

Avoiding Currency Crises*

Martin Feldstein**

Although the Asian crisis countries are now generally experiencing economic recoveries with rising exports and strong share prices, significant damage remains – high unemployment, corporate bankruptcies, nationalized or insolvent banks, and weakened political support for a market economy. Moreover, the risk of future currency crises in the emerging economies has certainly not been eliminated.

The paper by Barry Eichengreen and Ricardo Hausman is correct to focus on the policies that the emerging market countries (EMC) themselves can pursue to reduce the risk of future economic crises instead of discussing new policies for the IMF or for the industrial countries that some analysts hope might achieve that goal.¹ I agree with their emphasis on EMC self-help and on the multiple causes of fragility and currency crises (Feldstein 1999a, 1999b). Indeed, I would stress that just a single fundamental structural policy error is sufficient to make a currency crisis inevitable, with the associated adverse effects on the domestic economy. Avoiding a crisis therefore means avoiding all such mistakes. A bad exchange rate regime in particular can make a currency crisis inevitable but a good exchange rate regime is not enough to prevent a crisis.

In my own writing (Feldstein 1998, 1999a), I have emphasized three fundamental mistakes that have caused the recent currency crises: (1) large current account deficits caused by overvalued fixed-but-adjustable exchange rates; (2) mismatched balance sheets with short-term liabilities that exceed foreign exchange reserves; and (3) weak banking supervision that allow banks to be de facto insolvent. The 1997 crises in Thailand and Korea illustrate the impact of these problems and, in the case of Korea, the potential for a currency crisis even if the current account is not in fundamental imbalance.

Thailand's crisis was precipitated by a massive current account deficit that reached eight percent of GDP, the result of a fixed exchange rate between the Thai bhat and the dollar that was

*Remarks presented at the Jackson Hole Federal Reserve Conference on August 28, 1999 as a comment on Barry Eichengreen and Ricardo Hausman, "What International Monetary Arrangements are Appropriate in Light of the New Environment."

**Professor of Economics, Harvard University, and President of the National Bureau of Economic Research.

¹ Eichengreen and Hausman structure their discussion in terms of three alternative theories of the fragility of the EMC economies although in reality, as they acknowledge, the three are not mutually exclusive theories but rather three different aspects of the condition of many EMCs. It is not surprising therefore that the data that they analyze do not allow them to choose among the three theories.

exacerbated by the decline of the yen-dollar and rinminbi-dollar exchange rates. Korea in contrast had a managed floating exchange rate. Korea's current account deficit was not large, and its temporary increase was due to the collapse of the semiconductor market rather than to a general overvaluation of the Korean won. Korea's problem was not an overvalued exchange rates but a balance sheet mismatch in which short-term liabilities denominated in foreign currencies exceeded Korea's foreign exchange reserves.

In both countries, weak banking systems and weak banking supervision played an important role. In Korea, the relaxation of regulations that previously limited off-shore financial borrowing and investing allowed Korean financial institutions to incur excessive foreign exchange debts. In Thailand, the banks borrowed dollars and then lent those dollars to Thai businesses that did not have the ability to earn dollar profits because they produced and sold to domestic customers. The devaluation of the bhat caused a sharp increase in the bhat-equivalent value of the debt of the companies, leading to bankruptcies of firms and therefore of their bank creditors.

Not an Accident

Why did the governments in Thailand and Korea allow this to happen? It would be wrong to assume that the bad policies that caused the crises were just errors based on ignorance or irrationality. Consider the experience in Thailand.

For Thailand, a fixed exchange rate policy was initially a very tempting source of several advantages. Fixing the exchange rate to the dollar provided a nominal anchor for the economy that helped it to achieve price stability. By fixing the exchange rate and saying that it would not devalue the bhat, the government told labor and business that excessive wage claims or price increases would not be tolerated and accommodated. While a fixed exchange rate was a source of moral hazard to financial institutions, it was the opposite for nonfinancial businesses and labor.

In addition, a fixed exchange rate permitted cheaper credit for Thai borrowers. Although debt incurred in dollars had a higher interest rate than American borrowers would pay at the same time, the cost of funds to Thai firms was substantially cheaper than it would have been without a fixed exchange rate.

Thai exporters also benefitted as the yen-dollar rate rose, providing a de facto devaluation of the Thai bhat against the yen. This was particularly important since Japan is Thailand's biggest export customer.

Despite these initial advantages, over time the fixed exchange rate of 25 bhat per dollar became more and more overvalued. The large current account deficit rose from 5 percent of GDP a year to more than 8 percent of GDP.

The IMF and others advised floating the bhat. Why was this advice rejected? Why did Thailand not devalue while it still had substantial foreign exchange reserves? Why did Thailand keep supporting the bhat until reserves were exhausted and the country was forced to devalue, leading to massive deflation of economic activity and a painful IMF program?

There were, I believe, four distinct reasons for this apparently perverse behavior. First, the authorities resisted devaluation because they feared that devaluing the bhat could lead to a sharp rise in inflation caused by rising import prices, increased demand for exports, and an end to the nominal anchor that restrained general wage and price increases.

