Crisis prevention and crisis management: is there room for improvement?

Speech by William R White, Economic Adviser, Bank for International Settlements, at a conference on "The international financial architecture - a European-American discussion", organised jointly by the Deutsche Bundesbank and the American Council on Germany, and held in Frankfurt on 6 September 2002.

Today I am going to speak primarily about issues having to do with crisis prevention and crisis management. In large part this is to distinguish my contribution from those dealing with crisis resolution, which I take to involve some element of debt restructuring or even forgiveness, a topic discussed in another session at this conference. While such distinctions - prevention, management and resolution - have a certain analytical appeal, it must be recognised that in the real world they are often inextricably linked. Perhaps most importantly, the procedures followed in managing crises can easily have implications for the willingness of creditors to write off debts, as well as the likelihood of crises occurring in the future.

1. Crisis prevention

I would like to draw three sets of lessons from recent financial events, bearing upon the question of how to prevent financial crises. First, I would like to suggest that individual crises might not in fact be independent events. This implies we must look for still deeper causes in trying to prevent crises. Second, I suggest some specific lessons for emerging market economies and then another set for industrial countries. Third, I would finally like to suggest that a high degree of policy credibility may actually be counterproductive, and ultimately harmful to the economy, if that credibility is not based on solid enough foundations.

Let me speak to the first lesson. In recent years we have witnessed an enormous number of major financial events. We have focused in this conference on recent sovereign crises: in Mexico, East Asia, Russia, Argentina, Brazil and Uruguay. However we should not forget other, unusual financial events that have actually occurred much closer to our industrial homelands: the collapse of LTCM, the Nasdaq crash, the Enron scandal, the recent and continuing stock market declines and, more arguably, periods when the global markets for commercial paper and high-yield bonds have dried up. Moreover, as a number of people have already mentioned at this conference, including Jean-Claude Trichet, there are still many worrying financial imbalances which remain to be resolved. Not least of these is the long-standing disparity between Japanese and US private savings rates and associated current account imbalances. If history is any guide, and it should be, these imbalances could yet be the source of still further financial disruptions to come. In recent years, massive capital flows into the United States have increased foreign gross exposure to around $9 trillion. Should the dollar decline significantly in value, the obvious question is who would take the associated losses and how prepared are they to bear those losses?

The principal question I wish to raise is whether there is any thread linking all of these developments. My own view is that they are all, in part, by-products of the long period of rapid credit expansion, asset price increases and heavy investments seen in the industrial countries in the 1990s. These excesses, combined of course with idiosyncratic shortcomings in many emerging market countries, have combined to produce the financial crises that we have observed both at home and abroad.

What is the prima facie case for my believing that a thread exists? One aspect of it is that we have had almost a whole decade of deregulation and of rapid technological change that has led to increased competition globally in the financial services industry. At the same time, financial institutions have been increasingly encouraged to hit high hurdle rates for profits, even when increased competition made such ratios harder to achieve. In this environment, particularly given the secular growth of public sector safety nets and financial institutions supported by the public sector, it would not have been surprising if private sector financial institutions were drawn into imprudent behaviour. If the rate of return must go up, and you cannot achieve it in any other way, then increased risk-taking might seem the only option. This may have been a particular problem for European financial institutions given the various legal and financial constraints they faced in trying to adjust to competitive pressures through raising efficiency in their home markets.

Another set of evidence that a common cause relates these individual crises has been the growth rates of the broad monetary aggregates in the major countries over the course of the last five to six years. What one observes is that they have been fluctuating between 6 and 8% in aggregate terms, peaking at about 10% at the end of 2000. To me, these seem worryingly large numbers, particularly given an environment of effective price stability. A similar observation can be made using a rather different framework, that of real rates of interest as compared to the level of the so-called “natural” rate of interest as described by Wicksell. While subject to considerable measurement difficulties, both ex ante and ex post, ex post real rates averaged around 3% in the major countries in 1993, and effectively have been going down ever since. While measures of the “natural interest rate” are even harder to calculate, there seems general agreement that it bears some rough equality with the long-run rate of growth potential in the economy. This would seem to indicate that, in the late 1990s, ex post real rates were heading down even as New Era estimates of growth potential were heading up. An Austrian interpretation could indicate the potential for a build-up of excessive credit growth, asset price increases and overinvestment, all of which did in fact seem to occur over the last decade.

