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Financial Instability in Emerging Market Countries: Causes and Remedies

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1 Introduction

In the new era of worldwide financial integration, currency and financial crises seem to be circumscribed to the emerging market countries. While this is not surprising, less expected, perhaps, is that the crises seem to hit primarily those countries that have played by the rules of what used to be called the Washington Consensus. Developed countries can still be rocked by serious financial disturbances, as has been the case with the Nasdaq technology crash of 2000, but the consequences are mild. In the developed part of the world, the Washington Consensus has delivered; the financial markets are resilient, and so are the economies. In addition, governments and central banks in the developed countries have many tools available to cushion any blow.

The developing countries have not yet developed a similar degree of resilience. Minor disturbances can have massive effects. Chile is a good example. It has long adhered to disciplined macroeconomic policies. It has gone very far in liberalising not only its financial markets, but also much of its economic system. And yet, it has repeatedly suffered severe blows, be it contagion from the Tequila crisis or the NASDAQ crash. Argentina is another point in case. By the end of the 1990s, its currency regime was commonly described as unassailable and its banking system one of the safest in the world. Move forward to 2002 and you only see debris floating in troubled waters. Many other countries, from Korea to Brazil, have also painfully felt the extent of their vulnerabilities.

This chapter reviews the causes of emerging market instabilities. A number of explanations have been put forward. They invariably point to the financial markets. A serious question, therefore, is: What is wrong? Are we facing market failures or is it simply that financial markets play their role of monitoring country performance? A main theme of this chapter is that both factors are at work. This conclusion brings about the second theme, which concerns the possible policy responses. Adequate national policies, both microeconomic and macroeconomic, are necessary but not sufficient conditions for rotting out vulnerabilities. Instability – more precisely multiple equilibria – is in the nature of financial markets and will keep hitting forever. This requires a great dose of resilience and policy instruments, which are not always available, and take years to achieve after full internal and external liberalisation.

This, in turn, explains why the experience with financial liberalisation has not been as happy as promised by the Washington Consensus. Arteta *et al.* (2003) find that liberalisation may lead to higher growth in the long run but, in the shorter run, tends to be associated with crises that foster deep recessions. Edwards (2000) finds that capital account openness spurs growth only for countries that have reached a certain degree of development. Kaminsky and Reinhart (1999) find that financial liberalisation is the most reliable predictor of twin (currency and banking) crises. This impressive evidence explains much of the debate between those who argue that financial liberalisation is good for developing countries (e.g. Levine, 1997, or Guiso, Sapienza and Zingales, 2002) and those who take a more sceptical view (e.g. Rodrik, 1998, Stiglitz, 2002).¹

Fortunately, the debate is shifting. It is increasingly being recognised that what matters for growth and development is the quality of domestic institutions. Weak institutions lead to bad policies or to fragile financial systems, and most likely to both. The interaction of bad policies and fragile financial systems is a sure recipe for disaster. Financial repression, domestic and external, acts a fig leaf: it prevents markets from revealing existing weaknesses. At the same time, financial repression stunts growth, so it is not a long-term solution. Liberalisation is necessary, but it must first be recognised that there is a proper order, as recalled in Wyplosz (1998). It is also crucially important to recognise that financial repression is just one aspect of poor quality institutions. One of the lessons from the Asian crisis is that financial liberalisation alone, without a serious overhaul of other institutions, is bound to result in highly disappointing outcomes (for a recent contribution see Prasad *et al.*, 2003).

¹ An excellent review of this literature is Eichengreen (2001).

2 Causes of Financial Instability: the Institutional Connection

2.1 Policy Mistakes

Up until a decade ago, the standard presumption was that the blame for any episode of acute financial instability had to be laid to misguided macroeconomic policies.² Unsustainable fiscal policies led to the accumulation of public and external debts, or high inflation was inconsistent with a fixed exchange rate. This interpretation lies at the root of the IMF's classic conditionality approach.

While this remains a key reason for many financial crises, the simple view that governments should promptly adopt commonly agreed standards of good macroeconomic behaviour has been challenged both by economic theory and by the facts. Recent theoretical research (e.g. Persson and Tabellini, 2000, Drazen, 2000) has shown that the ability of governments to make wise economic decisions is constrained by the quality of the political and social institutions, and that these institutions are shaped by history and the make-up of society. These ideas are backed by an increasing amount of empirical evidence, drawn from both developed and developing countries. They imply that adequate policies will not just be possible, even if requested by the IMF or G-7 pronouncements. Indeed, it is quite naïve to expect most of the developing countries to adopt the same policies as the US or Switzerland, even if "it works" there.

