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Never Say Never: Commentary on a Policymaker's Reflections

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Never Say Never

Commentary on a Policymaker's Reflections

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In Honor of Stanley Fischer
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Introduction

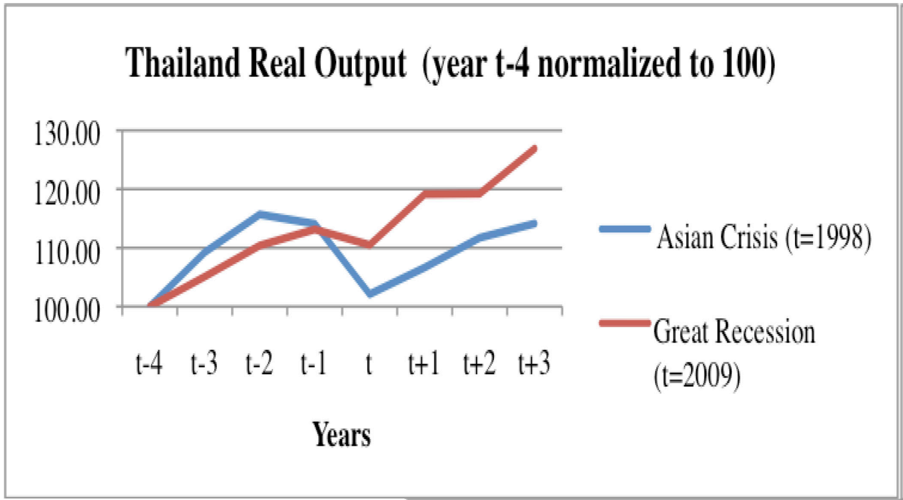
- Why were Asian countries more resilient in GFC than in the Asian crisis of 1997-98?
- Stanley Fischer's unpublished 2001 Robbins Lectures summarized his experience as an IMF crisis manager
- But he experienced the GFC as governor of an emerging-market central bank
- His thoughts – to which I add Talmudic commentary – give a unique perspective on our evolving thinking about crises

