Fiscal Conservatism, Exchange Rate Flexibility, and the Next Generation of Debt Crises

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Despite all the invective hurled at international financial markets by critics of the "Washington Consensus," the fact is that strong healthy financial markets are essential for middle-income countries that aspire to the ranks of advanced countries. Deeper financial markets mean a better allocation of risk, but they can also make economies more vulnerable to crises. The question is not simply how to avoid crises entirely, but how to handle the ones that do inevitably occur. When it comes to avoiding international debt crises, the single best precaution any middle-income country can take is to keep down its debt/GDP ratios, especially public debt, and especially public external debt. The second most important step is to adopt a sufficiently flexible exchange rate regime. Whereas relatively fixed exchange rates systems work well for poor developing countries that are insulated from international capital markets, they are a lightening rod for disaster for upper-middle-income and advanced countries, except perhaps for economies headed toward a currency union.

Lessons from the Recent Debt Crises

There is little question that overly rigid exchange rate regimes played a central role in virtually every major international debt crisis over the past decade. Mexico (1994), Thailand and Asia (1997–98), Russia (1998), Brazil (1999), and Argentina (2001) all fell into debt crises under the weight of unsustainable fixed exchange rate regimes. As Obstfeld and I wrote in our 1995 paper "The Mirage of Fixed Exchange Rates," countries with open capital markets are very

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seldom able to maintain fixed rates for more than half a dozen years without experiencing a major crisis.

Many economists (e.g., Jagdish Bhagwati, Dani Rodrik, and Joseph Stiglitz) lay the blame for the 1990s debt crises on premature capital market liberalization, and there is an important element of truth to this. But it would be far more accurate to say that the real problem in the 1990s was that Asian economies liberalized their capital markets without simultaneously making their exchange rates more flexible. Had they done both simultaneously, most if not all of the crisis-stricken countries would still have experienced a crisis, but the problems would likely have been smaller and easier to manage. One can point to many reasons why New Zealand and Australia did not collapse in the same way as other Asian economies, including better financial market regulation. But during the European Monetary System crisis of the early 1990s, Sweden had reasonably strong and well regulated financial markets, but this did not protect it from catastrophe when speculators challenged its exchange rate peg. I have little doubt that Australia and New Zealand would have met the same fate but for their very flexible exchange rates.

Vulnerability to Future Crises

Will the world be less vulnerable to crises over the next decade than it was over the preceding decade? There is good news and bad news. The good news is that outside Asia, and excluding central European countries that are hoping to join the euro system, few countries today have rigid exchange rates. Brazil can certainly thank its flexible exchange system for helping it to survive its 2002 crisis, together, of course, with prudent domestic macroeconomic management and $30 billion in back-loaded IMF loans.

But there are also several reasons for concern. First, what about countries that are still pegging? Investors seem confident that Central European countries will not have crises on their way to joining the euro, though it is hardly obvious why these countries should be immune to the problems that beset "Old Europe" in the early 1990s. Indeed, one can make the case, as did Ken Froot and I (1991) that risk of crisis can actually rise as a country's date to join currency union grows near. And then, of course, there is Asia, and especially China. These countries have slipped back into the quasi-pegs that got them into trouble in the late 1990s. The difference, today, of course, is that many Asian countries have vast reserves of dollars. But many European countries, too, had ample reserves in the early 1990s, but that did not stop them from being stared down by speculators. If local and

global investors lose confidence in a government's willingness to sustain a currency peg, skyrocketing interest rates can break a country's banking system and investment, and force even a financially well-armed government to back down and surrender (see Obstfeld and Rogoff 1995). I see no reason to believe that Asia's reserves will protect them any better today than Europe's reserves helped in the early 1990s.

It is curious that many of those who call for a more flexible exchange rate in China do so because they believe the yuan will appreciate and that stronger Chinese currency will help shore up the gaping U.S. current account deficit. If so, they are greatly exaggerating the effect. Most models (e.g., Obstfeld and Rogoff 2004) suggest that the effect would be relatively marginal. (Recall that Japan's exchange rate appreciated steadily throughout the 1970s, 80s, and 90s without making a big dent on its surplus.) That said, having more flexible exchange rates in Asia will provide a cushion if the U.S. current account were suddenly to implode, a distinct risk.

But the real reason why China should move now toward a more flexible exchange rate sooner rather than later is that exit from a fixed rate is far easier when the pressures are for appreciation. If, instead, China waits until it experiences a political or financial crisis, it may find all the pressures going the other way, and managing a soft depreciation under pressure can be extremely difficult.

Another source of concern is that whereas many parts of the world now have more flexible exchange rates, both public and external debt levels remain at record highs, even after the good policies in many countries over the past year. The IMF's *World Economic Outlook* (September 2003), for example, showed that average public debt levels in developing countries actually exceed those of OECD countries, despite much lower tax rates, and despite the fact that these countries often experience severe debt dynamics when debt levels exceed 50 percent of GDP, much less than Maastrict treaty levels of 60 percent. Another serious problem is the still high level of dollarization and indexation of debt, again despite the fact some countries have been moving to take advantage of current benign conditions to lengthen the maturity of their debts and to reduce indexation (see Reinhart, Rogoff, and Savastano 2003). Brazil's 2002 crisis came despite a flexible exchange rate, in large part due to the fact much of its debt was short term and indexed to the dollar, effectively taking away the option of inflation as an alternative to outright default. Indeed, in many ways, Brazil's flexible-rate crisis in 2002 may be the quintessential early 21st century debt crisis, as opposed to Mexico's 1994 crisis, which looked more like an old-fashioned fixed-rate collapse.