Adopting sound policies is not always a matter of good judgment or good will. A central banker may know what is appropriate but may be unable to do so because he is not independent, having to take instructions from the finance minister. The finance minister may be unable to control public spending because other ministers or the parliament (when it exists and has any power) can overrule him. Ministries and members of parliament may have to cater to special interests if they want to stay in power. These special interests may be segments of the business community, or of ethnic groups, not to mention the military establishment or widespread corruption.

The IMF has now explicitly recognised the importance of this observation. Its response, however, has not always been satisfactory. A good example is the Asian crisis, when the Fund effectively asked for changes in political personnel or sought to reshape ownership structures of firms and banks. The logic of such conditions is compelling, of

² This is the central insight of first-generation crisis theory. See Krugman (1979).

course, but deep interventions of this kind challenge national sovereignty and often provoke a backlash in the affected countries as well as among observers.³

2.2 Public Indebtedness

The quality of institutions also affects how governments view their own indebtedness. In a process called debt intolerance by Reinhart *et al.* (2003), some governments may be tempted to accumulate a large debt and then expropriate its creditors, whether they are domestic or foreign. Expropriating domestic creditors may carry large political costs but can be made “legal” in many ways, from taxation to hyperinflation. Expropriating foreign creditors may earn points with residents but it carries significant costs. Since it cannot be made legal, it leads to pariah status on financial markets until some agreement is found.

A sovereign default typically triggers a multifaceted crisis. The exchange rate usually crashes and the interest rate jumps. Private borrowers face much increased debts, either because of the depreciation effect on foreign currency loans or because index-linked domestic currency borrowings are affected by the interest rate. Private sector bankruptcies soon follow sovereign default, ripping through the financial sector.

Why should any government contemplate such an action? Obviously, when the debt is being accumulated, defaulting requires a very short horizon, poor political control and public opinion oversight. Yet, once indebtedness has been allowed to reach a high level, defaulting may well be the best option. This well-known time-inconsistency problem means that any sovereign borrower faces the temptation to default. Knowing that, lenders are cautious and, if they lend at all, they typically organise themselves in such a way that they can liquidate their exposure as soon as – sometimes well before – they perceive the threat of a default. The result is considerable potential financial instability, which has been characterised by a number of colourful expressions including capital flow reversals, sudden stops, twin crises, etc.

2.3 Market Volatility

An inherent characteristic of financial markets is their volatility. Because they deal with an uncertain future, market operators are prone to frequently changing their views and to adopting herding behaviour.

³ See, e.g. Feldstein (1998).

Technically, these markets are subject to self-fulfilling prophecies. Market sentiment can shift abruptly and without any advance notice. All it takes is that market expectations converge to a view that was previously considered unlikely or even misguided. Brazil offers two examples of such events. At short intervals, its currency was hit in the wake of the Russian crisis in 1998 and then again in 2002. In the former case, the markets thought that they had identified some macro-economic similarities between Russia and Brazil. In the latter case, the cause was the then-likely election of Lula, widely interpreted as signalling the end of policy discipline. In both cases, subsequent events disproved the analysis that underpinned market expectations, but harm had been done.

Deep financial markets tend to be less unstable than shallow markets. They can handle large swings in order flows with smaller price variations. One reason is that large asset stocks are mobilised when a swing is perceived to be excessive or unjustified. In addition, a more widely spread ownership translates into more heterogeneity of opinions, which works to reduce herding behaviour. The availability of more instruments also allows individual market participants to reduce their exposure to risk and steady their reactions. On the other side, the same advanced instruments allow speculators to take very large positions and may thus destabilise the markets.

Financial volatility has long been recognised as a serious problem. A first approach has been to ban or severely repress financial markets. For a long time, this has been the solution chosen by most countries, including many European countries until the 1980s,⁴ and virtually all developing countries until the 1990s. The second approach is to regulate the financial markets with two main aims in mind: (i) to make financial institutions more resilient in case of serious disturbances; (ii) to provide financial actors with incentives to act in responsible and prudent ways. Regulation in turn calls for supervision.