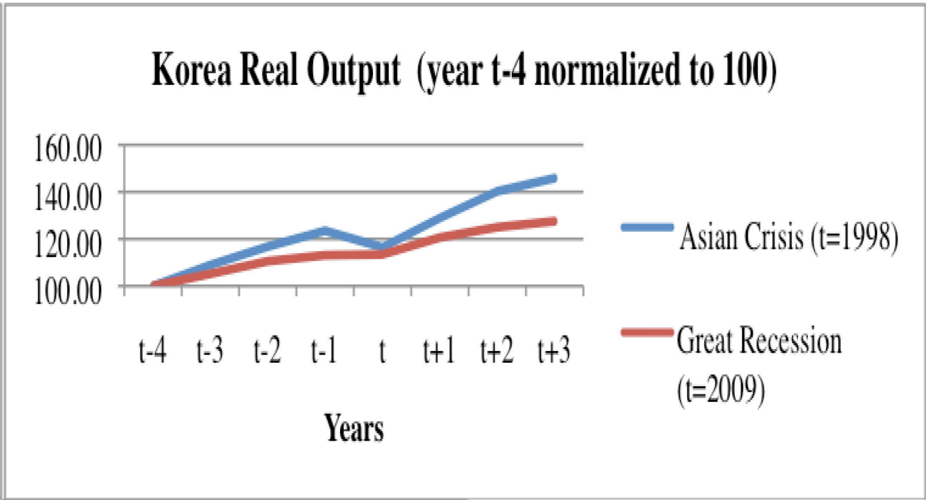
Focus on 3 Countries

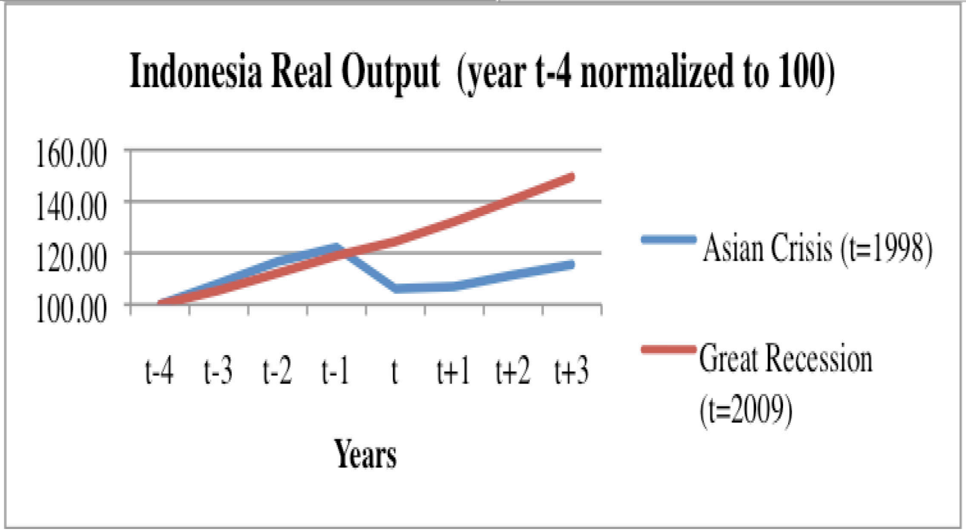
- Thailand, where the ‘97-’98 crisis began; and Korea and Indonesia, to which it spread contagiously

