Introduction

Over the past few years a standard agenda of crisis prevention measures has been developed to which most policymakers and analysts adhere. Opinions differ, however, when it comes to the specific policy that each country, given its particular circumstances, should choose from the variety of options available. This book reflects on today's standard agenda of crisis prevention, but most of all, it deals with two themes that ought to have been – but were not – included in the agenda. The first concerns the possibilities for major industrial countries to address global economic imbalances, and the second is how developing countries could counter boom-bust cycles. The four parts of the book provide a wealth of interesting analyses, discussions and proposals. In these introductory pages, I can highlight only a few.

In the opening chapter, Jan Kregel argues that advanced countries should address global economic imbalances. He analyses what he calls "a new cyclical pattern" of the global economy in which US expansion serves to offset contraction in other parts of the world, while the rest of the world is unable to compensate for contraction in the US. As a result, there are growing – internal and external – imbalances in the US economy that are currently leading to a global slowdown. More generally, Kregel blames the IMF and its major shareholders for not assessing the extent to which the monetary and exchange rate policies of the United States and other major industrial countries affect global stability and have a negative impact on developing countries. He stresses that the advanced countries could make a large contribution to the cause of development by coordinating their macroeconomic policies and addressing the global economic imbalances they cause. In this way, they would decrease the disruptions of trade and finance in developing countries that result from these imbalances, and make a contribution to development that might be greater than any form of aid.

In his comment on Kregel, Zdeněk Drábek observes that today's global economic imbalances cannot be treated by macroeconomic tools alone but must be supported by structural reforms in Japan, Europe and the US. Like Kregel, he stresses the need for policy coordination among the G-7 countries, but emphasises that Japan and Europe are as important as the United States. In addition, he sees the need for a "super-supervisor", a supranational institution like the IMF or WTO that would oversee the creditworthiness and soundness of economic policies of countries. In his view, such an institution would help to prevent excessive risk taking and address the problem of boom-bust cycles.

From: New Challenges of Crisis Prevention,
FONDAD, December 2001, www.fondad.org

In the ensuing floor discussion, a whole range of issues was discussed. Manuel Marfán, Chile's former deputy minister of finance, raises the issue of excessive spending by the private sector and its lack of macroeconomic concern. He sees this as one of the crucial problems that is missing in the policy agendas, especially in those of the Bretton Woods institutions. According to Marfán, there is no discussion whatsoever about how to manage these excess private expenditures in the context of a globalised economy, even though they have been the main driving force behind the boom-bust cycles of the 1990s. Another issue raised was that of the dominant role of the United States in the global economy and the feasibility of G-7 coordination to achieve greater stability in the system. Jan Kregel argues that if free trade is considered as the best overall system, exchange rate stability among the major economies' currencies should be pursued much more energetically to prevent exchange rates from distorting the free trade system. In his view, it would benefit everyone concerned to establish precise regulations – which are currently lacking.

In the second part of the book, José Antonio Ocampo looks at the role of developing countries' domestic policies in managing externally generated boom-bust cycles. He draws from an extensive recent literature on the subject and from the experience of Latin America in the 1990s. He first looks at the international asymmetries that lie behind the boom-bust cycles in the developing world and the macroeconomics of these cycles. He then examines the policy options for developing countries in terms of the choice of exchange rate regime, liability policies, prudential regulation and supervision, and fiscal stabilisation. He concludes that an adequate anti-cyclical policy package should be based on a mix that involves: managed exchange rate flexibility *cum* capital account regulations; strong "liability policies", aimed at improving private and public sector debt profiles; strong prudential regulation and supervision of domestic financial systems, with anti-cyclical instruments; and counter-cyclical fiscal stabilisation funds and adequately-designed social safety nets.

In her comment on Ocampo, Liliana Rojas-Suárez provides many useful policy insights. She agrees with the relevance of distinguishing between country risk and exchange rate risk and argues that the policy debate needs to be redirected from a discussion on the "right" exchange rate regime to the design of policies aimed at improving the perception of creditworthiness by foreign investors. Another issue she tackles is the appropriate design of regulatory and supervisory rules for the financial sector in emerging markets. In her view, the recommendations by the Basel Committee completely fail to consider the particular features of emerging economies. She suggests how, for example, early warning signals could be constructed as a more adequate tool for effective supervision in emerging markets.

In the second comment on Ocampo, Amar Bhattacharya supports the anti-cyclical policy package laid out by Ocampo and distinguishes two objectives of this package. The first is how to pursue counter-cyclical macroeconomic policies, in order to dampen the aggregate demand effects and mute the capital flows. The second is how to manage the balance sheet risks associated with these flows. With regard to the second objective, he stresses the need for anti-cyclical prudential regulation and observes that in East Asia, precisely the opposite was done. Regulation was lax in the boom period and it was tightened in the crisis, triggering just the opposite effect of what one would want. Bhattacharya remarks that Ocampo focuses primarily on managing the *boom* while it would be equally important to know how to manage the *bust*.

In the floor discussion on the policy options for developing countries to counter boom-bust cycles, much attention was given to the problems of prudential regulation. It is generally believed that counter-cyclical policy is difficult in boom times because when things are going well, it is hard to convince people that there are risks. Forward-looking provisioning, which means that one makes banks provision at a higher rate in the boom period because some loans will turn bad when the bust comes, may be an acceptable formula. Ocampo believes that one of the most powerful instruments would be a combination of liquidity requirements with preventive provisioning for delinquent loans.