Once again, we face a trade-off. Financial repression reduces an important source of economic instability but it carries serious effectiveness costs that may inhibit growth. From the experience of the developed countries, the lesson is that financial markets must be very gradually freed, starting domestically and then opening up, to allow for the establishment and honing of adequate regulation and supervision. Regulation and supervision, on the other hand, are fairly delicate to design and enforce in many emerging countries. Not only does it require skills

⁴ Wyplosz (2001) describes financial repression in post-war Europe.

often in short supply, but the regulator and supervision agencies must be independent from interference by political and special interest groups while being transparent and accountable. This, in turn, requires adequate political institutions. Indeed, recent research on financial instability increasingly provides support for the view that the quality of domestic governance – proxied by indices measuring the rule of law, corruption, political polarisation, etc. – play a crucial role in allowing financial liberalisation to boost growth rather than holding it back.⁵

2.4 Original Sin

Eichengreen *et al.* (2002) have called original sin the fact that most countries cannot borrow internationally in their own currencies. Table 1 documents this fact: by end 2003, just five currencies (US dollar, yen, euro, sterling and Swiss franc) accounted for 97 percent of all international bond and note issues, two of which (the US dollar and the euro) account for 84 percent of the total. Table 1 also shows that over the last ten years the situation has changed little; in fact, the concentration has increased.

While it is not clear who the sinner is, the fact is that borrowing in foreign currency creates an exposure to exchange risk that has proven to be the source of many recent currency crises of the self-fulfilling variety. Thus, the main benefit from financial openness, the ability to access the world pool of saving to finance development, is associated with an unlucky probability that adverse shocks, most of which do not originate locally, will result in a serious dislocation of domestic financial markets accompanied by a deep recession.

The emerging evidence is that the source of original sin lies with financial market failures. One suspect is the existence of increasing returns to scale in international financial markets.⁶ International investors, in this view, can diversify most of the currency risk by holding assets denominated in a small number of currencies. Fixed costs of developing additional markets limit the range of currencies actually in use, in effect imposing the original sin to most other currencies. Another suspect is adverse selection based on established country misbehaviour. In this view, international investors will not lend to a country in its own currency if they believe that the country will then inflate away its debt. Only the most trustworthy currencies can be used.

⁵ For a recent review, see Prasad *et al.* (2003).

⁶ This is the explanation advanced by Eichengreen *et al.* (2002).

Table 1 Currency of Issuance for International Bonds and Notes
(percentage of total)

	September 1993	December 2003
US dollar	38.2	40.4
Yen	14.4	4.4
Euro	26.1	43.5
Pound sterling	7.7	7.0
Swiss franc	8.0	1.8
Others	5.7	2.8
Total	100.0	100.0

Source: Bank for International Settlements.

The first view receives support from the evidence presented by Eichengreen *et al.* (2003), that country size is the single most significant explanatory variable for original sin. The second view is unable to explain why many developed countries with a solid policy and governance record, for example Denmark and Sweden, do not borrow much in their own currencies, nor does Chile after a long period of highly disciplined policies.

The original sin creates a very serious difficulty for affected countries. If they wish to tap the world financial markets, they have to accept a currency mismatch which, in turn, becomes the potential source of severe difficulties. Exchange rate fluctuations affect the debt level and its service: depreciation requires either raising taxes and cutting spending to contain the debt, or allowing the debt to grow, which is bound to raise concern among investors and to result in a full-blown crisis when capital inflows abruptly stop. The same pressure develops when interest rates in the major currency countries rise; indeed, it is well known that most crises in the emerging market countries have followed a period of rising interest rates in the US. Currency mismatch is widely recognised as a major source of economic vulnerability.

Many countries affected by the original sin have responded by pegging their exchange rates to the currency they most use to borrow internationally. This strategy reduces short-term volatility in debt levels and service but, as happened in South-East Asia in 1997-98, it can backfire and transform mundane currency depreciation into an unmanageable currency crisis. Another strategy, adopted by Korea and Taiwan for instance, is to cut the link between original sin and currency mismatch. To that effect, the monetary authorities accumulate a volume of foreign exchange reserves commensurate with external borrowing. It remains to

be seen whether this approach will be able to deter speculative attacks and currency crises.⁷ At any rate, this strategy implies that net external borrowing is strictly limited. What, then, is left of the key benefit from financial openness, that of tapping the international financial markets to supplement domestic saving in the financing of productive investments?

