How to Avoid International Financial Crises

Leland B. Yeager

Polar Arrangements and Compromise Systems

Financial crises of the kind experienced in Mexico and East Asia repeat speculative episodes experienced within the European Monetary System and earlier under the Bretton Woods system and still earlier, as in 1931, when pegged exchange rates came under attack. What needs to be said about such crises is much the same, I'm afraid, as I have been saying for 45 years or so. But I'll try to add something new.

The story of minor events and rumors triggering major repercussions is old stuff. Although chain reactions may be morbidly fascinating, the details are less important than fragility of the institutional arrangements. In explaining why a house of cards collapses, it is diversionary to stress someone's cough or the rumble of a train. Yet as Jacques Ellul (1967: 53–63) observes, the public has an appetite for the latest news, dramatically portrayed; and this appetite crowds out attention to fundamentals.

What sets the stage for currency crises is a lame compromise between the two extremes of full-fledged monetary unification and freely floating exchange rates between independent currencies. Each of these polar arrangements has advantages and disadvantages discussed in the abundant literature on optimum currency areas. Merely having disadvantages does not condemn a system. The central lesson of economics is that having more of one good thing costs having less of others and that choices must be made in view of these costs.

Despite its particular disadvantages, each polar arrangement has a certain logic of its own. We do not experience speculative capital

Cato Journal, Vol. 17, No. 3 (Winter 1998). Copyright © Cato Institute. All rights reserved.
Leland B. Yeager is Ludwig Von Mises Distinguished Professor Emeritus of Economics at Auburn University and Paul Goodloe McIntire Professor of Economics Emeritus at the University of Virginia.

flights across the boundaries of the individual United States. Within the country, no question arises of converting one currency into another nor of whether today's parity will still prevail tomorrow. Nor do exchange-rate crises plague freely floating currencies. None occurs as defined in the dictionary: a relatively sudden turning point at which a disease, for example, changes sharply for worse or better.

True enough, a floating currency may suffer chronic ill health, even decades-long depreciation in purchasing power and foreign-exchange value. But this condition is not a crisis. The required remedy, an internal one, may sometimes be politically difficult to apply; but it is fairly well understood, thanks to the quantity theory of money.

Of course, not all the requisites for economic health are financial ones. "Real" factors are vital to growth in productivity and output. These include institutions, morality, and the ethos of society. Government favoritism, pressures, and corruption reportedly enter into the East Asian story, including implicit guarantees and other nonmarket influences operating on banks and other lenders and borrowers. But assessing these real factors would go beyond my present topic.

Here we must focus on the incoherence of trying to keep exchange rates fixed between distinct currencies, each of which is separately managed by its home country's monetary authority. This attempt to have the best of both polar worlds defined the Bretton Woods system. In some respects it combines the worst of both. It is vulnerable to one-way-option speculation. When a change in a fixed rate seems likely or possible, speculators face an almost heads-I-win-tails-I-break-even bet, winning if the expected change occurs and losing only a little if it is somehow avoided. Hence the massive speculation sometimes experienced and the massive official intervention undertaken to defend the fixed rate. These observations are old stuff, of course. The remarkable thing is how often policymakers fail to heed them.

Nowadays, as an alternative to the Bretton Woods compromise, currency boards are recommended (Walters and Hanke 1992). A currency board operates near the currency-unification pole: the board fixes the exchange rate of the domestic currency, supposedly forever, against one foreign currency or a basket of several and makes that rate defensible by holding foreign-currency reserves worth at least 100 percent of domestic money (narrowly defined, as specified below). The currency board can never run out of reserves with which to defend the rate. Besides having the advantages of currency unification (almost), the system keeps most of the seigniorage from money issue for the home country, since its board holds its foreign reserves in readily marketable interest-bearing securities. (If, in contrast, foreign

currency actually circulated in the country, its foreign issuer would reap the seigniorage.)

The domestic money supply responds to the balance of payments, and the "automatic" balance-of-payments adjustment mechanism characteristic of currency unification (and theoretically characteristic of a full-fledged gold standard) operates.

The typical currency board holds foreign reserves worth 100 percent or more not of the entire domestic money supply, including private bank deposits, but only of paper money and any other base or high-powered money issued by or essentially on behalf of itself. These money issues of its own are the only kind that the board is required to redeem in foreign exchange. Unlike pegging of the Bretton Woods type, this type is secure, or it can be if the board disregards the situation of other domestic financial institutions. The commercial banks are responsible for conducting their affairs prudently enough to keep their own deposits (and banknotes, if any) redeemable in base money.