In the third part of the book, about exchange rate policies in developing countries, John Williamson gives his view on the exchange policies that Latin American countries could pursue. He defends the proposition that a so-called intermediate exchange rate regime (between fixed and floating) will be viable in all circumstances if it is managed competently – except in the case of strong contagion. He discusses how an intermediate regime might be modified in order to make it less vulnerable to speculative pressures. He then considers the advantages and disadvantages of this regime in comparison to a floating regime. Finally, he discusses how the problem of Latin American countries that have different exchange rate regimes and intense mutual intra-trade could be resolved.

In his comment on Williamson, Carlos Massad, governor of Chile's central bank, notes that the intermediate regime represented the exchange management in Chile during most of the 1990s when it had a band, basket and crawl until September 1999. On that date, Chile abandoned the formal band scheme and turned to a free floating regime. So far, it is quite content about that decision because exchange rate volatility has not been greater than it was with the band. Moreover, says Massad, prior to floating, every time the market exchange rate approached the limits of the band, speculative attacks forced the authorities to intervene by changing the band or

From: New Challenges of Crisis Prevention,
FONDAD, December 2001, www.fondad.org

adjusting restrictions.

Yung Chul Park and Chi-Young Song look at East Asia's recent experience with the free floating exchange rate system. They observe that despite the overwhelming support for the free floating system in emerging market economies, many countries in East Asia have been reluctant to let their exchange rates fluctuate freely. China continues to adhere to a managed floating system, and East Asian countries with a free floating system intervene extensively to stabilise their nominal exchange rates. Park and Song analyse the behaviour of the nominal and real exchange rates and the exchange rate policy of the three crisis countries in East Asia – Indonesia, Thailand, and Korea – that shifted to free floating in 1997 as part of the IMF conditionality for rescue financing. They discuss some of the reasons that make these countries reluctant floaters, and examine whether the intermediate exchange rate regime could be an alternative system appropriate to East Asian economies. They then investigate the extent to which volatility of the nominal exchange rate in the three countries has increased since lifting foreign exchange controls, and attempt to identify why the authorities of all three countries systematically intervened in the foreign exchange market. Finally, they examine whether the three countries have gained more monetary autonomy since adopting the free floating system. According to the authors, strong evidence of this cannot be found.

In his comment on Park and Song, Brian Kahn disputes their argument that exchange rate volatility in the three East Asian countries has increased significantly because they adopted a more flexible exchange rate regime. He also disputes the authors' assertion that their tests do not provide evidence of greater monetary policy independence after moving to flexible exchange rates. In Kahn's view, the results of their tests rather show that there is no evidence that monetary policy independence has *not* increased.

In the floor discussion, Liliana Rojas-Suárez observes that the choice of exchange rate regime cannot be separated from the situation in which the domestic financial system finds itself. In her view, many countries do not dare to float because they fear that sharp exchange rate movements may harm the financial system. At the same time, they do not dare to fix, because if they have to defend the exchange rate, they will have to increase the interest rate, which will also affect the financial system. Amar Bhattacharya stresses the importance of initial conditions for choosing the appropriate exchange rate regime. The Chilean experience, for instance, may be quite different from the current East Asian experience because the prerequisites are so dissimilar, he says. That raises the question: even if one has a floating exchange rate regime, how could the government limit itself only to inflation targeting or how could the central bank act as a centre for

From: New Challenges of Crisis Prevention,
FONDAD, December 2001, www.fondad.org

managing private sector expenditure? Bhattacharya believes that none of the East Asian crisis countries has really moved to free floating but rather to managed floating. Stephany Griffith-Jones argues that the volatility of capital flows makes a band regime highly unstable. In her view, such a regime could only become more stable when a tough control of capital flows is applied.

In the fourth part of the book, José María Fanelli argues that, in an increasingly globalised world, counter-cyclical policies are also needed at a level exceeding national boundaries. He presents a Latin American perspective and, more specifically, a Mercosur perspective. Fanelli first discusses a set of stylised facts associated with trade and international financial markets in Latin America, showing that international market failures and macroeconomic fluctuations are closely associated. Based on this analysis, he draws some lessons for counter-cyclical policies at the regional and international level and outlines the goals that Latin American countries should pursue in negotiating a regional and multilateral counter-cyclical agenda. These include: minimising the volatility of national income; reducing international capital imperfections; minimising the variance of foreign exchange receipts; and developing international institutions to support more stable macroeconomic regimes.

In the final chapter of the book, Stephany Griffith-Jones and Stephen Spratt discuss some of the negative effects of the proposed new Basel Capital Accord. They are concerned that the new Accord will reduce lending to developing countries and increase the pro-cyclical character of bank lending. They suggest a number of measures to address the pro-cyclical effects of the new Accord. These include: forward-looking provisioning to allow for provisions to be built up in good times to be used in bad times; placing a cap on the value of assets that can be used as collateral to protect against inflated asset prices that occur during a boom; and limiting lending for property, construction and personal consumption since these tend to increase substantially in boom periods.

Jan Joost Teunissen
November 2001

From: New Challenges of Crisis Prevention,
FONDAD, December 2001, www.fondad.org