3 Remedies and Policy Implications

The revised Washington Consensus now recognises that capital liberalisation is not working as smoothly and efficiently as once argued. The official view is that liberalisation is to be approached cautiously and should follow the development of adequate institutions that deliver prudent macroeconomic policies and sophisticated regulation and supervision of the financial markets. This is a welcome step, but not quite enough yet. This section first asks whether liberalisation is, in fact, desirable, and if so, what must be done to make it deliver its promises.

3.1 Should All Countries Eventually Liberalise?

Conventional wisdom holds that financial liberalisation is on the agenda for all countries. As noted above, the evidence that it is growth-enhancing remains muddled. The Washington Consensus interpretation is that the benefits from liberalisation are theoretically unassailable and that the evidence is concealed by ill-designed experiments. Once all the necessary preventive steps are taken, it is argued, liberalisation will deliver.⁸

It is not clear at all that the theoretical case for financial liberalisation is as robust as claimed. True, financial liberalisation opens up important possibilities to draw upon the world pool of saving and to diversify investments. Equally true is that financial markets play an important role in monitoring national policies and thus provide incentives for governments to follow best practice in carrying out macroeconomic and structural policies.

All this assumes, however, that financial markets are adequately functioning and that market failures can be corrected through appropriate regulation. In that respect, the record of the last decade among the developed countries is impressive. The financial markets

⁷ The arguments presented in Jeanne *et al.* (2003) cast serious doubts on the robustness of this strategy.

⁸ For an excellent presentation of this view, see Prasad *et al.* (2003).

have weathered many storms, including the LTCM failure, the bursting of the IT bubble, and the attack on the World Trade Center in New York. A combination of deft policy actions and well-crafted regulation has made financial markets remarkably resilient. In previous times, any of these shocks would have precipitated a serious world crisis. It is fair to conclude that the developed countries have passed the stage where financial instability is potentially lethal. Financial markets remain volatile, but they are able to cope with this volatility by themselves, and the real economy is largely immune. Hence, the belief that all that is left for the developing countries is to draw on this accumulated knowledge and prepare their own liberalisation. This is the road followed by Chile, for instance, and success there is impressive.

The assumption behind this view is that every country can adopt the set of policies that have proven to work elsewhere. Governments are seen as both benevolent and able to implement welfare-enhancing policies. Unfortunately, there is no evidence that these conditions are met in practice. Few students of public affairs are willing to accept the hypothesis that governments are benevolent, and even fewer take it for granted that good policies are easy to implement. Interestingly enough, many of those who argue that market failures are small enough to be ignored, and who therefore strongly support financial liberalisation, also consider governments as captured by a host of private interests. They see economic and financial liberalisation as a way of lessening the grip of ill-intended governments and malfunctioning political systems.

They have a point, but they need to recognise that successful liberalisation requires first adopting good policies, which requires good government. Put differently, the countries that stand to benefit most from being subject to market-based discipline are precisely those less able to liberalise. Implicitly, the Washington Consensus was that the benefits from market-based discipline and market access were worth the early liberalisation costs, including possible currency crises which were seen as a cleansing influence. The revised view recognises that the costs, economic and political, may well exceed the benefits.

Is financial liberalisation still on the agenda, then? A positive answer requires a more subtle argument. It rests first and foremost on the need for every country to have good governance, a government less captured by private interests and subject to rigorous accountability. Such a requirement is based both on political and economic grounds: good governance is a desirable objective in and by itself, and it delivers better economic policies, which in turn promote growth. Financial liberalisation becomes the by-product of a wider agenda.

3.2 What to Do with the Exchange Rate?

Even assuming good governance and a reasonably benevolent government, financial liberalisation does not come easily. A particularly difficult question concerns the choice of an exchange rate regime. The Washington Consensus view, for a while, seemed to adopt the two-corner solution.⁹ According to this view, with full capital mobility, the only sustainable exchange regimes are either fully floating rates or hard pegs such as currency boards, dollarisation or currency unions. This view is now undermined by recent events.

