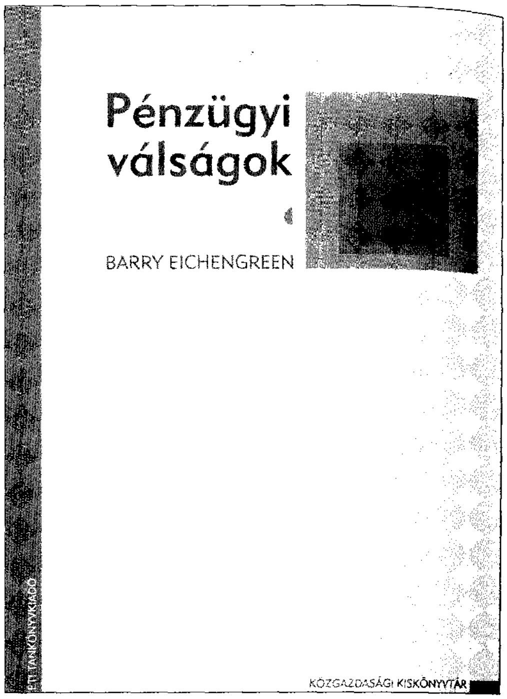
Barry Eichengreen

Financial crises: how can we counter them?



NATIONAL TEXTBOOK (NEMZETI TANKÖNYVKIADÓ) PUBLISHING HOUSE, 2005

Following the sweeping crises of 1997–99 the issue of financial stability has become one of the central problems of international finances for both researchers and decision makers. After the Asian crisis and the subsequent Russian and Brazilian collapse many feared that the events came to jeopardise the system of global capitalism[1]. What happened generated numerous theories on how to avoid future shocks of the same kind, and how to mitigate exposure brought about by international movements of capital.

In the present volume *Barry Eichengreen,* professor at Berkley University attempts a summary of the efforts made by the international community in the area of crisis prevention and crisis management, i.e. investigating how much more stable our current financial system is than the a decade before. Two series of lectures served as the basis of the book, held in 2001–2002 in Göteborg and Helsinki. The structure of the lectures segments the book into six chapters. In the first three the author discusses the main issues concerning crises, crisis prevention, and crisis management, and in the fourth he presents, through summing up the experience of the Argentine, and the Turkish crisis how these difficulties emerge in economic policy practice. In the last two chapters he outlines the desirable direction of the reform of the international financial system, and warns of the still outstanding problems. In what follows I will first summarise the book's main lines of thought, then go on to highlight their Hungarian relevance.

■ The inevitability of crises is the most important statement of the first chapter. Eichengreen claims that crises are the by-product of a financial system as 'financial markets essentially trade with information, and information is, by its very nature, asymmetric and incomprehensive. News travels around according to no predictable schedule, and the market responds immediately to its unpredictability. Thus it is inevitable that the price tag of financial instruments should change once in a while. That happens sometimes so inadvertently that it poses a threat to the financial system and the stability of the economy.' (p 14)

The necessity of crises is confirmed by history. The last two centuries have seen regular crises of indebtedness and foreign currency, the only difference was in the number of occurrences. The present system is different from the previous ones in that destructive twin-crises are more frequent, meaning that foreign currency and banking crises take place at the same time. The main reason according to Eichengreen is the combination of a high rate of capital mobility, and political democratisation: for governments securing external equilibrium is but one objective among the many, and is easily superseded by short-term political considerations. That significantly reduces the credibility of fixed exchange rates, and thereby raises their vulnerability.

■ If one accepts crises to be inevitable, the only question remaining is the extent to which one manages to increase protection against them. The second chapter of the book focuses on crisis prevention, where Eichengreen claims significant progress has been made over the last years. One proof of success is that in 2001 the securities of the emerging countries became independent from Argentine bonds, so that the Argentine crisis eventually did not trigger another pandemic in international markets. That means that investors can better distinguish between securities of emerging countries than they did in the last decades.

Eichengreen puts down the weakening of the contagious effect to greater transparency that enables investors to make informed decisions, and thus reduces the risk of panic responses resulting from uncertainty. Greater transparency experienced all over the world justifies the efforts of international financial organisations at designing/elaborating and disseminating a variety of standards[2].

Whilst recognising the progress made, the author has serious reservations concerning the general applicability of international standards as nothing seems to justify the assumption that developing countries need the same standards as the most developed ones. The problem deserves attention all the more since the standards are primarily elaborated by representatives of G7 countries. If they do not know the alternative economic systems, they may underestimate their chances of survival. In an environment of low trust the prohibition of in-family lending or portfolio concentration may undermine the only livable channel of economic transactions, and may thus do more harm than good.