Second, there was also a well justified fear that devaluing the bhat would cause a sharp fall in economic activity because companies that had very large dollar debts and were highly leveraged would experience a very large rise in the bhat value of that debt that would be too heavy a burden to bear.

Third, and perhaps more important, the reluctance to devalue was not just a concern about macroeconomic effects. Thailand is a small society. Devaluation would have devastating effects on the financial situation of influential wealthy individuals and important local businesses that had large dollar debts. And the politicians themselves realized their own vulnerability to these effects. Delaying devaluation gave these well-placed individuals and businesses time to shift their obligations from dollars to bhat.

Finally, government officials could tell themselves that the overvaluation of the bhat might correct itself without a change in the dollar-bhat exchange rate if the yen rose again relative to the dollar.

The Thai government's decision to support the overvalued bhat until the bitter end nevertheless illustrates the triumph of hope over experience. Experience shows over and over again that current account deficits of more than about four percent of GDP cannot be sustained.

The private investors and banks that continued to lend dollars to the Thai banks and to hold bhat assets did not generally believe that they had an ironclad guarantee from the Thai government that the exchange rate would never be changed. If they had really believed fully in the guarantee, the interest premium on Thai dollar debts would not have existed. But with this interest rate differential, foreign lenders continued to participate because they believed that the balance of the odds made doing so a good bet as part of an overall investment and loan portfolio.

Flexible Exchange Rates

In my judgement, the best way to avoid the overvalued exchange rate problem that led to the crisis in Thailand and elsewhere is a flexible exchange rate. I will return to the option of dollarization

(that Eichengreen and Haussman appear to favor) below.²

In addition to the usual reasons for preferring a flexible exchange rate, including the moral hazard issue stressed by Eichengreen and Haussman, a flexible exchange rate avoids the political problems of adjustment to which I have referred. It insulates politicians and government officials from pressures and from personal fears. It avoids the temptation to delay adjusting in the overly optimistic hope that something will occur to eliminate the overvaluation without an explicit devaluation.

Eichengreen and Haussman discuss the possibility that a floating exchange rate would encourage hedging of exposures and therefore would reduce the adverse effects of devaluation. They stress that a floating exchange rate encourages hedging by continually reminding market participants of currency risk. Although this may be true, the interest differential between dollar interest rates and bhat interest rates should also have been a reminder to any large and sophisticated borrower. In addition, there is an important reason why hedging would be less likely in a floating system than in a fixed exchange rate system. The usual insurance arguments suggest that big losses are the risks that individuals and companies would be willing to pay to avoid. With a floating exchange rate, there is less risk of a big decline in the value of the currency and therefore less reason to hedge.

The question of whether hedging is likely to be greater with fixed or floating exchange rates is not likely to be resolved by looking at the extent of hedged and unhedged positions in different exchange rate regimes (as Eichengreen and Haussman suggest) since currency exposure is much broader than financial assets and liabilities. For example, a Thai firm that will sell output abroad for dollars may choose to sell dollars forward or to borrow in dollars. That financial exposure may look like an unhedged position but it is really hedged by the expected future sales receipts.

An exchange rate system that avoids sustained current account deficits is necessary but not sufficient for eliminating the inevitability of a currency crisis. A country must also avoid the kind of balance sheet mismatch that undid Korea and the banking system weakness that encourages runs on a country's banks. For that reason, the evidence that crises occur in countries with flexible exchange rates cannot be taken as evidence against exchange rate flexibility.

International Liquidity

Moreover, although avoiding the three mistakes that I have stressed should mean that a currency crisis is not inevitable, a large risk remains in a world in which fragility is a matter of degree and in which global trade and investing causes crisis contagion. To reduce the risk of such unwarranted currency crises, countries should take steps to increase their international liquidity, i.e., the ratio of their

²Eichengreen and Haussman do not discuss the option of a currency board. I have discussed the reasons for my own skepticism of the usefulness of a currency board in Feldstein (1999a).

foreign exchange reserves to their short-term foreign liabilities.

A country like China with more than \$100 billion in foreign exchange reserves is not an attractive target for speculators. Countries that still think of desired foreign exchange reserves as equal to three or six months of imports are courting trouble in a world where capital flows are a more important source of exchange rate problems than fluctuations in trade.

Building foreign exchange reserves through current account surpluses is however time consuming and has a high opportunity cost in terms of foregone real investment. I believe that an attractive alternative way to build foreign exchange reserves is to borrow dollars with longer-term maturities and invest those funds in liquid assets. I recognize the usual objection to this approach is that such borrowing is expensive because the cost of longer-term borrowing even by the sovereign borrower in an emerging market country is typically substantially higher than the yield on short-term U.S. Treasury bills or other equivalent assets in which such reserves are typically invested. There is however no need to restrict the investment of reserves in that way. The net cost of building reserves can be substantially reduced by investing the reserve funds in higher yielding liquid securities – longer term government bonds, corporate bonds and even some equities. Although such investments bring a risk of their own, it is surely better to accept some such portfolio risk than to accept an even greater risk of inadequate reserves because the country is deterred by the cost of building reserves. An optimal reserve policy requires balancing both types of risks, taking more portfolio risk to have a lower risk of inadequate foreign exchange reserves.