What happens, however, if the banks have been imprudent or have innocently suffered some misfortune? The currency board might be tempted to rescue them by lending to them or otherwise providing them with additional domestic base money. Creating it, the board shrinks the percentage of foreign reserves against its own liabilities. The domestic currency becomes potentially exposed, after all, to one-way-option bets on its devaluation.

This possibility surfaced in Argentina early in 1995, as I understand the story, in the wake of the Mexican crisis. Previously, the Convertibility Law of March 1991 had established the peso at parity with the U.S. dollar and had drastically cut inflation. This reform, along with restructuring of the private sector, had helped bolster investors' confidence and attract capital inflows. These, along with a "real" appreciation of the peso, had contributed to a current-account deficit.

When the crisis struck, reversal of the capital flows

> reduced the foreign exchange reserves from over $14 billion at the end of 1994 to under $9 billion in March 1995 and domestic currency bank deposits fell by about one-fifth. . . . A substantial easing of reserve requirements helped the banks cope with the sudden withdrawal of deposits. The impact of reserve losses on the money supply was further cushioned by an expansion of dollar-denominated government paper as backing for the monetary base. Finally, the reserves were rebuilt by substantial borrowing, with foreign official creditors providing over $3-1/2 billion in 1995 and public sector issuance of international bonds amounting to $5 billion [Bank for International Settlements 1996: 42].

Thus the worry that the authorities would rescue the banks by loosening the constraints of the currency-board system was partially borne out. But only partially. The peso's parity with the dollar endured. Argentina tolerated an episode of sharply increased real interest rates, tight credit, and deep recession. These conditions helped improve the foreign-trade balance. Confidence returned and business recovered, industrial production recovering in 1996. As things worked out, the Argentine authorities resisted the temptation to rescue the banks by actually abandoning the currency-board system.

In the summer of 1997 rumors occasionally circulated that even Hong Kong might abandon or modify its currency-board system and allow its dollar to depreciate. Yet reserves seemed ample, especially since they might be supplemented in case of necessity by the foreign-exchange reserves of China.

Still another supposed compromise between the polar extremes of independent floating currencies and monetary unification is *managed* floating of independent currencies: official intervention will not resist exchange-rate changes required by fundamentals but will smooth out fluctuations due to random short-term mismatchings of supply and demand and to destabilizing speculation. This verbally attractive prospectus is an old combination of nice-sounding words rather than a concrete combination of coherent institutions and policies. And this interventionist solution is bedeviled by "big-player" effects, explained below. The old proposals for letting exchange rates float, but only within bands or target zones, deserve the same description: they are hardly more than superficially attractive combinations of words.

Compromise systems exhibit a frequent problem of interventionism: some interventions cause disruptions appearing to necessitate further interventions. Something similar can be true when interventions are undone: mere partial liberalization may leave controls in effect whose perverse consequences appear to argue for halting or even reversing the liberalization. Perhaps other and sounder compromises between the two polar exchange-rate systems are available than those I have mentioned, but I do not know of any.

Capital Movements

All crises of one-way-option speculation involve capital movements, of course. Speculative outflows of recent years, perhaps especially those from Mexico, Argentina, and Thailand, had been preceded by not particularly speculative capital inflows. These had been more or less predicated on the perception that the destination country had made itself attractive to investors by reforming its earlier bad ways.

Under a fixed exchange rate, even one maintained by a currency board, an overall balance-of-payments surplus due to capital inflows tends to expand the country's monetary base and broader money supplies and to feed a boom or even inflation. Sterilization against these monetary effects is scarcely feasible on a large scale and for a long time. Even though thus imported from abroad, monetary expansion is painful to reverse. This ratchet effect is one characteristic of the Bretton Woods system.

Capital movements among parts of a unified monetary area are rather different. They do not cause creation of base money in the place of destination. Base and broader money acquired there has flowed out of the capital-exporting parts of the unified area, with its *total* money supply unchanged (perhaps with minor qualifications about different reserve ratios of different banks). No big player—the central bank—has to decide whether to allow capital flows to expand and contract local money supplies or to try to resist these responses by sterilization; and no big player provides a focus for speculators' conjectures about its actions (as further explained below).

Capital movements among countries with independently floating currencies tend to be restrained by exchange-rate uncertainty itself and by movements of the rate that discourage further investment. Appreciation of the currency of a country of destination makes its investment securities and properties more expensive for foreign investors than before (but a qualification must be made if rises and falls of prices of investments translated into foreign currency perversely attract and reverse capital inflows). Furthermore, volatile exchange rates responding to capital flows affect all sorts of transactions and not just the capital movements themselves. Floating exchange rates do, well, float, to the disadvantage of some economic sectors on each occasion.