The above considerations shed light on the importance of institutional coherence. If they weaken some components of a given system, they will thereby significantly deteriorate the effectiveness of the remaining elements, too. To overcome the problem, Eichengreen recommends more general regulation than so far, which means that if people use more lenient standards in one area, it must be compensated by more rigour in another area. E.g. permitting greater portfolio concentration must be followed by higher capital requirements than what the Basel Committee stipulated.

The issue of institutional coherence is inevitable also upon extorting standards since the introduction of a given set of rules is worth very little without a board of judges that are able to apply the rules.

The importance of background institutions is given particular importance even in the part of the book that discusses exchange rate policy. The dilemma of the vulnerability of a fixed exchange rate and the volatility of the floating exchange rate is increasingly resolved by the introduction of full compliance with inflation targets all over the world. This system, however, can only work besides strict discipline that is not necessarily given in a developing country. The most important condition is to ensure fiscal equilibrium, whose absence would disable commitment to price stability and would thus undermine the credibility of compliance with inflation targets. The most important condition is to ensure budgetary equilibrium. Freeing up exchange rates may be dangerous in a country that is indebted in foreign currency because a possible devaluation of the currency could significantly increase the country's debt service. Moreover, a volatile exchange rate would encourage both the population and businesses to keep their money in foreign currency thereby slowing down the growth of the market of instruments denominated in the domestic currency.

Eichengreen's suggestions highlight the main dilemma of crisis prevention based on standards: in the least developed countries the introduction of the best international solutions may render these countries even more exposed to crises rather than stabilising them. We do not know the institutional level where these rules already really help, and know even less about how developing countries may get there. However, insisting on practice different from international results in higher exposure-related costs, which in fact further deteriorates the chances of access to international resources, and may thus slow the convergence of these countries.

■ The necessity of crises and the numerous unresolved problems of crisis prevention makes crisis management inevitable, and that is what forms the subject of chapter one. The author finds that very little has been done in the past period in this area. The chief dilemma of crisis management is the role of the International Monetary Fund. Financial consolidation through rescue packages has created serious moral exposure in the system for both investors and governments. For investors aid means that they can minimise the potential losses on their risky investments, thus they are no longer interested in prudent lending. And governments may stick to their unsustainable economic policies, and the country is becoming increasingly vulnerable. The bill is paid by the country's taxpayers and consumers through the austerity measures introduced as a result.

The main dilemma concerning aid or rescue packages derives from the problem that liquidity and insolvency crises are extremely hard to distinguish. While with a liquidity crisis IMF loans may contribute to calming down investors, in an insolvency the aid only regroups resources from debtors to creditors, from domestic organisations to foreign ones. When making its decision, the Monetary Fund has to deliberate whether the loan in fact helps the country to get back on track or only serves to pay off some more creditors, thereby encouraging even more intensive refuge of capital. Investors will only stay when they see that uncertainty of economic policy reduces. And that – so Eichengreen assumes – only takes place if the electors of the given country are also in favour of the reforms. Loans may diminish the sacrifices to be made for the sake of the reforms so that commitment should not thaw away. Social support and political commitment, however, are rather difficult to measure accurately, and so in a crisis the Monetary Fund is under serious pressure to lend. Eichengreen sees that pressure further increased by the fact that virtually no progress has been made in crisis management based on involvement of the private sector. Agreement on debt re-scheduling with creditors is reached very rarely, and even when that happens the first move is to suspend disbursements. The author claims that one reason is the threat of litigation that may inflict further damage on the given country e.g. through seizure of the state's foreign assets. The other reason is fear of the pandemic effect that may destabilise the financial system.

As a result of the above the main recommendations with regard to the international financial system concern the change of the role of the Monetary Fund. For those in favour of the status quo it would be sufficient if the Monetary Fund could more resolutely refuse to lend to countries that do not deliver the relevant criteria. That, however, says Eichengreen, would not solve the fundamental problem of the existence of the pressure to lend. Radical suggestions include the creation of an international court of bankruptcy that would be empowered to rule in disputes concerning state debts. Critics, on the other hand voice their fear that such an institution would significantly reduce the role of market mechanisms, and could render the resources required for development for emerging markets massively more expensive. Eichengreen is an advocate of the golden mean, which stands for the more frequent application of re-payment holidays and the introduction of joint action clauses, both approved by the IMF. Those solutions could promote the more effective involvement of the private sector in crisis management, providing a framework to smoothing the conflict between debtors and creditors.