Accumulating reserves can be supplemented with back-up lines of credit from private sector creditors, as Argentina has done. While such lines of credit may cause lenders to reduce their other lending in times of trouble, there is a net gain of liquidity as long as there is a less than a one-for-one offset.

Another frequently suggested way to increase a country's net liquidity is to impose a tax on capital inflows, as Chile has done. This is a strategy advocated earlier by Eichengreen and one that Eichengreen and Haussman note is gaining favor in Washington. I think such a policy is not generally appropriate. It unambiguously raises the cost of capital to businesses in the country and may have very little benefit if substantial amounts of the country's own domestic bank deposits can and would be sent abroad in the same circumstances in which foreign lenders would withdraw their funds. Because this balancing depends on national circumstances, no general rule is possible.

Dollarization

I turn finally to the alternative policy of dollarization, i.e. of explicitly substituting the dollar (or the yen or the euro) for the domestic currency. Eichengreen and Haussman claim that dollarization brings several advantages: it allows borrowing abroad in the domestic currency, thereby eliminating the

potential deflationary effects of currency devaluations; it would also reduce the level and volatility of interest rates, in particular eliminating periods of very high interest rates used to stabilize the exchange rate under a floating rate system; and (again in their view) it would attenuate the severity of the business cycle. I think their analysis overstates the advantages and ignores many of the disadvantages of dollarization.

First, borrowing in a foreign currency is only a problem if there is too much such foreign debt and if corporate debt-capital ratios are too high. Since domestic saving typically finances between 80 percent and 90 percent of domestic investment in emerging market countries and some of the remaining foreign investment takes the form of equity, there is no reason for foreign currency borrowing as such to be a problem. While access to more foreign debt could raise domestic investment, experience shows that countries that seek substantially more foreign debt frequently invest those funds in relatively unproductive ways, thus compounding the problem of excess debt and exchange rate risk.

Second, sharp increases in interest rates to stabilize the exchange rate should not be a long-run issue in a country with a floating exchange rate. Although some periods of high rates may be needed during the early years of floating, it would eventually be possible to have a relatively free float with little interest rate intervention. I might say parenthetically that the recent excess sensitivity to U.S. interest rates of domestic rates in Latin American countries with floating exchange rates is unlikely to be a long-run equilibrium property.

Third, the severity of the business cycle could be significantly worse with dollarization than with a floating exchange rate for reasons that are well known in the literature on the optimal currency areas. In a country that dollarizes, the domestic interest rate and the exchange rate cannot respond to changes in domestic demand – either naturally or as a matter of policy. With dollarization, the local interest rate and exchange rate cannot decline to offset weakness of demand and cannot increase to offset excess demand that arises from nonmonetary sources.

The interest rate will be determined by the Federal Reserve with a view to conditions in the United States. When the US needs higher interest rates, any country that has dollarized will get that interest rate increase whether or not it is appropriate locally. The extent of the damage that this does to a local economy will depend on how much of its nonmonetary business cycle is correlated with that of the United States. Thus Mexico may lose less from dollarization because its business cycle – through trade – is linked closely to that of the US. In contrast, Chile with its heavy dependence on the price of copper, needs flexible interest and exchange rates that can vary quite separately from those in the United States.

There are other problems with dollarization. The central bank of a country that dollarizes will lose the ability to act as a lender of last resort to its own banking system. For that reason, most of the domestic commercial banks could become foreign owned since depositors will recognize that US banks are likely to have access to liquidity in a crisis.

A further disadvantage of dollarization is that there is no way to return to a national currency that has a sound reputation or to reestablish a central bank with significant credibility. Even if dollarization were desirable for a country now, it might not be ten or twenty years from now. The country that nevertheless dollarizes now will have lost the opportunity to use those 10 or 20 years to build confidence in its currency and its central bank

Despite these disadvantages, there are no doubt several countries that would have been better off over the past two decades if they had previously dollarized. Can the central banks of these countries expect to do better in the future? Has there been learning from the past mistakes made by themselves and by others? Those are the key questions that must be answered in assessing the desirability of dollarization.

Rudi Dornbush in his comments yesterday was quite condescending when he dismissed the current and future central bankers of Latin America and Eastern Europe as incompetent neophytes who are congenitally incapable of ever making good monetary policy. I disagree. I have more confidence in the potential ability of these countries and of their central banks. Moreover, I remember the European and US inflation of the 1970s and 1980s and am therefore less confident about the future soundness of the monetary policy of the European Central Bank and of the Federal Reserve. And, perhaps more importantly, I believe in the old fashioned idea that sovereign nations have the right to learn from their own mistakes and to control their own economic policies.

Cambridge, MA
August 1999

References

- Feldstein, Martin. (1998) "Refocusing the IMF," Foreign Affairs, March-April 1998, pp 20-33.
- Feldstein, Martin. (1999a) "A Self-Help Guide for Emerging Markets," Foreign Affairs, March-April 1999, pp 93-109.
- Feldstein, Martin. (1999b) "No New Architecture," International Economy, September/October 1999, pp 32-35.