First comes the demise of Argentina's convertibility law. A currency board was presumed unassailable, at least if supported by adequate financial sector regulation and supervision and by reasonably disciplined macroeconomic policies. Argentina's financial sector was considered as a model to follow, and no one seems willing to argue that it was not so. There is much debate about fiscal discipline. Mussa (2002) argues that provincial authorities failed in that respect, raising the spectre of a federal bailout incompatible with the sustainability of the currency board. Yet, the combined deficit of state and provincial governments remained subdued, barely exceeding 3 percent in 2001, for the first time since the adoption in 1991 of the currency board. This is why an alternative interpretation emphasises instead an overvaluation of the peso and the rigidity of wages.¹⁰

Second, studies that attempt to identify the *de facto* exchange regime¹¹ show that the migration to either of the two corners has not happened. Many countries declare that they let their exchange rates float but they intervene more or less heavily, as several Asian countries currently do. Fear of floating is widespread and reveals deep-seated preferences for nominal exchange rate stability. Fear of fixing too is widespread, especially concerning hard pegs, reflecting a general reluctance to fully sacrifice the monetary policy instrument. What seemed once to be a new fashion, spearheaded by Argentina and Ecuador, has now come to a full stop.

There are good reasons for developing countries to be reluctant to adopt either of the extreme exchange rate regimes. Free floating never

⁹ See Fischer (2001).

¹⁰ This alternative is sometimes criticised on the ground that exports doubled in volume since the adoption of the currency board. On the other side, as a percentage of GDP, exports remained essentially flat at a very low level and the current account deficit fluctuated around 4 percent of GDP.

¹¹ Levy-Yeyati *et al.* (2002) and Reinhart *et al.* (2004).

resembled Friedman's classic description. Freely floating exchange rates move quite a lot; for reasons now well understood, exchange rates behave like asset prices. As they do, they become an autonomous source of uncertainty, in effect discouraging international trade. Hard pegs, of either variety, require quite a large degree of price and wage flexibility. What is possible in Hong Kong is not easily achieved elsewhere. Hard pegs without an exit strategy amount to a huge bet, with considerable costs if the bet is lost. So far, no one has been able to design a credible hard peg with an exit strategy. The challenge is plain to see. Not only does an explicit exit strategy mean that the peg is only temporarily hard, but the activation of the strategy is likely to require some advance preparation, which is bound to precipitate a full-blown crisis.¹²

Well-designed limits on capital mobility make the middle ground – soft pegs, managed exchange rates – possible. That does not mean that intermediate arrangements are easy to operate; in fact, the evidence is that they are prone to misalignments and to speculative attacks. Misalignments require realignments and realignments remain difficult to implement. Not only is there much evidence that many countries wait far too long to correct misalignments, but realignments can often be foreseen, which invariably triggers speculative attacks. The only virtue of limits to full capital mobility is to make speculative attacks manageable, at least if the authorities are well-prepared and ready to act fast. When this is the case, soft pegs equipped with an explicit realignment escape clause offer a very attractive way out of the two-corner strategy. Financial liberalisation all but closes down the escape clause option and limits the choice of an exchange regime to the two corners. Advocates of full capital mobility must also take into account this important aspect. This is the object of the next two sections. In both cases, the challenge is to establish domestic institutions that deliver outcomes compatible with the exchange rate regime.

3.3 Institutions for the Two-Corner Exchange Rate Regimes

Freely Floating Exchange Rates

Freely floating exchange rates are a source of uncertainty that may trigger the various forms of financial instability identified previously.

¹² Interestingly, the currency boards in Europe (Bulgaria, Estonia, and Lithuania) have as explicit strategy the adoption of the euro. Activation of this strategy is only going to strengthen the arrangements.

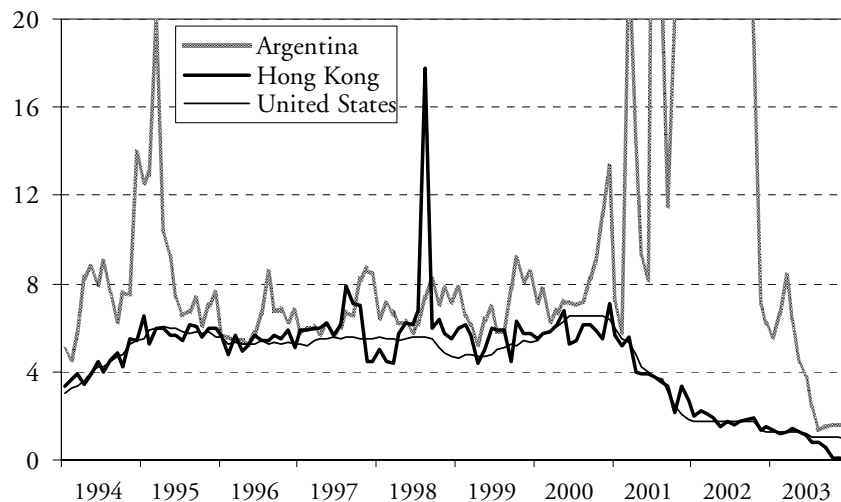
On the other side, freely floating exchange rates may exert a strong disciplinary effect on governments, thus reducing the odds of policy mistakes and providing strong incentives to contain, and possibly reduce public debts. The following is a list of requirements that must be met when adopting freely floating exchange rates:

- The financial markets must be able to cope with sizeable exchange rate volatility. This calls for the implementation of international norms in terms of accounting standards, financial market regulation and supervision. Accountants, regulators and supervisors must not only be competent, they must also be free from political and special interest influence.
- Macroeconomic policies must be shielded from political interferences. For monetary policy, this means a clear framework and strong central bank independence. A number of emerging market countries has adopted the inflation targeting strategy, very successfully so far. The strategy offers a clear objective and a high level of transparency, which helps upholding the central bank's independence.
- In the area of fiscal policy, the original sin implies that public debts denominated in foreign currency are a major source of vulnerability. Reducing this vulnerability constitutes therefore an overriding objective. One obvious step is to issue the debt domestically in domestic currency, but experience shows that, in this case, most governments cannot place bonds beyond a short maturity or they must accept indexation; in both cases, via the interest rate parity condition, the difference with foreign currency debt is symbolic.
- In such a situation, it becomes essential to provide a hard commitment to long-term debt sustainability. Chile has taken a step in this direction with the adoption of a fiscal rule. Countries with less accumulated credibility should consider more constraining arrangements, yet allowing for the shorter-run counter-cyclical use of the fiscal policy instrument. Wyplosz (2002b) suggests setting up independent fiscal policy committees that monitor or mandate annual budget balances designed to achieve a long-run debt target, much like inflation-targeting central banks use the interest rate to achieve a long-run inflation target (see also Teunissen and Teunissen, 2003).

Hard Pegs

A hard peg provides some credibility to monetary policy, although not always a perfect one, nor is it guaranteed forever. This is exemplified in Figure 1a, which displays short-term interest rates in Argentina and

Figure 1a Money Market Interest Rates in Argentina, Hong Kong and the United States
(percentages)



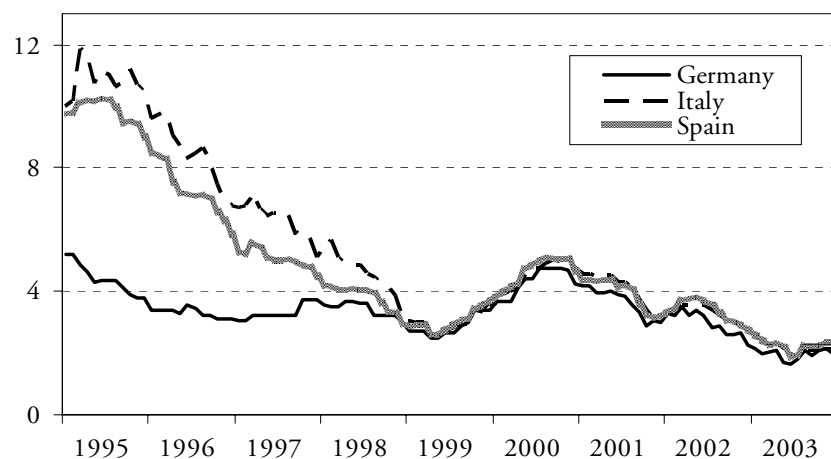
Source: IMF 2004.

Hong Kong, comparing them with those in the US since Argentina and Hong Kong had currency board arrangements vis-à-vis the dollar. The figure shows that the Argentine interest rate never came down to the US level, reflecting a limited credibility. Interestingly, much the same applies to Hong Kong until it repelled powerful speculative attacks during the Asian crisis. On the other side, Figure 1b shows that the adoption of a hard peg in Europe, a common currency, has delivered immediate and full credibility.

A hard peg needs to be supported by a number of specific features:

- The loss of the exchange rate instrument means that external competitiveness must be maintained through other means. This is why prices and wages must be flexible, a difficult task in many countries. The solution may be two-part wages or indexation schemes.
- The loss of monetary policy implies that the monetary authorities will not be able to carry out large-scale lender of last resort operations. For this reason, banks in particular but also other financial institutions have to be strengthened. As with freely floating rates, this calls for the adoption of international norms in terms of accounting standards, financial market regulation and supervision, in the full knowledge that crises will occur and financial institutions will fail.