Finally, another major cloud hanging over the global horizon is the gaping U.S. current account, whose inevitable adjustment is likely to lead to a sharp drop in the dollar, the consequences of which could easily be increased stress on emerging markets. Obstfeld and I recently recalibrated our Jackson Hole (2000) paper in which we first drew attention to the problem of the U.S. current account. Our new analysis, which takes into account the global general equilibrium effects of a U.S. current account collapse, suggests a 50 percent larger fall in the dollar than we had thought previously (Obstfeld and Rogoff 2004).

So, one must conclude that whereas things are better than a decade ago in some dimensions, in other ways, things are worse. What can countries do to mitigate their risks?

Avoiding Future Sovereign Debt Crises

Some lucky countries may be able to solve their problems through a political marriage. Spain, Portugal, and Greece, three long-time serial defaulters, have seen marked improvements in their interest-rate spreads over the course of the last 20 years, thanks to the European experiment. Countries in Central Europe today are hoping to do the same. Otherwise, countries must do as Chile has done over the last 20 years, or as the United States and Australia did in an earlier era, and bring public debts down to very low levels for a sustained period. Unfortunately, short of an up-front debt restructuring (which may not be such a crazy strategy for some countries, although right now the timing would be very poor), few countries have the political fortitude to run the kind of surpluses needed to replicate the Chilean experience. Doubly so since emerging market debts, both public and external, are still at record levels.

So, in all likelihood, we will still see more major debt crises within a few years, either in Asia where de facto fixed exchange rate regimes still rule, or in Latin America, Turkey, and a few other emerging markets, where debt levels are still high, and debt is too highly indexed to simply inflate it away. What can the international financial community do to prepare for this eventuality?

Many different ideas have been advanced. Some have argued that with a bit of financial engineering to help countries borrow in their own currency, the problems can be solved, and countries will be able to borrow even more. I am quite dubious that financial engineering solutions can cure deep-seated political economy and development problems in middle-income countries.

Another approach is to recognize that collapses will occur and debt restructurings will be necessary in some cases, but that we need to

find more efficient ways of dealing with them. In 2001, the IMF, led by First Deputy Managing Director Anne Krueger, endorsed the idea of an international bankruptcy court. The idea of bankruptcy court had been widely discussed in journals since the early 1980s (Rogoff and Zettelmeyer 2002), and had been popularized by Jeffrey Sachs in the mid-1990s. There is great merit to this basic idea of improving international legal coordination over bankruptcy proceedings, and I would venture that some movement in this direction is likely over the next 50 years. (Although I expect the scheme that the world ultimately evolves to will be more decentralized than was envisioned in the IMF proposal.) For now, however, a bankruptcy court of any type is not in the cards politically.

Another idea is to reverse legal changes made during the 1970s that made it easier for countries to issue debt under New York, London, or Tokyo courts (Bulow and Rogoff 1989, 1990). Rescinding these changes would work to "level the playing field" for equity and direct foreign investment. The idea would be to force debtor countries and foreign investors to rely on debtor-country institutions for enforcement of debt contracts, as is already largely the case for equity and direct foreign investment. In the short run, capital flows would likely contract, but in the long run they would resume in a healthier form with better risk-sharing properties, because countries that desire to borrow would have incentives to improve their own legal systems. In all likelihood an international bankruptcy court, were one ever established, would have a very similar effect of leading to an initial contraction in debt flows relative to equity and direct foreign investment.

So far, officials have only tinkered with the system, introducing majority action clauses into new bond issues, so that rogue creditors have a harder time blocking debt restructurings. This is a small positive development, but contrary to claims, unlikely to have more than a marginal effect, not least because each country issues many different bonds. Debtors and creditors have also been working to establish a "code of conduct." This is another small positive step. Still, all this tinkering feels a bit like the many interim updates of Windows software that Microsoft keeps offering PC users. The changes do not seem to make much difference to the operation of the system, and it still is going to crash periodically.

Reshaping the IMF and the World Bank

This leaves a final question, which I can only touch upon here: how to reshape the International Monetary Fund and its sister institution the World Bank. Though most discussions start and end with the

IMF, I think the clearer course is with the World Bank. As Bulow and I argued in 1990, and as I argued again recently (Rogoff 2004), it is high time to financially restructure the World Bank so that it continues its excellent work but as a pure grant-making agency, rather than as a "bank." When the Bank was formed after World War II, one could make a case that a multilateral official creditor was needed to substitute for missing private markets. Today, however, this is an absurdity and leads to the bizarre situation in which the World Bank Group makes loans to countries like China and Russia, both of whom have hoards of reserves and extensive access to private markets. Instead, the Bank's future in middle-income countries lies in its role as a repository of development ideas and advice, and in its excellent and broad-ranging professional staff. Changing the Bank's financial structure will help avert problems such as in Argentina, where the Bank was pouring money in the late 1990s at just the time Argentina most needed to rein in its belt.

Deciding now to change the financial structure of the Fund is more difficult. I have long favored having the Fund phase out of the bailout business. In the long run, this seems inevitable. With the explosion of private markets, the Fund's most important role is in its so-called surveillance capacity, and in providing a secretariat for global financial leadership. In crises, it can still play a central role even without its own bailout funds by coordinating the international response. To maintain the strength of the Fund, it is important that any financial restructuring leave it with ample resources to cover its operation costs without relying on the whims of politicians. It would also be desirable to strengthen the independence of the executive board that oversees the Fund, and recalibrate voting shares to be consistent with today's world.

Conclusion

Improving international financial governance will help the system, but the real responsibility lies with developing country governments. Those that adopt rigid exchange rate regimes or engage in excessive borrowing are going to eventually run into problems under any international system.

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