Again, no particular system has all advantages and no disadvantages. Exchange-rate pegging replaces rate movements with rises and falls of domestic money supplies and with uncertainty about whether the pegging will be maintained after all. Monetary unification sacrifices a kind of quasi-flexibility in regional prices and wages, as well as the possibility of monetary policy attuned to local conditions.

We must distinguish among kinds of claims, securities, and properties acquired by investors who undertake international capital movements. Inflows into bank accounts and currency that do not bear interest are presumably slight for that very reason, but they are the most subject to quick reversal. Flows into portfolio securities are also awkwardly reversible. Movements of flexible security prices should ideally share the restraining effect of exchange-rate fluctuations, and

more appropriately, since these are the prices of the specific targets of the capital movements. Again, though, a qualification is necessary about possible bandwagon speculation.

Foreign direct investment is perhaps a lesser problem because direct investments, unlike portfolio securities, cannot be quickly dumped in preparation for capital flight. Still potentially troublesome, though, is the intermediate step of buying the medium of exchange of the destination country. Even though aimed at direct investment projects, capital inflows still tend to expand the money supply of the destination country under exchange-rate pegging or to appreciate a floating exchange rate.

We must not forget about capital moving at the initiative not of foreign investors but of borrowers in the target country, such as banks incurring debt in foreign currencies and reassured by the fixity of the exchange rate.

Big Players

Big players have already been mentioned. In our context, these are predominantly governments, central banks, and international organizations. Expectations of other transactors focus largely on them. (Witness reactions to denunciations of currency speculation by the prime minister of Malaysia in September 1997.) A big player is defined as anyone who habitually exercises discretionary power to influence the market while himself remaining largely immune from the discipline of profit and loss (Koppl and Yeager 1996, Butos and Koppl 1993).

Exchange-rate pegging or intervention is the work of big players. So are changes in the economic policy regime, such as restoration of relative monetary stability and confidence after years of inflation. Big players can be the focus of rent-seeking. The International Monetary Fund is a big player in its decisions whether or not to help support a pegged currency under attack or otherwise to provide loans. Intentionally or not, the IMF has occasionally played the role of vetter of a borrower's creditworthiness, with its extension of credit giving encouragement to private lenders. Regarding capital inflows into low-credit-rated countries, *The Economist* (1997a: 54) wrote: "One reason for investors' sanguine reactions seems to be the feeling that countries are simply not allowed to default any more: the IMF, together with rich countries, will always come to the rescue" (see also *The Economist* 1997b: 70).

Some such ideas find support from a surprising source. Treasury Secretary Robert Rubin observes that financial rescue packages have protected investors who lent money to the government or financial

institutions of countries like Mexico and Thailand, leaving the residents of those countries to bear the heaviest costs of unsound policies. If investors ran a greater risk of losing money, they would act more prudently, forcing governments to change course sooner. Rubin deplored "a situation where people can do unwise things and not pay a price for it" (reported in Wessel 1997).

I am inclined to concur in points made by Ian Vásquez (1997) and Allan Meltzer (1995) about activities of the IMF (and similarly of the World Bank). These tend to support government domination of economies, despite "conditionality" purporting to do otherwise; and politicization of economies increases the scope for rent-seeking. Thrusting debt onto poor countries, putting them onto a debt treadmill, ill serves economic development. Funds for bailouts create moral hazard, tending to delay reforming crisis-prone policies (see *The Economist* 1997b). New issues of SDRs, which the IMF staff likes to propose, accomplish international transfers of wealth in a way that most legislators do not even understand. Self-important international bureaucracies have institutional incentives to invent new functions for themselves, to expand, and to keep client countries dependent on their aid.

Currency Crises and Monetarist Theory

The Asian currency disorders of 1997–98 are not the same as episodes of unsustainable boom or of recession or depression within a country. Different disorders require different strands of explanation. Still, these strands reconcile well with one another. "Monetary-disequilibrium" or "monetarist" theory, put briefly, attributes inflationary boom or business recession to a quantity of money in a country that exceeds or falls short, respectively, of the quantity that the public desires to hold at the hitherto prevailing general price and wage level. Monetarist theory stresses the great and varied contributions that money makes to an economy of fine-grained division of labor and the attendant scope that monetary disorder has for doing damage. It stresses not only money's medium-of-exchange function and the damage done by excess or deficiency of that medium. It also stresses money's function as unit of account and unit in which debts are expressed. Monetarist theory describes the inevitable complications and delays that bedevil adjustment of the size of the unit (e.g., the purchasing power of the dollar, peso, or whatever) when money's supply and demand have become imbalanced at the unit's old size.