Figure 1b Money Market Interest Rates in Germany, Italy and Spain
(percentages)



Source: IMF 2004.

One lesson from Argentina is that undisciplined fiscal policy can undermine a hard peg. On the other side, fiscal policy becomes the only counter-cyclical macroeconomic instrument available, which rules out strict rules like balanced budget laws or the European Monetary Union's Stability and Growth Pact (Box 1 explains why the pact failed).

- As in the case of free floating, the solution is the establishment of solid institutions that credibly aim at a long-run debt target while allowing for shorter-term flexibility.
- A hard peg provides an implicit guarantee for borrowers in foreign currency. This has the effect of eliminating the original sin and is therefore highly beneficial. If, however, the peg arrangement needs to be reconsidered, or is unexpectedly dissolved, the resulting currency mismatch can be destructive, as was the case in Argentina. One approach is to accumulate a large volume of foreign exchange reserves, which is costly *ex ante* and insufficient *ex post*.¹³ Another approach is to have an exit strategy regarding the treatment of all assets and liabilities.

¹³ A currency board requires that the reserves be equal to the money base. In Argentina, the coverage was higher, at some 130%. However, the currency mismatch extends potentially to all financial institution liabilities, representing a multiple of the money base.

Box 1 Why Europe's Stability and Growth Pact Failed

The Stability and Growth Pact stipulates that the budget deficit can never exceed 3 percent of GDP. It allows for "exceptional circumstances" but these are so exceptional that the cause is irrelevant. The Pact includes a procedure, which starts with an advance warning when the first excessive deficit is happening, and gradually raises the surveillance until a fine is imposed if the deficit is still above 3 percent of GDP after three years. The European Commission is mandated to exercise surveillance and make recommendations to the Council of Finance Ministers. The Council decides on a qualified majority.

In November 2003, the Commission asked the Council to trigger the procedure that should have eventually imposed a fine on France and Germany. After intense lobbying by the euro zone's two largest countries, the Council decided to put the Pact in abeyance, arguing that the long slowdown did not allow these two countries to fulfil their commitments. The Commission took the Council to the European Court of Justice. In June 2004, the Court ruled that the Pact could not be put in abeyance, that the Council was free to not follow the Commission's recommendations, and therefore set the stage for a new vote, to be formulated differently.

This episode has confirmed what many analysts had argued: the Stability and Growth Pact is badly flawed. The Pact suffers from two key weaknesses:

- **Economic flaw.** The aim of the Pact is to enforce fiscal discipline. The correct definition of fiscal discipline is that the intertemporal budget constraint be met at all times. In practical terms, this means that the public debt must remain sustainable. A particular year's annual deficit is largely irrelevant. By focusing on annual deficits, the Pact has chosen the wrong indicator. This is precisely the argument used by the Council in its November 2003 decision.
- **Political flaw.** Fiscal policy is explicitly recognised as a sovereign competence. In each country, the budget is drawn up by the government and voted upon by the parliament. The Pact requires that fiscal policy be subjected to international constraint. While, formally, this is the implication of a national commitment – enshrined in a Treaty – the procedure is politically unacceptable.

3.4 Building Institutions for Soft Pegs

Traditional Unilateral Pegs

A number of countries will want to continue to operate some form of soft peg vis-à-vis a major currency or a basket of major currencies.¹⁴

Any peg must include the escape clause of realignments. Realignments, in turn, are unlikely to be possible in the presence of full capital mobility. An obvious possibility is to restrict capital mobility. This is, by far, not a guarantee of success, and offers only a limited ability to deal with speculative pressure. Unless financial repression is severe, the risk of financial instability remains, as does the original sin problem. Here again, the main requirement is the adoption of well-designed macro-economic policies. A brief list of desirable features is as follows:

- As always, strengthening the financial sector is highly desirable.
- Great care must be paid to dismiss the belief that the peg will be indefinitely maintained; this concerns current exchange rate level and the fixed exchange rate regime itself. This is especially important to limit the extent of currency mismatch. Borrowers in foreign currencies, including the authorities, must remain aware at all time that the existing peg can be unhooked.
- The choice of a monetary policy strategy is delicate. Adopting a peg implies subordinating monetary policy to the exchange rate target. Limits to capital mobility can create the misguided impression that there is a sizeable room for manoeuvre. This is illusory. Herein lies the main drawback of soft pegs: they do not provide much more flexibility than hard pegs – except for the realignment option – but the perceived commitment is weaker, opening up the way to policy miscalculations. Central bank independence is a guarantee that monetary policy will not be misused for political advantage.
- Fiscal policy discipline remains a necessary condition for the long-run survival of soft pegs.