- Key comparisons:
  - Output
  - Current account

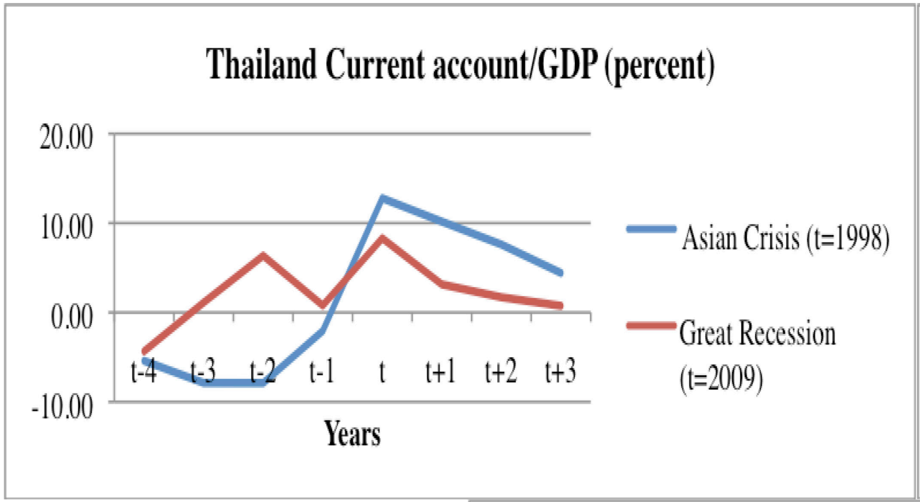
Output Performance Contrast

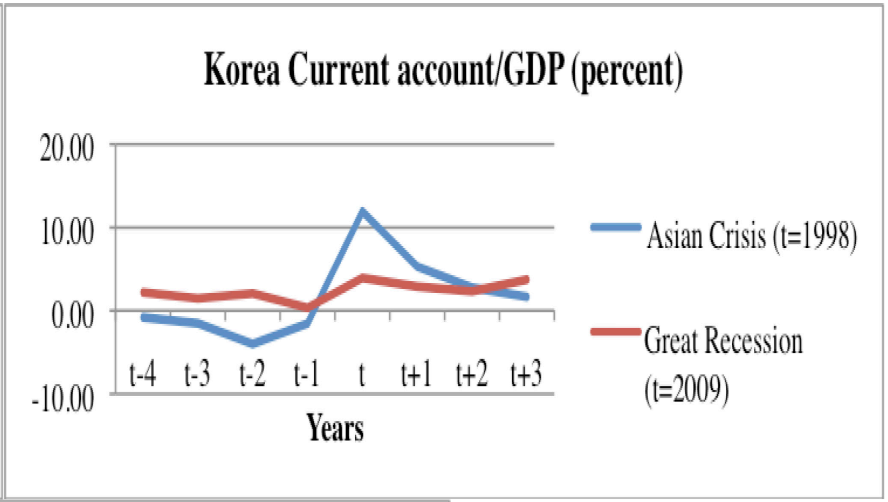


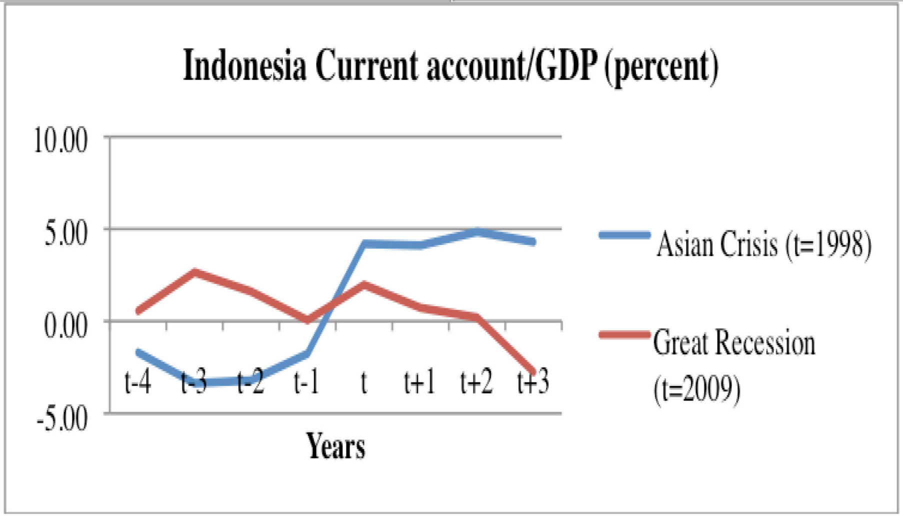




Current Account Contrast







What Lessons Helped in 2008-09?

- Stan saw lessons in 6 main areas:

1. Exchange-rate system/nominal anchor
2. Reserve management
3. Debt management
4. Capital controls
5. Financial oversight
6. Transparency and standards

1. Nominal Anchor

- Fischer (2001): *"of all the changes in the inter-national financial system that have taken place since 1994, the shift towards flexible exchange rates by emerging market countries is the one that has most reduced the risk of future crises."*
- In 1997 the 3 countries had pegs or quasi-pegs
- All 3 bolstered central bank independence and became inflation – as Stan recommended
- Success? Yes in Korea and Thailand, less definitively in Indonesia

