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Comment on Rogério Studart

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The chapter by Rogério Studart focuses on the crucial issue of how to achieve stability and growth. To put it differently: what are the preconditions for sustainable non-inflationary growth? In this regard, let me quote a famous saying of a former German economics and finance minister, who once said: "Stability is not everything, but without stability everything is nothing". This saying was originally about price stability. However, it also applies to financial stability and macroeconomic stability and in particular to developments in Latin American countries over the past few years.

By financial stability I mean sound financial institutions and the ability of markets to function well. Rogério Studart makes an important contribution to the issue of financial stability. His analysis of the banking sector of four Latin American countries sheds light on crucial topics. He thoroughly scrutinises the close links between regulation and supervision of the banking sector, changing expectations and financial cycles and macroeconomic performance. To a large degree, I share his conclusions. In particular, I agree that "the Argentine crisis ... indicates the limits of regulation and supervision to prevent crises in a context of highly unstable macroeconomic settings and expectations".

Rogério Studart focuses on banking regulation and supervision, and in this area he has done an excellent job. However, something important is missing: the crucial role of macroeconomic stability and the related policies. Moreover, understanding the links between financial stability and macroeconomic stability is imperative for understanding developments in Latin America. In this regard – and

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that is my first comment – it is important to avoid any misunderstanding. Rogério Studart talks about a trade-off with respect to stability and growth. However, one should be clear on that point. According to the "orthodox" view, financial stability and price stability are the platforms to maximise economic growth. Policies directed at exploiting short-term trade-offs between price stability and economic activity and growth, risk contributing to instability – or unsustainable inflationary growth – over longer horizons.

My second comment will be on macroeconomic policy and particularly on exchange rate policy and the liberalisation of capital movements. Argentina is a striking example in this respect. In just over a decade the country has managed to lurch from one disaster to the next. Now the economic and social situation is most precarious.

Because Argentina had one of the most strictly regulated financial sectors in the region since 1997 – as Rogério Studart correctly mentions – other policy areas are responsible for the mess, primarily exchange rate policy. The decision in 1991 to peg the peso to the US dollar was correct at that time. After years of hyperinflation, the introduction of the currency board – accompanied by an IMF-supported programme – was a successful and decisive element in the Argentinean disinflation strategy. However, while the US dollar-based currency board maximised the credibility of the commitment to price stability in the short run, it also was responsible for Argentina's competitiveness problem. While economic and political developments worsened, Argentina was increasingly caught in a vicious circle that became inconsistent with the currency board. Following the rise of the dollar since 1997-98 and the devaluation of the Brazilian real in 1999, the peso became overvalued, resulting in protracted high current account deficits, substantial external borrowing needs and downward pressure on growth. At the same time, the priority of monetary policy to defend the exchange rate also hampered domestic growth. Briefly said, the currency board played a central role in both the initial success and ultimate collapse of Argentina's stabilisation and reform efforts. In the end, Argentina became a textbook case for problematic exchange rate fixing.

Another – related – problem is that Argentina followed an unsustainable fiscal policy in the context of a currency board system. A "hard peg" solution requires a sound fiscal policy and a high degree of flexibility of the economy and particularly in the labour market. Although fiscal policy had started off in the right direction, the programme was far from being successful. The fiscal regime tying the federal government and the provincial governments together remained full of loopholes. The lack of a sound fiscal framework hindered credibility and contributed to the build-up of an unsustainable foreign debt burden. Finally, a policy based on illusions ended up by defaulting against creditors.

Only in a very narrow view can the crisis in Argentina be regarded as a special case, because Argentina was the first country with a "hard peg" exchange rate system to abolish this regime under market pressure, in particular stemming from inside the country. From a broader standpoint, however, Argentina is only another example of an emerging market economy formerly adhering to a pegged exchange rate system that eventually became embroiled in a currency, debt and banking crisis. Experience has shown that fixed exchange rates may render economies whose capital markets are opening up more crisis-prone. Pegged exchange rates increase the risk of the national currency being overvalued. Moreover, fixed rates entail the risk of excessive foreign-currency debt, since under such conditions cheaper foreign loans are often not hedged against exchange rate losses. That, however, ultimately heightens the risk of a crisis. As a consequence of the most recent crises, there has been a growing trend towards choosing flexible exchange rate regimes.

