How to Avoid International Financial Crises and the Role of the International Monetary Fund

Stanley Fischer[1]

1. History will record the globalization of trade and financial markets as among the most important economic developments of the late 20th century. In 1996 net international capital flows to developing countries amounted to $235 billion—an impressive 0.8 percent of world GDP, and more than two percent of developing country GDP. And since international portfolio diversification is far from complete, the scale of international financial flows is bound to continue increasing for some time. While the long-term benefits of financial liberalization and globalization are not in doubt, the increased volume and volatility of capital flows have exposed vulnerabilities in recipient developing countries that have led to major financial crises in the last three years in Mexico and Thailand, with associated contagion effects spreading the crisis to other countries in Latin America and South-East Asia respectively. All this of course leads to the topic of this session, the question of what can be done to reduce the likelihood of future crises.

2. In discussing that question, I will focus first on the need to strengthen macroeconomic policies and financial systems in developing countries, as well as the desirability of improving the quality of information provided to markets. Comparative advantage dictates that I turn then to the role of the IMF, both in preventing crises and in mitigating the consequences of the crises that will inevitably occur.[2] In the interests of time, I shall have to omit discussion of the potential role of the private sector, and the possibility of improved information provision about, and prudential regulation of, its activities, in reducing the probability of future crises.

I. Recipient country policies

3. To avoid crises, a country needs both sound macroeconomic policies and a strong financial system. A sound macroeconomic policy framework is one that promotes growth by keeping inflation low, the budget deficit small, and the current account sustainable. As a formal matter of debt dynamics, the sustainability of the current account depends on the economy's growth rate and the real interest rate at which the country can borrow. But sustainability has another sense, of the ability to withstand shocks, and that is less susceptible to formal analysis. In any case, large current account deficits—depending on the growth rate of the economy, in the range of 5-8 percent of GDP, and certainly any higher—should be cause for concern. Current account deficits financed by longer-term borrowing and in particular by foreign direct investment are more sustainable; sizable deficits financed in large part by short-term capital flows are a cause for alarm.

4. It is sometimes difficult to deal with short-term capital inflows that are a response to high

domestic interest rates, particularly in a context in which policy limits exchange rate flexibility. This is the famous capital inflows problem that so many countries seeking to stabilize from moderate rates of inflation have faced. There is no easy answer to this problem, but a tightening of fiscal policy is the first line of defense. A second response is to increase the flexibility of the exchange rate.

5. How flexible should exchange rates be? The recent experience of East Asia has reopened the question of whether any form of fixed exchange rate system is consistent with free capital mobility. The G-7 countries, except for those intending to join EMU, long ago decided on flexible rates. But freely floating rates, even among the major currencies, have moved excessively, and no developing country seeking growth through integration into the world economy would want to live with such fluctuations. East Asian countries were well served over a long period by exchange rate systems that either fixed the exchange rate or limited its flexibility, thus providing exporters and importers with a measure of exchange rate certainty that facilitated their participation in the international economy. Nonetheless, those countries that allowed the rate to float when threatened by an imminent speculative attack, made the right choice.

6. As more normal conditions return, the question of the optimal exchange rate system will be back on the agenda. There is no generally agreed answer to that question. Some conclusions are easy: if the exchange rate is pegged, it is almost certainly better to peg to a basket of currencies rather than a single currency. Beyond that, it may be that countries will return to some form of exchange rate band, with very wide margins, perhaps—depending on domestic inflation—a crawling band. If they do, they should stand ready if circumstances warrant, to move the band. In any case, the level of the exchange rate is bound to be a concern for policymakers, particularly in developing countries relying on export-led growth, and macroeconomic policy needs to be adjusted when the exchange rate (equivalently the balance of payments) shows signs of moving out of desired ranges.

7. The critical role of the strength of the financial system was becoming clear before the Mexican crisis; it was crystal clear in that crisis and its aftermath; and it has been equally clear in the Thai crisis and its aftermath. The international institutions—including the IMF, the World Bank and the Basle Committee—have been looking intensively into these financial sector issues.[3] By now, policymakers have a good idea of what needs to be done to strengthen financial systems, by improving supervision and prudential standards, by ensuring that banks meet capital requirements, provision for bad loans, limit connected lending, publish informative financial information, and by ensuring that insolvent institutions are dealt with rapidly. Implementing those changes, particularly in a banking system already in trouble, is frequently difficult, especially where political pressures hamper the supervisory authorities. The task is nonetheless urgent, both in countries now seeking to recover from recent crises, and those that seek to avoid future crises: it cannot be emphasized strongly enough that a healthy banking and financial system is essential for the growth of the economy, and that a weak banking system is both a standing invitation to a macroeconomic crisis and a guarantee of the severity of any such crisis.