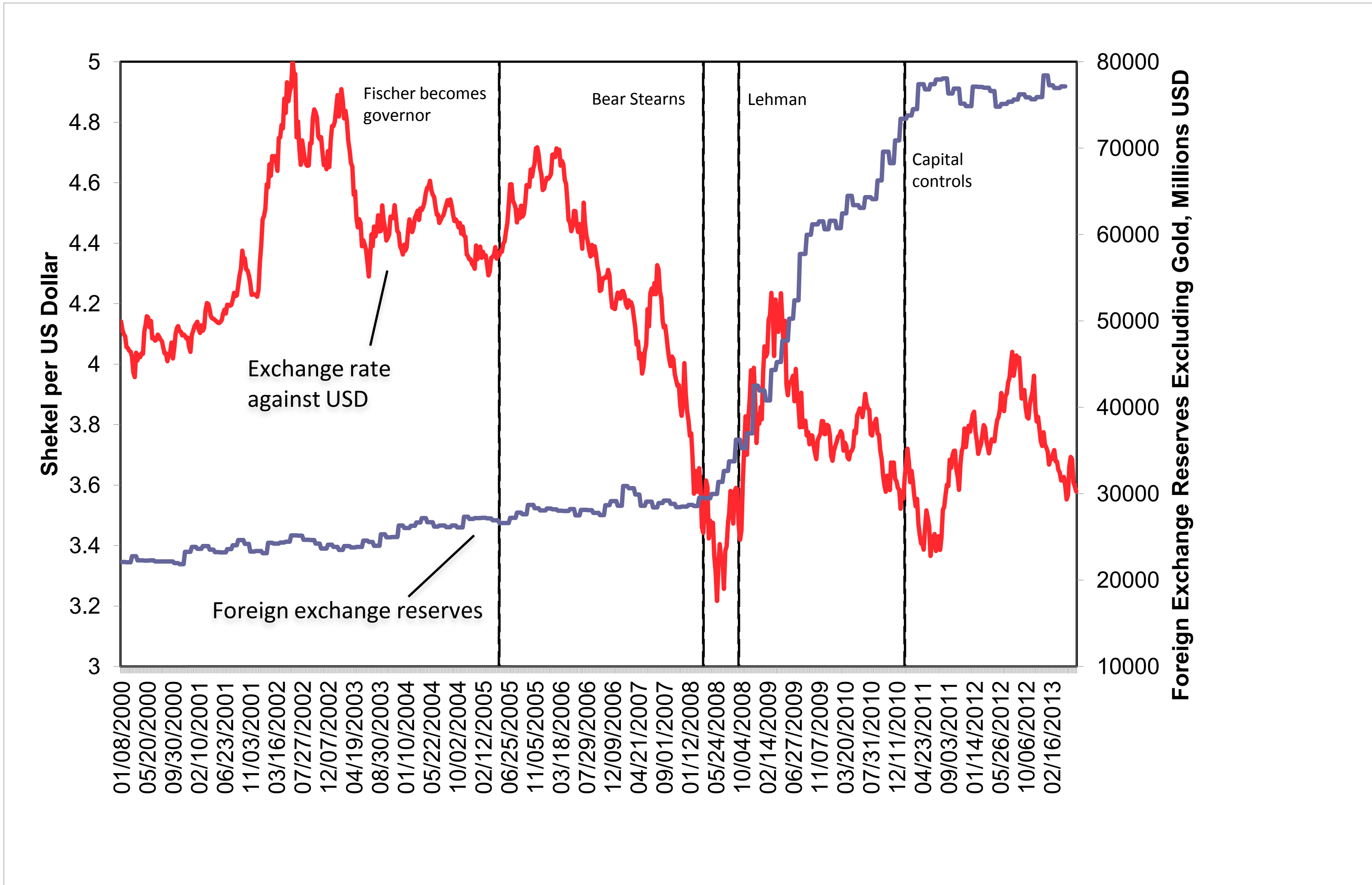
Inflation Outcomes

- Countercyclical monetary response in GFC – how?
  - Anchored inflation expectations
  - Flexible rates reduce currency mismatch
  - So do domestic-currency bond markets
- Counterargument: Malaysia?

Role of the Exchange Rate?

- But what about the trilemma? Exchange rate is a key target too in EMEs
- In recent writing Stan suggests intervention, even if sterilized, can prevent appreciation at least – less so, depreciation: “half instrument”
- Mechanisms? Heterogeneity across EMEs?
- Israel illustrates the abandonment of non-intervention
- As well as the drive to accumulate FX reserves