■ In chapter four the author demonstrates the economic policy relevance of theoretical considerations through the experiences of the most recent crises. Argentina and Turkey used to be the example countries of the Washington consensus in the mid-1990s having stabilised their price level through fixing their exchange rates following lasting financial disturbances. In Argentina they introduced a USD based foreign exchange chart, while in Turkey they instituted the crawling peg against a USD/Deutschmark based basket. Following initial success the unfinished fiscal consolidation failed to slow down inflation to the expected rate eventually resulting in the increasing real value of their currency, and thus in weakening competitiveness. A fundamental dilemma developed between the required adjustment of the exchange rate, and the credibility of the stabilisation process. Therefore the two countries became vulnerable to the deterioration of external conditions, which materialised in the form of rising oil prices, strengthening USD, and 11 September. The slowing down of the world economy raised doubts concerning whether these countries can finance their debts through their exports. When capital began to flee they freed up the exchange rate in Turkey, which brought about 50% devaluation and an explosion of debts. The IMF placed a loan in return for a rigorous budget targeting a 5% surplus. That brought peace back to the market, interest rates began to drop, greatly easing the costs of fiscal adjustment. In Argentina, in order to maintain credibility they did not abandon the foreign currency chart, but imposed drastic restrictions through the zero-deficit law (including the 13% reduction of public sector salaries and of pensions). These measures triggered the predictable political resistance to an extent where they jeopardised the sustainability of the entire programme. Capital flight continued, unrest and bank panic ensued causing the International Monetary Fund to suspend its loans. The solution was the abandonment of the foreign currency chart and a debt moratorium.

Eichengreen claims that the difference between the two countries was that in Turkey the devaluation of their currency gave an impetus to competitiveness, while in Argentina insistence on the foreign currency chart intensified the recession, and that further deepened the crisis. The reason for the different decision of exchange rate policy was that while in the latter case the only pledge of the credibility of economic policy was the foreign currency chart, in Turkey the flagging of EU membership ensured much greater social backing to the reforms, thereby contributing to greater credibility.

Drawing the appropriate conclusions from the two cases Eichengreen states numerous lessons that add further shades to the doubts formulated in the theoretical part concerning the results achieved in preventing and managing crises. The lack of fiscal consolidation undermined the success of exchange rate based stabilisation in both countries, froze higher than desirable inflation, which brought real-term appreciation and dropping competitiveness. Although the voluntary debt-swaps instituted when the crisis broke out freed the countries from the pressure of immediate repayment, they rendered future financing of debts more difficult, and further shrank the credibility of long-term budgetary adjustment. That situation was particularly unsuitable for attempts at involving the private sector as market actors were not willing to place new loans to countries in crisis, and expected instead aid to be channelled by international organisations.

■ After summarising theoretical and economic policy experience, in the fifth chapter Eichengreen suggests a possible direction for the reform of the international financial system. He repeatedly emphasizes that using international standards in the least developed countries may, instead of preventing a crisis, generate one, and may slow down development as a result. In these countries it should be given consideration if capital limitations should be maintained until their institutions mature to a point where they can survive in an open environment. In his suggestion for crisis management Eichengreen argues again for golden-mean type solutions, and the introduction of *clauses of sharing* whereby the lending pressure on the Monetary Fund and the moral exposure inherent in the system could be eased. That, however, would require the changes in national legislation and statutes of the IMF, which requires political will and joint action.

■ In conclusion Eichengreen warns of the problems of the reform processes of the international financial system. Amidst a wave of recommendations concerning crisis prevention the problems of the poorest countries are not given the attention they deserve, and thus the new standards would raise new obstacles in the way of the development of these countries. On the other hand, between the two extreme versions of the reform, the maintenance of the status quo, and politically unrealistic radical recommendations, much less attention is focussed on golden-mean type solutions, which significantly hampers the possibility of progress.

Eichengreen's book discusses current debates, issues on international financial systems in a balanced fashion void of any prejudice. He illustrates that financial liberalisation can only contribute to growth at very strict conditions. If an emerging country is to escape crises, it must operate rigorous macroeconomic policies and a stable network of institutions. Until it has these conditions in place, liberalising capital flow could be a major source of danger in these economies. During the period elapsed since the completion of the book that fact has been proven even on an empirical basis[3].

However, recognising the importance of institutions does not mean having the recipe for preventing crises. One of the most important merits of the book is proving how little we know of the way in which the necessary institutions should be built. It is not just about borrowing standards, but also about a coherent system where the individual elements reinforce one another's effect. And that makes the obtainment and maintenance of political support indispensable. That factor raises further concerns regarding the applicability of simple recipes.

■ The book's chief messages are particularly topical for Hungary. One realises that crises are the by-product of the financial system, and defence/protection at a national level cannot be substituted by a possible reform of the international system. The irresponsible use of the global abundance of liquidity resulted in huge amounts of budgetary deficit, rendering the Hungarian economy extremely vulnerable to processes of world economy as illustrated by the exceptional sensitiveness of the Hungarian currency to any volatility in the world economy[4].