To the extent that one buys into this story, which effectively states that “boom” conditions ultimately lead to painful “busts”, one must also conclude that two topics which have recently seized the imaginations of both economists and policymakers are not really the heart of the problem. The first of these issues is that of the international financial architecture. Here a number of suggestions have recently been made as to how crises might be better prevented, managed and resolved. These suggestions should be vigorously pursued. Yet these endeavours should not blind us to the fact that the problems are fundamentally macroeconomic in origin rather than institutional. The second of these fashionable issues has to do with corporate governance. Arising from the Enron and related affairs, our consciousness has been raised that many layers of corporate oversight failed to work as intended. Clearly each set of problems should be addressed individually, with a particular emphasis on removing the conflicts of interest that prevented individual overseers from behaving prudently. But, viewed from a more macroeconomic perspective, the more fundamental question arises as to why all these layers of governance failed simultaneously. Irving Fisher, in his classic article of 1933 (The debt deflation theory of great depressions), may have provided the answer when he noted that the public psychology of going into debt for gain passes through more or less distinct phases. The last two of these he describes as “reckless promotion and finally, downright fraud”. In the midst of any bubble, no one has ever been inclined to ask obvious questions about the origins and sustainability of above normal rates of return.

So to conclude this general point about “threads”, there are many useful ways in which institutional reforms might help prevent or mitigate future financial crises. However, we must also recognise that crises of this sort may in fact be endemic in the capitalist system. Thus, measures to enhance stability could well come at the expense, not only of static efficiency, but also the creative part of Joseph Schumpeter’s dynamic process of “creative destruction”. In short, institutional reforms must be nested within the broader macroeconomic context in order to judge whether they are sensible or not. Safety is important, but it is not everything.

Let me now turn to a second set of more idiosyncratic lessons pertaining to crisis prevention. Some are more specific to emerging market economies and some to industrial countries.

The principal point to make concerning emerging markets is that portfolio mismatch problems can have powerfully disruptive effects on the domestic economy. While this applies to duration mismatches, the problems associated with currency mismatches can be even more damaging. We saw this problem for the first time in recent years in the 1994 crisis in Mexico. We saw it again in East Asia in 1997, in particular in Indonesia, and yet again in Turkey in 2001. Still more recently, currency mismatch problems were central to the meltdown in Argentina. Moreover, similar concerns associated with indexation to both inflation and the exchange rate have made a significant contribution to recent market instability in Brazil. The principal problem with a country having more liabilities than assets denominated in foreign currency (generally the dollar) is that any significant decline in the value of the domestic currency can take the banking system down with it. This is generally not because the banking system itself is mismatched, but because enough of the bank’s clients suffer from this problem to ensure a sharp rise in non-performing loans. My BIS colleague, Philip Turner, in association with Morris Goldstein of the IIE, has recently written an interesting paper on this issue.

What can be done to avoid such currency mismatch problems? Many suggestions have been made: development of domestic currency debt markets, better banking supervision, better disclosure, and better property rights among them. The central point that I would like to make, and I do not wish to sound overly pessimistic, is that emerging market countries should probably try to implement all of these recommendations if they can. Given the nature of things, not least human psychology, there is not likely to be any silver bullet that will deal with the currency mismatch problem all on its own. For example, consider the merits of greater disclosure of a country's foreign exchange exposure, a recommendation made particularly forcefully after the Asian crisis. However, the fact is that the dangerous extent to which a number of Asian countries were exposed to short-term foreign currency liabilities had been perfectly clear for years, on the basis of publicly available numbers compiled by the BIS. The related fact is that many people in authority chose not to look at these numbers and, in this regard at least, were derelict in their responsibility for "due diligence". Indeed, there is a strong similarity here with the governance issues pertaining to disclosure that surfaced more recently during the Enron affair.