Some Data from Israel



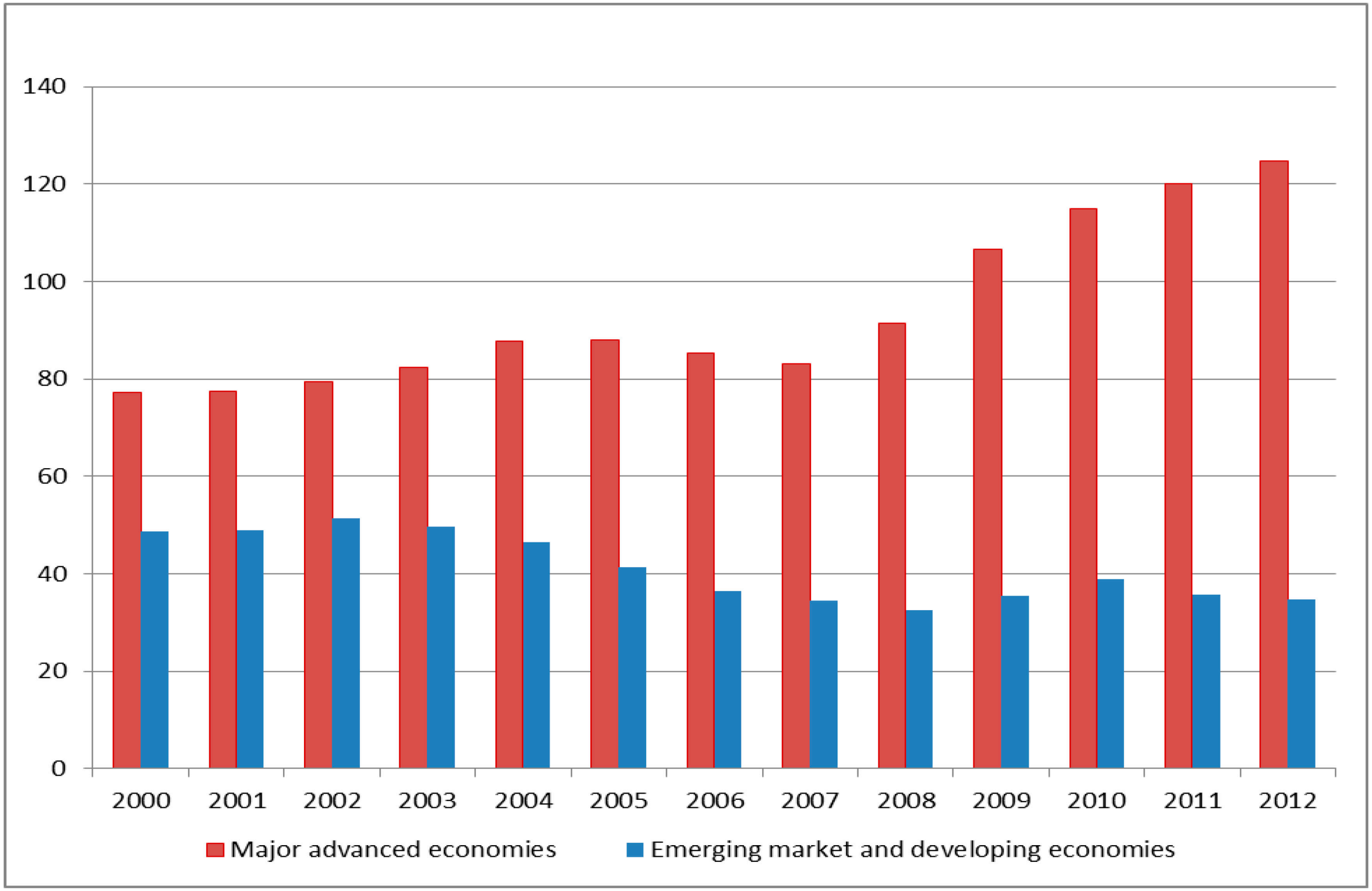
2. Reserves and Debt

- Stan in 2001 noted how Korea and Thailand in 1997 drove reserves nearly to zero; he approved Korea's buildup
- They went much further, as did Israel from March 2008
- EMEs have used reserves strategically in unconventional operations, rather than funding general capital flight
- AEs too, but unlike most EMEs using swap lines

Debt Management

- 3 Asian countries had substantial fiscal space entering GFC
- The IMF prescribed fiscal tightening in 1997 to make room for costs of bank reorganization; but it quickly backed off
- Similar debate a major issue in the euro crisis
- Fischer’s 30% “rule”
- Domestic bond markets promote resilience

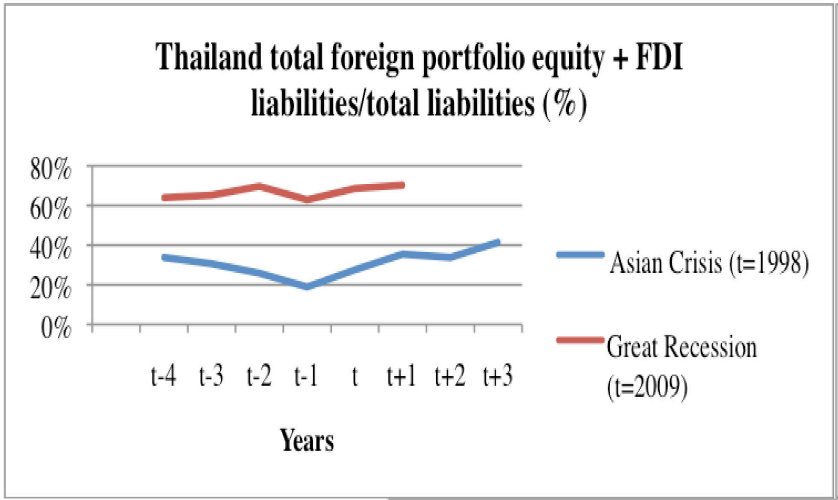
Public Debts in Rich and Poorer Countries

