned to think of exchange controls as being “bad,” while enhanced and improved banking regulation are, usually considered to be, “good.” So, if we can achieve the same objective by a good route, that is an advantage. And, as a final tail-piece and query, if better and more comprehensive bank regulation could be a useful means of preventing twin crises, what implications might that have for the question of whether commercial bank supervision should be separated from the Central Bank, or kept as a joint function within Central Banks?