INTERNATIONAL FINANCIAL CRISES: MYTHS AND REALITIES

Anna J. Schwartz

International transmission of financial crises under the gold standard was a well-understood phenomenon. Changes in the gold, monetary, capital, and trade flows from one country affected prices, incomes, and output in other countries. To prevent international transmission, it was necessary to abandon the gold standard. Under floating exchange rates, the economic links between one country and others are weaker. We should not expect international transmission in such an exchange-rate regime.

Financial crises and exchange-rate crises may be interconnected. Under the gold standard, banking crises could lead to currency crises and devaluation, as happened in 1931. In recent experience, in emerging countries that peg their exchange rates, currency crises occur when internal economic conditions—unsound monetary and fiscal policies—are incompatible with external conditions set for the currency. Problems of the banking system may become apparent after the currency crisis. Few emerging countries have reformed their banking structures or created the proper mix of regulation, oversight, and market discipline to prevent continued instability.

The question is whether an individual country that has mismanaged its affairs will precipitate an international financial crisis. Two myths have propagated the view that the question has an affirmative answer. One myth is that the individual country's loss of creditworthiness has a tequila effect. The supposed tequila effect is that other countries without the problems of the troubled country are unfairly tarnished as also subject to those problems. In this way, it is said, contagion spreads the crisis from its initial source to other innocent victims.

The second myth is that a bailout of the troubled country is essential. The rationale is again the idea of contagion. Failure to organize a

Cato Journal, Vol. 17, No. 3 (Winter 1998).
Anna J. Schwartz is a Research Associate at the National Bureau of Economic Research.

bailout will create an international financial crisis by a domino effect. Rescuing the troubled country saves the rest of the world from unwarranted financial collapse.

The Myth of Contagion

Let's see if we can puncture the myths. Is it true that the market will withdraw its support not only from a country which has financial problems that the market has at some point become aware of but also from other countries in the region that do not share those problems? We can examine the recent turmoil in Southeast Asia for one example. No one doubts that Thailand's plight that led to the plunge in the Thai baht on July 2nd, 1997 was due to its own unwise policies: a growing current-account deficit, excessive short-term foreign borrowing, a banking sector weighed down by speculative property loans, corrupt government and business practices. To show that Thailand spread contagion, however, it would be necessary to demonstrate that otherwise sound economies suffered the Thai fate.

Were the sharp moves in foreign-exchange markets that followed the fall of the baht—as the Indonesian rupiah, the Malaysian ringgit, and the Philippine peso slipped their pegs—an overreaction by investors that belied sound conditions in each of these economies? Such a conclusion lacks credibility.

To reduce inflation and keep it low, each of these countries pegged the exchange rate at a fixed value to that of the dollar or a basket of currencies, with the idea of achieving an inflation rate comparable to that of the dollar or the currency basket.

In today's world of highly mobile capital and deep capital markets, a pegged exchange rate signifying a low inflation policy attracts large capital inflows from abroad. That is what happened to the Southeast Asian economies. At the start, the exchange-rate peg and declining inflation gave the investment climate enormous drawing power. However, while the pegged nominal exchange rate was fixed, the real exchange rate appreciated with growing capital inflows. Widening of the current-account deficit typically accompanied an appreciation of the real exchange rate, which made imports cheap and exports expensive. As the current-account deficit mounted as a percentage of GDP, confidence in the economy deteriorated. Moreover, if the capital that was attracted from abroad was not used productively, the inflow became the basis for nonperforming loans by domestic banks, some of which might be state owned.

Because local lenders harbored doubts about the future value of the domestic currency, as seen in a risk premium on domestic securities, nonfinancial firms and governments of these countries were tempted to issue lower-interest-bearing debt denominated in foreign currencies. In fact, in each country, companies borrowed in dollars but earned revenue in local currencies. Those companies are now vulnerable to the increase in the burden of their foreign indebtedness given their limited ability to repay it.

Finally, the foreign-exchange reserves of the countries were far from ample. To defend the exchange rate, the central bank would have had to tighten monetary policy to convince the market that it would not devalue. To tighten, however, would restrict economic growth and exacerbate the problems of distressed financial institutions.

The foreign-exchange market summed up these concerns about the Southeast Asian countries by selling off their currencies. Stock market declines have matched the currency declines. It was not contagion from Thailand, however, that made the countries vulnerable to a financial crisis. They were vulnerable because of their home-grown economic problems.

Another frequently cited example of supposed contagion is the experience of Argentina in 1995 after the devaluation of the Mexican peso in 1994. Argentina adopted a currency-board-like arrangement in March 1991, establishing one-to-one convertibility of the peso and the U.S. dollar. The arrangement succeeded in reducing inflation and imposing fiscal discipline. Private capital inflows followed. Although the central bank had regulatory powers, no great improvement of the banking sector with undercapitalized institutions was achieved. An institutional weakness of a currency board arrangement is that it cannot act as a lender of last resort to inject liquidity into a banking system under stress. In Argentina the central bank was in no position to ameliorate the problematic banking sector. Assistance to the banking system was provided by two trust funds established for this purpose.