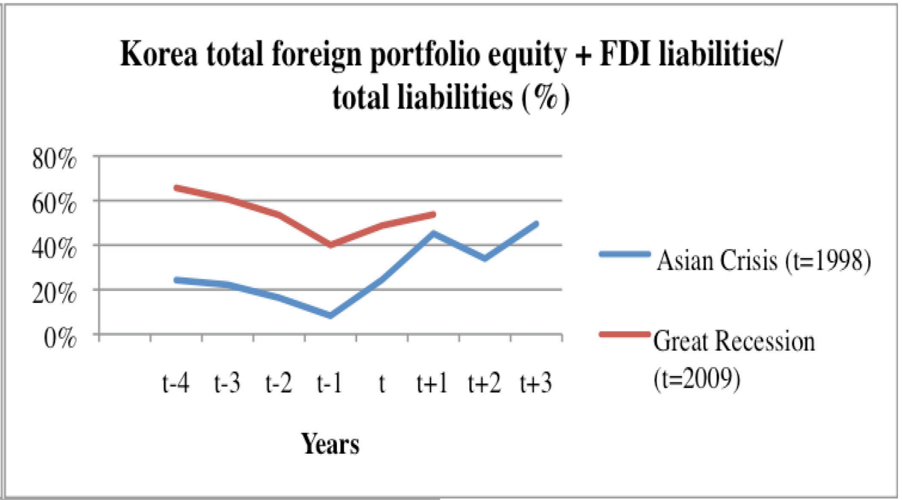


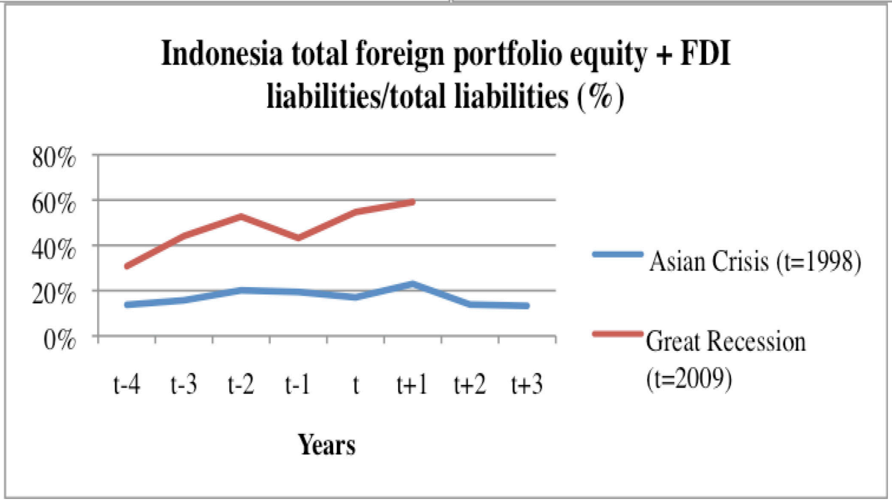
Private Balance Sheets

- Move from external debt to equity
- Despite progress, some maturity and currency mismatch remained in 2008
- Case of Korea
- Hedging by foreign holders of domestic currency bonds
- Were Korea's deep and liquid markets a liability?

Aggregate Equity/Debt Ratios







3. Capital Controls and Oversight

- Stan in 1997 advocated for the Fund to codify an orderly capital account liberalization process
- Evidence on liberalization and growth not as clear cut as Fischer hoped it would be by now
- Instead: increasing acceptance of the use of capital controls on macro-prudential grounds
- In practice discouraging real appreciation is a more important motivation
- Stan: “Central bankers should never say never.”

Failings of Theory and Policy

- Fischer on financial reg in 2013 BOI volume
- But in 2001 the concept was just starting to be clearly discerned (e.g., Crockett’s 2000 speech)
- Two big problems:
  - Macro framework missed financial frictions and plumbing that could lead to nonlinear outcomes involving market collapse
  - Regulatory framework missed macro perspective
- The 3 Asian countries have embraced the macro-prudential approach

Conclusions

- Updates to Fischer (2001) based on lessons of GFC:
  - Small economies are not indifferent to their exchange rates; eventually, capital controls or congruent domestic measures may become attractive
  - FX reserves can help the individual country, though there are serious downsides and systemic externalities
  - Active domestic-currency bond markets help immensely
  - Moving balance sheets from debt toward equity helps
  - Public debts should be moderate:
    - To reduce risk of sovereign debt crises
    - To provide credibility for the financial stability regime
    - To provide room for action during financial crises
  - To make crises less likely, a macro-prudential approach also is vital