Turning to crisis prevention in the industrial countries, what are the principal lessons to draw from recent financial crises? To return to a point I made at the beginning of this presentation, we need to pay more attention to the inherent procyclicality of the financial sector. Given this tendency, the achievement of low inflation, while absolutely imperative and desirable, may still have one downside. The optimism generated about future sustained growth in output and earnings (manifest in lower risk premia) could potentially lead to credit excesses, asset price increases, unprofitable investments, and balance sheet exposures of the sort that ultimately feed back negatively on the health of the financial system itself. We saw such "headwinds" in the United States in the early 1990s, and in Japan through much of the 1990s, and still more recently. This is one issue that needs more attention. Indeed, my colleagues Claudio Borio and Philip Lowe have recently prepared an interesting paper on this topic. It shows that sustained above trend growth, in a number of financial variables taken together, can give a quite accurate indication of when problems in the financial sector will subsequently emerge. Moreover, their results seem to apply to emerging market countries as well as industrial ones.

The next question is an obvious one. How should policymakers respond to signs of such growing financial imbalances? Chairman Greenspan recently gave at Jackson Hole an eloquent statement emphasising the difficulties of using monetary policy for such a purpose. Such difficulties, allied with the realisation that the principal concern is less financial excess itself than harmful feedback effects on the financial system, would seem to point to a regulatory response. Such a response would, of course, have to be directed to minimising the exposure of the financial system as a whole rather than the exposure of individual financial institutions. Greater emphasis on a regulatory response also raises some interesting issues having to do with the institutional relationships, both formal and informal, between supervisory bodies and central banks. All of these issues currently need further analysis.

The third lesson that I would draw from recent financial crises is that policy "credibility" can sometimes be bad for a country's health. What I mean by this is that financial gimmicks, indexation provisions of various sorts or reliance on exchange rate regimes to peg expectations can have dangerous consequences if they are used as a substitute for the fundamental changes to underlying policies that might be really required. Should these endeavours build up a significant degree of certainty and security in the future external value of the currency, it will absolutely invite people to borrow in foreign currency. The resulting potential for a currency mismatch problem of the sort mentioned above would seem obvious. Here, Argentina is the example which springs immediately to mind. The underlying problems surface when the policy fundamentals once again come into question and confidence then recedes. In effect, such financial gimmicks are equivalent to tying oneself to the mast. This may be good practice in a strong gale, but not if the ship is actually sinking.

As an aside, and I will just mention this before I get on to the crisis management side of things, the international community also needs to do more work on how to measure debt sustainability, both internal and external. Such a methodology would be useful for crisis prevention: that is, it would allow a better understanding of when debt levels should be seen as a potential problem and acted upon. But such measures would also be useful in crisis management: knowledge of whether a country is facing a liquidity as opposed to a solvency crisis is crucial for choosing the proper policy response. And, as a final benefit, debt resolution demands knowledge of how much debt reduction is required to restore the country to a sustainable growth path. Accepting in principle all these potential uses of better measures of debt sustainability, one very serious complication is that we may actually live in a world of potential multiple equilibria. If with very high interest rate spreads the debt is not sustainable, but with lower interest rates it is, is the debt burden sustainable or is it not? This is a problem for which there is no obvious solution.

2. Crisis management

Let me make two sets of comments. The first one has to do with the emerging markets and potential IMF support in the case of difficulties. The second comment has to do with domestic macroeconomic policy responses in industrial countries in the face of international pressures. In both cases, I wish to focus on the potential for moral hazard. That is, we must evaluate the possibility that sensible actions directed to crisis management can also have longer-lasting negative effects as well.