Of course crises are rather difficult to predict[5], thus nobody can know in the case of Hungary how long these processes are sustainable. At any rate, one thing is for certain: the global abundance of liquidity will not last forever. Forecasts of the next crises suggest the adjustment of the US' adjustment in its balance of payment, and China's possible slowing down to bring about changes in the world economy. *Goldstein's* (2004) analysis sees three ways which uniformly place Hungary among the five most vulnerable countries in the world economy if such a scenario should materialise: a general rise in interest rates could seriously increase the country's debt service, the devaluation of the USD may lead to the excessive strengthening of the HUF, and thus to shrinking competitiveness, and growing uncertainty may cause the country to come first among victims of a possible pandemic due to its poor macroeconomic indicators.

Eliminating vulnerability requires budgetary consolidation. Consolidation, however, means more than mere stabilisation: long-term equilibrium may only be ensured through institutional reform. Although there is little attention in the book concentrated on budgetary institutions, the importance of rules is well known even in this area[6]. These rules, however, can only operate besides political commitment, and societal support, without which balanced budgets are not possible to operate on the long term. Gaining and re-gaining the trust of society is therefore one of the key conditions of consolidation. That necessitates on the one hand the design of professionally credible reform steps rather than hasty extemporisation, and initiating social dialogue on these issues rather than applying the method of reform-dictatorship.

By translating Barry Eichengreen's book into Hungarian, and publishing it, the Nemzeti Tankönyvkiadó Publishing House has truly made up for a deficiency. Even though the issue of crises is presently one of the most popular subjects of international financial literature, and is especially topical for Hungary, very little technical literature is available in Hungarian. Thus we hope that the book will be followed by others. The recensionist would like to recommend Sándor Lámfalussy's book of a similar subject providing a detailed discussion of the crisis of the 90s aptly complementing Eichengreen's work targeted chiefly at a more erudite readership.

Dóra Győrffy

Notes

[1] Soros reflects the contemporary mood (1998)

[2] The 12 standards deemed to be the most important by the Financial Stability Forum are as follows (the names of the author organisations are given in brackets):

1. The collection of the best procedures to ensure the transparency of financial policy (IMF)
2. The collection of the best procedures to ensure the transparency of fiscal policy (IMF)
3. General data-publication system (IMF)
4. Procedures for insolvency, liquidation, or bankruptcy (Worldbank)
5. The basic principles of corporate leadership (OECD)
6. International Accounting Standards (IASC)
7. International financial audit standards (IFAC)
8. The basic principles of the operation of systemically important payment systems (CPSS)
9. Forty recommendations to prevent money laundering (FATF)

10. The basic principles of effective bank supervision (BCBS)
11. The basic principles of securities control (IOSCO)
12. The basic principles of insurance supervision (IAIS).

[3] See Prasad et al (2003) and Kose et al (2006).

[4] That sensitiveness is presented in detail by the analysis by the International Monetary Fund's through a description of the fluctuation of the Hungarian Foring over the last 3 years. See IMF (2006).

[5] On the difficulty of forecasts see Berg et al (2004).

[6] See Kopits (2004), and on the Hungarian system Győrffy (2005).

LITERATURE

BERG, A. – E. BORENSZTEIN – PATILLO, C. (2004): Assessing Early Warning Systems: how did they work in practice? *IMF Working Paper, No. 04/52*

GOLDSTEIN, M. (2004): What might the next emerging-market financial crisis look like? *Institute for International Economics Working Paper, No. 05–7, (3–4)*

GYŐRFFY D. (2005): Az intézményi tényezők szerepe az államháztartási hiány alakulásában Magyarországon, *Közgazdasági Szemle, 52. évf. 10. szám 755–773. oldal*

IMF (2006): Hungary – Selected Issues. *IMF Country Report, No. 06/367*

KOPITS, GY. (2004): Rules–Based Fiscal Policy in Emerging Markets, *New York: Palgrave MacMillan*

KOSE, A. – PRASAD, E. – ROGOFF, K. – WEI, S. (2006): Financial Globalization: A Reappraisal, *NBER Working Paper No. 12484*

LÁMFALUSSY, S. (2000): Financial Crises in Emerging Markets: An Essay on Financial Globalization and Fragility, *New Haven and London: Yale University Press*

PRASAD, E. S. – ROGOFF, K. – WEI, S. – KOSE, A. (2003): Effects of Financial Liberalization on Developing Countries: Some Empirical Evidence, *IMF Occasional Paper No. 220*

SOROS, GY. (1998): The Crisis of Global Capitalism, *New York: Public Affairs*, (magyarul: A globális kapitalizmus válsága, *Budapest: Scolar Kiadó, 1999*)