Comment on "How Can Future Currency Crises Be Prevented?" by Peter Kenen

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Peter Kenen surveys a good number of the issues that need to be raised in any consideration of how future currency crises à la Mexico can be prevented. However, I am not sure that I know quite what to conclude when I come away from the paper.

A few points are made that I would very much agree with. Countries must manage capital inflows better. I think the discussion we had this morning begins to touch on some of the aspects of that question. Similarly, there is a need, and here I begin to detect differences around the table, to limit current account deficits. And on this I would say that it is better to err, as Bernd Goos says, on the side of caution. These points are generally unarguable, but when given operational content - the limitation of current accounts, for example, to 3 or 4% of GDP - they may not be generally applicable. Country situations just differ too much. I do not think that there really are any simple, quantitative rules by which to gear economic policies across diverse country situations, which would both minimise the potential adverse effects of shocks and at the same time maximise the economic well-being of the country that can come from successful exploitation - if I can use that word - of capital inflows. At the same time, I would certainly support the proposition that before current account deficits get up to the levels reached in Mexico, somebody had better start scrutinising them very carefully.

Here, there is some difference between my view and that expressed by Ariel Buira and perhaps also by Peter Kenen. The offsetting decline in savings that occurred in Mexico was almost extreme by country experience. Looking at a chart of the increase in foreign investment over the period cited in Ariel's paper, from 1989 to 1994, we see that if this is plotted against the corresponding decline in domestic savings in the country, they virtually offset each other, suggesting that most of the capital in Mexico going into the country went into domestic consumption. This is a very dangerous set of circumstances and one that distinguishes the Mexican case from the Asian experience.

Peter makes a number of points regarding markets and market reactions with which I would like to associate myself. I agree, for example, that we cannot tranquillise markets and indeed, I would argue that we shouldn't. In fact, the policy disciplining aspect of financial markets is something that should not be lost and

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should not be neutralised. It is a matter, rather, of finding means to react to the disciplining force of markets in a timely manner. But, as discussed in the context of Buira's paper, the extent to which markets are likely to be traumatised by events can be limited and can be influenced by policy; specifically, by limiting the underlying vulnerability of the economy and the financial system.

I would also agree that getting the fundamentals right is not foolproof protection against market attacks. It is even more difficult than that, since the correct fundamentals may themselves be a function of market perceptions and market confidence. However, the Asian experience in the wake of Mexico suggests that having strong fundamentals goes a long way in limiting the severity, the duration and therefore the impact of such attacks.

Peter makes an assertion in this context with which I do have some problems. He says: "The shift in the market's views cannot be ascribed to a change in the way that markets were reading the Mexican numbers. It must be ascribed to the way that markets were reading the Mexican headlines." I would argue that the way that markets read headlines is not independent of the policy atmosphere in which they are read, i.e. market judgement of the fundamentals and market expectations regarding the response of policymakers to shocks that may occur. And on both of these accounts, I would argue that the situation in Mexico was arguably worsening. Let's take just two examples on the fundamentals. First, while the current account deficit might not have widened in 1994, as was noted this morning, the cumulative impact on debt stocks of the way in which it was financed was taking a toll. For example, debt service plus amortisation of Mexico in 1995 - about a three hundred billion dollar economy at that time - was fifty-two billion dollars because of the required amortisation of Tesobonos. Secondly, on the expected policy response, lack of action on the fiscal side in the face of earlier shocks may have generated negative expectations. I would agree here with the point made by Charles Siegman, that you have to look at some of the off-budget operations that were taking place in 1994 and, specifically, the lending taking place through the development banks, to get a full picture of that situation. The full sterilisation of reserve losses that took place in the course of 1994 must also have been raising questions in the markets. In my view, it was the reading of headlines in the context of this set of events that had an impact on investor confidence. I would argue that the political shocks were somewhat in the nature of wake-up calls, offsetting what had been a bit of a market stupor about the Mexican miracle. When I say that, I don't in any way mean to demean what was accomplished in Mexico, which is extraordinary, by any standards. At the same time, the "successful case syndrome" set in, which tends to blind people or allow them to assume the best of every circumstance that arises, rather than to look at the risk in each circumstance that arises.

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Why Did the IMF Support Mexico?

Now, by saying all this I don't by any means wish to disclaim the impact of shocks completely. My favourite example of that - not example, but fear - is Indonesia. Indonesia is a country with strong fundamentals across the board. However, I shudder to imagine what would happen if President Suharto had a heart attack. So shocks do matter. The response to those shocks is a function of the perceived vulnerabilities of the country, which has something to do with all these other factors we're talking about. This brings me to the issue of data reporting.

I don't think I agree with what Peter says, at least not quite the way he puts it. He cites others as saying that the prompt production of economic statistics can by itself contribute substantially to the stabilisation of capitals flows. He takes issue with that. To a certain extent I agree, and I think that there is an enthusiasm for this exercise that perhaps has run a little bit too far ahead of the exercise, which is creating unwarranted expectations. But at the same time, I do believe that there's an important contribution to be made here. Better information can help reduce the vulnerabilities, if authorities are encouraged or forced by markets to adjust gradually as imbalances emerge, and as markets react adversely to them. In order for the markets to react gradually in time, better information than markets have been getting from a number of countries is required.

Now, to take up the question of the size of the Fund's support in the case of Mexico and the reasons given for it. I will use this question to make a number of points regarding the nature and purpose of the Fund, on which I agree with Peter's basic propositions. In particular, the Fund's powers to provide assistance are not limited to cases that threaten the international financial system. The articles are clear on this. They clearly speak of assisting individual members in the context of their own problems, not just in the context of the system. It is, as Peter says - and it's a good phrase - a "mechanism for collective support in time of individual distress". That is indeed what it is. But the reasons for the exceptional support for Mexico are not hard to find. There may have been an unfortunate reaching for the word "systemic" in the early days of thinking about and talking about the response to Mexico, and perhaps less of a distinction between what systemic is and what "contagious" really means.