In particular, the theory describes a catch-22 aspect of a fall in the price level that might otherwise remedy an excess demand for holdings

of money. Existing debt becomes more burdensome in real terms. Larger real claims hardly benefit creditors if their debtors go bankrupt. The difficulties of indebted firms are likely to impair the productive activities of others as well, notably of supplier firms. Irving Fisher invoked this "debt-deflation" theory in explaining the severity of depression in the 1930s; actually, he had been anticipated by Pehr N. Christiernin, an 18th-century Swedish economist.

The recent Asian crises exhibit analogous troubles of banks and industrial firms that had borrowed heavily in foreign currencies. Depreciation of the local currencies on the foreign-exchange market means an increased burden of external debt. The demand for foreign exchange to service this debt is relatively inelastic, contributing to a possible situation in which depreciation brings on further depreciation in a vicious circle. Debtors, creditors, and their trading partners all suffer. Calls arise for debt moratoria and international rescue operations.

The international context is complicated by involvement of two or more currencies. Change in an insecurely pegged exchange rate, and even the mere prospect of change, impairs money's unit-of-account function. So does jumpiness of a floating rate associated with actual or feared inflation of money and prices within a country. All and all, international currency crises further illustrate, by contrast, why stable money is vital to economic coordination, calculation, and business planning.

Conclusion

The key to avoiding crises is not international gimmickry. Instead of fiddling with exchange-rate arrangements, policymakers should pay attention to the currencies themselves. So far, absurdly, these remain undefined in value; and their values depend precariously on the changeable policies of central banks, which are constantly badgered with short-run-oriented advice from home and abroad.

In recent years critics have castigated the Federal Reserve for continuing to fight an inflation that, they say, does not exist. They seem not to realize that the several consequences of monetary policy stretch out over many years, and with lags of different lengths. The Federal Reserve must attend to whatever early signs it can detect of inflationary pressures that would show up unambiguously in prices only several or many months later. The (near) absence of inflation that critics so often cite is due precisely to the policy that they do not bother to understand. A major defect of the existing system is its depending so heavily on the ability of the Federal Reserve chairman to resist the badgering of ignorant critics.

Fundamental reform would avoid such dependence. It would avoid sudden unpredictable changes in policy regimes and in official transactions; it would hold down the scope of large centralized decisions, whose effects are harder to cope with than the gradually occurring cumulative effects of innumerable decentralized private decisions; it would reduce the role of official big players on whose dominant decisions the changeable expectations of the public focus. It would provide money of stable or at least of predictable purchasing power.

Although it is not my task here, I am tempted to describe how to achieve these results by getting money issue out of the hands of governments.[1] Each competing issuer of notes and deposits would take pains to remain able to honor its own commitments. Each, in accepting deposits and issuing currency, would have reason to take account of the possible reversal of inflows of funds; it would pay due attention not only to its own asset portfolio but also to the terms on which it incurred monetary liabilities. It would be a shame to foreclose such fundamental reform by embracing pseudo-internationalism in the realm of exchange rates and money.

References

Bank for International Settlements (1996) *66th Annual Report*. Basle, Switzerland.

Butos, W., and Koppl, R. (1993) "Hayekian Expectations: Theory and Empirical Applications." *Constitutional Political Economy* 4(3): 303–29.

The Economist (1997a) "Why Risk Is No Longer a Four-Letter Word." 30 August: 53–4.

The Economist (1997b) "A Walk on the Wild Side." 6 September: 70.

Ellul, J. (1967) *The Political Illusion*. Translated by K. Kellen. New York: Knopf.

Koppl, R., and Yeager, L.B. (1996) "Big Players and Herding in Asset Markets: The Case of the Russian Ruble." *Explorations in Economic History* 33: 367–83.

Meltzer, A.H. (1995) "End the IMF." Paper presented at the Cato Institute's Annual Monetary Conference, 25 May.

Vásquez, I. (1997) "The Record and Relevance of the World Bank and the IMF." In T.G. Carpenter (ed.) *Delusions of Grandeur,* 239–51. Washington, D.C.: Cato Institute.

Walters, A., and Hanke, S.H. (1992) "Currency Boards." *The New Palgrave Dictionary of Money & Finance* 1: 558–61. New York: Stockton Press.

Wessel, D. (1997) "Rubin Says Global Investors Don't Suffer Enough." *Wall Street Journal*, 19 September: A2.

Yeager, L.B. (1997) *The Fluttering Veil. Essays on Monetary Disequilibrium*. Edited by G. Selgin. Indianapolis, Ind.: Liberty Fund.

[1]For a detailed discussion, see Yeager (1997: 337–425).