The conventional description of what happened in Argentina after the Mexican problems surfaced is that domestic bank depositors became concerned about the health of the economy, withdrew their deposits, and converted pesos into dollars, producing a sharp contraction in the money supply. As a result, GDP in 1995 fell more than 5 percent and unemployment rose from 10 to 17 percent. The public sector reverted to marked deficit. This is described as contagion. In my view, banks in Argentina were weak constituents of the economy. Confidence in the banks vanished because many were bankrupt. Forty-five out of 205 were closed or merged in 1995. It did not require the Mexican troubles to alert domestic residents to the doubtful safety of their deposits.

It seems ludicrous to believe that financial troubles in a Mexico or a Thailand can trigger a calamity of global proportions. In Mexico's checkered past, despite the number of times it has lived through financial fiascos, it has never undermined the world's finances. The collapse of the 1824–25 boom in London in Mexican and South American mining shares and government bonds resulted in wealth losses for British investors in those securities. Is this a result that should cause financial regulators worry?

The Bailout Myth

The second myth is that a bailout is required if a country fails to pursue sound fiscal and monetary policies. The script for this prescription was written at the Halifax Summit in June 1995. The IMF was urged to "establish a new standing procedure—'Emergency Financing Mechanism'—which would provide faster access to Fund arrangements with strong conditionality and larger upfront disbursements in crisis situations." Thailand has provided the immediate occasion for an emergency multibillion dollar loan bailout to which the IMF, other international lenders, and regional Asian governments have contributed.

But if there is no proof of a spillover effect from Thailand to other Southeast Asian countries, much less to the rest of the world, and the external repercussions are limited to wealth losses by investors in advanced countries, why is the IMF engaged in this activity?

It is ironic that the Mexican bailout of 1995 inspired the model of what needs to be done. The Clinton administration after some false starts orchestrated a $50 billion rescue package—it is not certain that Mexico in fact obtained the full amount—so there was a delay of many weeks in arranging the rescue. Hence the emphasis on a standing procedure and faster access to funds. For Thailand, the bailout, however, was much smaller than the Mexican one.

The first question to ask is: For whose benefit was the Mexican rescue arranged? Is there any doubt that the loan package was designed to pay dollars to Americans and other nationals who invested in *Tesobonos* and *Cetes* and dollar-denominated loans to Mexican nonfinancial firms? Is that the reason emergency loans are needed? To eliminate risk from investment in high-yielding foreign assets?

Treasury Secretary Robert Rubin, one of the architects of the Mexican bailout, apparently has had second thoughts about bailouts. He was reported as saying at a business forum in Seattle last September that the people in countries that pursue unsound economic policies pay a heavy cost for those mistakes—slower growth, government austerity, and unemployment. But U.S.-backed bailouts protect investors who lent money to governments or private-sector institutions, not the people who suffer the consequences of unsound policies. Now, however, Secretary Rubin advocates exposing investors to a greater risk of losing money because that would induce them to cut back on bad investments (reported in Wessel 1997b). This is like Robert McNamara, long after the fact, regretting his support for the Vietnam War.

Although Secretary Rubin did not refer to moral hazard, that was the point of his remarks. The question of moral hazard was, however, raised by Federal Reserve Chairman Alan Greenspan at the Kansas City Federal Reserve Bank Conference in Jackson Hole, Wyoming, which convened before Rubin made his remarks. Greenspan noted that if investors can count on bailouts, they would have an incentive to take "reckless and irresponsible risks." He advocated limiting bailouts "for only the rarest of disasters." Was Thailand an example of such a disaster? Jeffrey Sachs at the same conference suggested that it was a crisis only for people who "are going to lose money." So, as in the Mexican example, is this the reason for a bailout? Stanley Fischer defended the bailout. Otherwise, in his view, "You punish three policymakers . . . and 60 million [Thai] people."[1]

In the Mexican case, it was the bailout that punished 100 million people who gained nothing. IMF conditionality notwithstanding, in the Thai case, the rescue package, rather than benefiting the 60 million, can end up in the hands of politically connected speculators who will bail out their money-losing ventures.

Conclusion

The way to ensure global financial stability is for each global financial institution to monitor and control risk in managing its own internal affairs; for the home central bank to preserve the payments system by providing liquidity in the event of a stock market crash and by preventing both banking panics and forbearance to undercapitalized banks; and for each country to conduct stable monetary and fiscal policies. If there are slipups and an individual country endures a financial crisis, floating exchange rates will preclude international transmission effects.

Glib references to spillovers from disturbances that originate elsewhere are common in the current literature on international financial crises. The truth is that it is not necessary to invoke spillovers to

[1]The remarks by Greenspan, Sachs, and Fischer were reported in Wessel (1997a: A2).

account for multicountry financial disturbances. Capital flight from countries with similar unsustainable policies is not evidence of contagion.

References

Wessel, D. (1997a) "Central Bankers and Economists Ponder Lessons of Thailand's Financial Crisis." *Wall Street Journal*, 2 September: A2.

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