8. One of the many lessons drawn from Mexico was that the extent of the crisis was worsened by the poor quality of information supplied to both the official sector (including the IMF) and the markets. As a result, the IMF undertook its data standards initiative, and the Special Data Dissemination Standard was established in early 1996. Considerable progress has been made with the development of the associated Dissemination Standards

Bulletin Board.[4] The Thai crisis reinforces the argument for better and more timely provision of information, including information on central bank forward operations. There are two arguments for the provision of such information. First, better informed markets are likely to make better decisions. In each of the Mexican and Thai crises, this would have meant that the markets would have withdrawn funds sooner than they did, thereby hastening adjustments that needed to be made in each of those cases. Second, the obligation to publish information on certain interventions would affect the extent and nature of those interventions, and help prevent some unwise decisions.

II. The Role of the IMF

9. The IMF plays its role in stabilizing the international financial system through crisis prevention and crisis mitigation. IMF surveillance, technical assistance, and information provision, contribute to the prevention of crises. IMF lending in support of a country's adjustment program contributes to the mitigation of crises.

10. Since the Mexican crisis, the IMF has placed increased emphasis on timely surveillance of market developments. Surveillance takes the form of regular reporting to the Executive Board of the IMF, and through the Board to member countries, on the state of each country'seconomy, and particularly of any emerging problems. It is fair to say that the Fund's new surveillance procedures worked well in the case of Thailand, in that the Thai authorities were warned of the likelihood of a crisis and the measures they could take to avert it. The Fund staff also informed member governments of its concerns. But as the Thai case demonstrates, the effectiveness of Fund surveillance is limited by the fact that a country may be warned but not take action, either because it disbelieves the warning, or because it is too weak to act short of a crisis. In the past few years we have made significant progress in publishing more of our analyses, and it is reasonable to hope that we will gradually be able to do more in this regard. But because the Fund's ability to conduct its surveillance depends on its privileged access to information, it is not in a position to enlist the markets in the cause of surveillance by making its concerns fully public. We have to accept the limitation that we cannot go so far in speaking out as to create the crises that are we seeking to prevent.

11. In addition to its surveillance activities, the IMF provides technical assistance to member countries seeking to strengthen various aspects of their economies, such as the financial system, the tax system, monetary policy, and the exchange rate system. Through our extensive publication of statistics, including through the Data Standards Bulletin Board, we strengthen the capacity of the markets to operate efficiently.

12. It is reasonable to expect that Fund surveillance will work well in future. But it would be a mistake to imagine that Fund or any other surveillance could ever be made perfect. We will surely miss the warning signs of some future crisis, and just as surely will predict some crises that do not happen. The international system cannot be built on the assumption that improved surveillance, or the increased provision of information to markets, will prevent all future crises, even though they should reduce the frequency of crises. Crises will happen.

13. In a crisis, private sector financing evaporates, and countries are forced to take painful adjustment measures. One of the purposes of the IMF set out in the first Article of Agreement is "To give confidence to members by making the general resources of the Fund

temporarily available to them under appropriate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity". The Fund—that is the international community—has shown its willingness to act in this way in many crises. The Fund will continue to act in accordance with its purposes, and to provide financing, with the conditionality that provides the safeguards referred to in Article I (v), to countries faced with the need to take actions to stem the destructive effects of an external crisis. It is for these reasons that the Fund's Board of Governors voted, at our recent September 1997 meetings in Hong Kong, to increase Fund quotas, which constitute our capital base, by 45 percent.