First of all, in looking at the reasons for the support, there is the size and the nature of the financial threat to Mexico itself. This is always difficult to define. We had to judge the situation as large in the early days of the crisis and frankly, it was given greater definition, rightly or wrongly, when the United States put the forty billion dollar guarantee package to Congress. In the weeks after having submitted that package to Congress, the US repeatedly defended it as the minimum necessary package. So in an environment where it is very difficult to define quantitatively the size of a threat to a country, that commitment became - if you want

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- the atmospheric definition of the size of the threat. Peter is therefore right to note that "no package" after the one that was promised would have been the worst possible outcome. The sequence of events is such that when the US withdrew the forty billion dollar guarantee package and substituted the twenty billion from the exchange stabilisation fund, it was at that particular moment that the Fund increased its support from 300% of quota to nearly 700% of quota. That decision had not been made before that moment.

Secondly, besides the size of the threat to Mexico itself, there is the issue of contagion, which I have mentioned and which we indeed believed to be very real. I think we were proved right on that by the events on Asian markets and on the Latin American markets throughout January and February - in fact, until the Mexican package was strengthened in early March.

Third was our best guess about the cost of the alternative, i.e. a failure of the package, by which I don't just mean access to Fund resources but the policy side of the package as well. The size of the recession - which is already bigger than had been expected, not just in Mexico but across the other countries that suffered those contagion effects - would have been very large if Mexico's adjustment turned out to be more disruptive than was anticipated and if that disruption spread to other emerging markets, thereby affecting the industrial world. We can't forget the extent to which the US economy itself, no longer a closed economy in any sense of the word, is dependent upon very rapidly growing exports to Latin America as well as elsewhere.

I would add as a last element the danger to "the paradigm". We are in a world where people have basically accepted the opening of markets, the liberalisation of capital flows, the kind of structural reform that Mexico was so successful in implementing. Mexico was clearly the beacon in terms of this paradigm and if Mexico failed, so to speak, it certainly would have raised serious questions about that model.

So there was both a financing aspect to the question and also a confidence-building aspect. To the extent that the latter worked, perhaps Mexico will not draw all the resources committed by the Fund, as looks likely now on the basis of statements by Mexican officials, and it is anticipated as well in the arrangement with Mexico. That might have something to do with whether or not it will be possible to steer a quota increase through US Congress. If those resources are not fully drawn and if they are repurchased early, perhaps attitudes could be influenced a bit about what was the nature of this operation.

IMF Emergency Financing

I was going to say a few words about Peter's last proposal but he didn't say anything about it! ...Let me take up very briefly two points in connection with it.

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He mentioned the emergency financing mechanism. I find his proposal interesting. If I understand it right, it is basically a mechanism by which the Fund would be able to provide supplementary credit to members, tied in some way to deposits they would make in the Fund out of accumulating reserves. He suggests briefly in this paper that access be under something like first credit tranche conditionality. It is interesting that his proposal has elements that characterise the mechanisms we have recently been looking at - not the association of access with deposits, and not specifically the first credit tranche conditionality, but much more importantly, some kind of a tie-in between any of these mechanisms and strengthened surveillance. A year ago, we put a paper to the Board on a possible short-term financing facility. This didn't go anywhere. This was going to be a mechanism, at least in one of its guises, which would have provided something like lines of credit to member countries, which they could draw against automatically, on the basis of a certification of policy performance in the Article IV consultation. If the Article IV consultation was conducted in a way that allowed the Board to come to a conclusion about the satisfactory nature of the country's policies, the country may have had access, let's say for a period of six months, to a line of credit from the Fund. This was not supported by the Board, to a large extent, I think, because of the fear of committing Fund resources to an environment - even if only for six months - during which circumstances can change very dramatically. There are other questions as well about the way in which the proposal was put forward, but I think that was possibly the major issue that people had.

One of the keys, though, which is the same one Peter was getting at, is: How do you tie the surveillance process to access to Fund resources to make it a more orderly process? We have recently (just last week, as a matter of fact) received approval from the Board on the emergency financing mechanism. The formulation of the emergency financing mechanism is basically a set of procedures, very similar to the procedures that operated in the context of the Mexican case: involving the Board at a very early stage, finding informal mechanisms to keep the Board informed of the progress in negotiations, and then shortening every procedural requirement within the Fund to be sure of obtaining approval of use of resources very, very quickly. The key there, again, is the attachment to surveillance. The extent to which the Fund is able to assist a member quickly is a function of the extent to which the Fund staff, the Fund management and the Board know the situation in a country and in addition, of course, the extent to which the country is then ready, willing and able to take the kind of actions that are thought necessary. The trick is to introduce the necessary conditionality. That is not something which is timeless, and that really is the reason why the Board was uncomfortable with the proposals that had been made on the short-term financing facility.

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Two very brief final points on the emergency financing mechanism. There are many, many unanswered questions. One of them is the link or tie-in between an emergency financing mechanism and whatever enlargement takes place of the GAB or other mechanisms; that is not defined in the agreement that was reached by the Board last week. The second, of course, is a very difficult question that is being worked on in many forums, namely that of orderly work-outs. Is there a way of dealing with creditors in the very short period between the advent of a crisis and the provision of financial support from the Fund? Both of these questions will be on the table for a good period of time in the future, and Stephany Griffith-Jones' paper this afternoon begins to address at least one of them.

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