Multilateral Pegs

Nearly all countries that adopt soft pegs do so unilaterally vis-à-vis a major currency. The successful European experience has been different

¹⁴ This is likely to be optimal under most conditions. Indeed, the term “two-corner” is borrowed from the optimisation literature. Unconstrained optima are typically “interior solutions”, meaning that the extreme cases are not generally optimal.

since 1979, however. The choice of an exchange rate regime has been collective and based on multilateral pegs among the members of the European Monetary System (EMS). Undoubtedly motivated by the existence of a common market, this arrangement has proven to be superior to the traditional unilateral peg to an outside currency. Although the EMS has been buffeted by a number of speculative crises, it has served as a training ground for the eventual adoption of a hard peg in the form of a common currency. The crucial element has been the setting up of common institutions.

Since the pegs were unilateral, holding large amounts of dollar reserves was not essential; indeed, mutual foreign market assistance in European currencies allowed for major savings regarding foreign exchange reserves. Yet, the European experience includes a number of very specific features:

- The emergence of an anchor currency, the Deutsche Mark, provided increasingly clear guidance for the conduct of national monetary policies. Most of the crises occurred when this evolution was ignored or resisted, as was the case during the 1992-1993 crisis.
- The European countries were largely spared the original sin challenge. Developing countries that might also adopt multilateral pegs will not be in a similar solution. If one member country's currency is free from the original sin (for example Japan in South-East Asia), it can be used for international borrowing, under the assumption that the arrangement will be upheld. However, failure to uphold the arrangement, or simply realignments, will always remain a possibility. In such instances, intensified cooperation among all member countries may cushion the impact of currency mismatch by limiting the size of exchange rate changes.

If no member country is free from the original sin (as would be the case in Latin America), the proper approach is to adopt the institutional arrangement described previously in the case of freely floating exchange rates.

4 Conclusion

The emerging market countries are going through a phase that is perilous from the financial point of view. To maintain fast growth, do they need to integrate themselves economically and financially into the world economy? Trade is everywhere an engine of growth; in fact, the most successful emerging market countries from Asia have all adopted the Japanese export-led growth strategy. Financial integration is also in

their interest. Not only do they need to access the pool of foreign savings, but their own corporations will not become world players unless they can rely on wider ownership and get involved in the process of mergers and acquisitions that support their expansion and guarantees a timely transfer of technologies.

Nearly every emerging market country already had had at least one, and usually many more, encounter with currency and financial crises. Crises are parts and parcels of financial markets. The objective, therefore, should not be to aim at no crisis, but to make crises manageable, as innocuous as possible. This, in turn, raises two deeply inter-related issues: the exchange rate regime and the capital mobility regime.

The Washington Consensus had easy answers: exchange rates should be of the two-corner variety and capital should be freely mobile. These recommendations have not been followed – very few countries have moved to the corners – or have provoked severe currency and financial crises where capital has been fully liberalised. A better approach is possible, at the cost of eschewing the simplicity of the Washington Consensus. Three lessons must be kept in mind.

First, adopting “good policies” is easier said than done. Most countries have not yet developed well-performing political institutions. Weak institutions make it impossible for the best-intentioned government to carry out good policies. Bemoaning policy mistakes, as is often the case, missed that point, as do many of the conditions requested by the IMF and recommendations from the developed countries. Building up good institutions is the first step, one that takes a very long time and that cannot be imposed from outside. This may be a frustrating conclusion.

Second, most countries seem to prefer soft pegs to either corner. There are good theoretical and practical reasons for that. Soft pegs come in many forms and shapes, but they all require a number of accompanying measures. In particular, they must be flexible enough to accommodate policy mistakes. This means that the currency will have to be realigned now and then. This, in turn, argues for limiting capital mobility. The line of reasoning here is the exact opposite of that followed by the Washington Consensus, which starts with the assumption that capital movements should be fully liberalised and, therefore, would imply the choice of either one of the two corner regimes.

Finally, unilateral peg to a major currency is not the only option. A multilateral peg organised at the regional level is another option. That such a peg have worked well in Europe, however, does not mean that it will work in other regions. Here again, the building up of institutions is a prerequisite.

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