With respect to the emerging market countries and crisis management, a good place to begin is with analysis of the recently published “G7 Action Plan”. The Plan begins by saying that “We are prepared to limit official sector (IMF) lending to normal access levels”. This is a major step forward which should, in principle, help disabuse private sector creditors of the view that unlimited public sector funds will be made available to bail them out in the event of distress. However, the Plan then goes on to say that such limits will apply “except when circumstances justify an exception”. While, again in principle, this seems sensible, it does also raise some very practical questions. What are the specific principles according to which discretionary action could be invoked, within the proposed framework of essentially limited financing? Without such principles, the presumed limits could be systematically violated.

Three sets of exceptional circumstances immediately spring to mind. A first possibility is that a crisis might be clearly identified as a liquidity rather than a solvency (or debt overhang) crisis. This would be more likely if the problem did not seem to originate in the country itself, but was a product of contagion from some other country in distress. In this case, it would be very easy to argue for virtually unlimited lending in the tradition of Bagehot. Moreover, political considerations and associated pressures might sometimes support such an interpretation. This stands in contrast to a situation where a debt overhang was clearly identified, presumably leading to a decision not to lend at all. The objective of such a tough policy would be to induce creditors and debtors to recognise reality and to begin negotiating how the debt should be restructured. In practice, the fact that these different kinds of crises often cannot be clearly distinguished ex ante leaves the door open for a lot of discretionary activity.

A second set of exceptions might occur in the case of crises identified as having systemic implications. The problem here, as was evident in the Mexican crisis of 1994, is that what is judged systemic is often in the eye of the beholder. Again, this raises the possibility of discretionary action. And finally, a third reason for extraordinary support arises when the market seems to be demanding interest rates in the crisis country which are well above what the Fund believes to be consistent with the underlying economic fundamentals. In such a case of multiple equilibria, the Fund might be tempted to support its views with a very large package indeed. Alternatively, of course, it might conclude that the market should be forced to accept the implications of its own judgment: namely, if the market believes the country’s debt is unsustainable, then negotiations should begin as soon as possible on a restructuring package. In this case, presumably the Fund would be very reluctant to lend ex ante in order to get the bargaining agents to the table.

The point being made here is not that exceptional lending is always bad. There are many circumstances in which it might be desirable. However, clearly stated principles on access would allow for a more consistent pattern of exceptions as well as greater accountability on the part of those making such decisions.

My second and final lesson concerning crisis management has to do with how, at the margin, the conduct of domestic macroeconomic policies in the major industrial countries might be influenced by international developments. A possible concern is that, over the last decade, every time an international financial crisis has erupted there has been a tendency either to fail to raise interest rates, when it might otherwise have been desirable, or even to lower policy rates in consequence. The “headwinds” in the US in the early 1990s led to a sharp easing of monetary policy and further declines in the value of the US dollar. The decision of many Asian countries to let their currencies float down with the dollar led to massive increases in foreign direct investment that contributed materially to the subsequent Asian crisis. The fact that this constituted a favourable terms-of-trade shock for a number of industrial countries led to interest rate increases being put on hold, which contributed in turn to the inflows into Russia and the massive use of leverage by LTCM. Subsequent interest rate decreases were then followed by a further 150% increase in the value of the Nasdaq and substantial gains in other markets as well. When this bubble collapsed, sharp reductions in interest rates were followed by major increases in housing prices in a number of countries, accompanied by heavy cash-outs of equity which were in significant part spent on consumer goods. These accommodative policy moves provided welcome support to the expansion in economic activity in the main industrial economies which was generally sustained throughout the last decade. Nevertheless, some doubts are now beginning to surface about future prospects. In effect, many imbalances have built up over the last decade which could yet rebound negatively on future economic activity. Should policymakers have been less willing to adjust policy to offset the impact of individual cases of financial instability? While it is now accepted that letting little forest fires burn unimpeded on a regular basis is the best way to avoid occasional massive fires, this conclusion rests on having actually seen the big fires occur. Clearly, that has not yet happened in the financial sphere. Hopefully, it never will, given the very substantial efforts, by both the public and private sectors, to improve the resilience of the financial systems in many countries.