14. At the Hong Kong meeting, the Board of Governors also approved moving ahead to develop an amendment of the IMF Articles of Agreement to make the liberalization of international capital flows one of the purposes of the Fund. The Mexican and Thai crises, and the proposed amendment of the Articles of Agreement, raise two important interrelatedquestions about Fund lending. The first is whether we should expect a change in the scale of international financial crises; the second is whether the Fund's willingness to lend in a crisis contributes to moral hazard. The answer to both questions is yes. As the efficiency of the international capital markets improves, it is reasonable to expect that there will be fewer crises requiring official funding in future, but it is also likely that they will be on a larger scale than typical in the past.

15. As in the case of any insurance, the possibility of IMF lending to countries in trouble creates a moral hazard. The hazard is not that the availability of IMF financing in emergencies encourages countries to behave recklessly, for Fund conditionality is such that governments in trouble are usually too slow rather than too fast to come to the Fund. Instead the hazard is that the private sector may be too willing to lend, because it knows that a country in trouble will go to the Fund rather than default. Spreads in some markets are so low as to support this view, but they are also consistent with the view that the private sector is too willing to lend to some borrowers. Spreads in some domestic markets support the second view.

16. The international community has struggled with the question of how to reduce this moral hazard. The potential moral hazard is easier to deal with in the case of lending to the private sector, for in those circumstances some private companies and financial institutions in the crisis country are likely to be closed or forced to restructure, and some of the losses will be borne by foreign lenders. This has already to some extent been evident in Thailand. The problem is more difficult in the case of lending to a government, for there is no accepted bankruptcy procedure for governments. Severe legal complications could follow for any government seeking to impose a moratorium, and no international organization has, or is likely to have, the authority to overrule domestic law by authorizing a moratorium. Nonetheless, the international system needs to find a solution to the moral hazard problem posed by private sector international lending to governments, a solution that ensures that the private sector shares in the financial costs of dealing with crises.

III. Concluding Comments

17. After a crisis, we in the Fund sometimes hear the refrain, generally from policymakers but sometimes from the markets, "But no-one—including the Fund—warned us of the dangers we faced". When such a complaint is accurate, and after every crisis, we need to

draw the lessons and seek to improve our performance. At the same time, it is important not to lose sight of where the primary responsibilities lie. The prime responsibility for pursuing the right policies rests with the national authorities; the Fund and other countries can provide information, analyze, suggest, seek to persuade, and cajole, but it is ultimately the government that has the duty to evaluate the situation and make the right decisions. There is also a responsibility on market participants to appraise the underlying economic situation accurately; if they do so, market incentives will ensure that markets operate efficiently. The prime responsibility for correctly evaluating the economic situation rests with market players, provided they are given the information they need.

18. The new world of globalized capital markets provides countries with new opportunities to tap a global pool of saving for productive investment to boost living standards, and to diversify their own savings. The benefits of globalization are clear, and so are its challenges and risks. For their part, countries seeking to benefit from international capital flows need to pursue sound macroeconomic policies, and to strengthen their financial systems, including through the provision of information on both government and private sector activities. There is also a premium on the adaptability of policy, should the external environment shift and capital inflows begin to decline or even reverse. This adaptability is likely to entail a willingness to adjust fiscal policy quickly and to allow the exchange rate to move if needed. For the IMF, the globalization of capital flows has required us to strengthen our surveillance, to assist member countries in strengthening their policies and the structure of their economies, to take new initiatives to support rapid dissemination of accurate economic and financial information, and to ensure that the Fund has adequate financial resources to support its members when the need arises. We will do all we can to reduce the risk of financial crisis, but that risk cannot be eliminated, and we need also to be ready to help deal with the consequences.

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[1] First Deputy Managing Director, International Monetary Fund. These remarks were prepared for delivery to the 15th Annual Cato Institute Monetary Conference, October 14, 1997, Washington DC. I am grateful to Owen Evans of the IMF for his assistance. Views expressed are not necessarily those of the IMF.

[2]These views are developed at greater length in my paper "Capital Account Liberalization and the Role of the IMF", International Monetary Fund, September 1997.

[3]See David Folkerts-Landau and Carl Lindgren, "Toward a Framework for Financial Stability ", IMF, September 1997, for a detailed analysis of what is required for a healthy banking and financial system, with the Core Principles of the Basle Committee included as an annex to the paper.

[4]This electronic bulletin board on the Internet (http:\\dsbb.imf.org) provides information on countries' economic and financial data systems. By September 1997, there were 43 subscribers, including virtually all industrial and emerging market economies.