Of course, financial crises are not unique to current financial systems; history is replete with banking and currency crises. The increasing integration of global financial markets in the past two decades, however, appears to have introduced some new elements and concerns. Under conditions of unrestricted capital flows, pegged exchange rate systems became increasingly crisis-prone. Admittedly, fixed exchange rate systems are viable when certain demanding requirements are met. But in the real world of policy slippages and protracted structural problems, we have to accept that these requirements will not be met in the long run. Sooner or later, therefore, the sustainability of a pegged exchange rate system will be undermined. The lesson to be learned from exchange rate regimes is that a country that has given priority to pegged rates must figure out whether or not it can keep its internal flexibility sufficiently high to enable it to make all the necessary adjustments. In particular, with priority given to fixed rates, monetary policy has to be completely subordinated to the exchange rate target. Moreover, there is not much room for fiscal policy. It has to be conducted in a stabilityoriented manner in order to maintain domestic and external confidence. Thus, a stable exchange rate is only sustainable if the corresponding fundamentals are adequately streamlined. A pegged currency alone cannot guarantee lasting market confidence.

Mexico was the first emerging market economy to go through this experience, followed by East Asian economies, Brazil, Argentina and other countries. This raises the question of why Chile, the fourth country Rogério Studart mentions, was different. This brings me to my third comment. For over a decade, this country also had a fixed exchange rate system – or to be more precise: an exchange rate band – and was successful in resisting contagion from the Mexican and East Asian crises. Of course, as we all know, capital controls constitute the difference. Because Chilean policymakers were wary of allowing large capital inflows that could eventually reverse themselves violently, they imposed capital controls on these inflows. By limiting in part the openness of the capital account, some degree of control on the exchange rate front was possible while at the same time monetary policy could be conducted with some independence. Evidence of their effectiveness is mixed. Total capital inflows were not substantially abated. Also, it was not possible to prevent a trend appreciation of over 30 percent between 1990 and 1997. More important, there has not been an appraisal of the opportunity cost of these controls given by lost investment.

The example of Chile should not give rise to misinterpretations. On the road towards capital account liberalisation, capital controls may at best act as a "temporary substitute" for still-underdeveloped supervisory and risk management systems. However, it still does not make sense to call for a reversal of the liberalisation of capital transactions. In principle, the fact that the free movement of capital contributes to the optimum allocation of resources is not open to question. But that must not imply liberalisation at all costs. More importantly, there is a clear need for an orderly process of liberalisation. Greater emphasis should be put on appropriately sequencing the process of liberalisation. Priority should be given to establishing a domestic financial market and the commensurate institutions and supervisory bodies. In the case of long-term capital flows, and especially direct investment, there is less danger of them being withdrawn in the event of economic difficulties. Therefore, liberalisation should start in this area. Opening up the market to short-term capital flows is something which should be handled with care. This should be done more towards the end of the liberalisation process.

Recent financial crises prove that, where capital is highly mobile, the effects of bad economic policy and an insufficient framework can be much more serious now than was the case a decade ago. Therefore, crisis prevention through intensified bilateral and multilateral IMF surveillance is of prime importance. In particular, deficiencies in member countries' economic policies must be identified at an early stage. However, further-reaching IMF financial support for the process of liberalisation is neither justifiable nor necessary. In particular, the IMF should not unduly give incentives for the rash liberalisation of capital movements and later on take action to "bail out" those countries. It appears that in some cases the IMF pushed countries to speed up the process of capital account liberalisation and stood ready to bail out the country in the case of a crisis, thereby creating moral hazard. The IMF has drawn conclusions from recent crises and now requires an adequate financial supervisory structure before promoting the liberalisation of capital flows.

The crises in Argentina, Mexico and other emerging market economies are examples of the disastrous consequences the instability of macroeconomic policy has had for financial stability. Conversely, banking crises have often preceded currency crises, for instance in the Scandinavian countries or recently in Turkey. In effect, crises of all types have often had common origins: the build-up of unsustainable economic imbalances and misalignments in asset prices or exchange rates, often in a context of financial sector distortions and structural rigidities. Of course, not all corrections of imbalances involve a crisis. Whether they do or not depends, apart from the magnitude of the imbalances themselves, on the credibility of policy to correct the imbalances and on the robustness of the country's financial system.

In my fourth and last comment, I will argue that, as recent financial crises demonstrate, it is all about policy. This is particularly true in the case of Argentina, where the lack of political leadership and of a broad consensus regarding stability and sound public finances is the fundamental obstacle to reform. In a broader context, however, this is true of all emerging market economies, which urgently need strong domestic institutions. Strong domestic institutions are of utmost importance for financial stability and development. This includes, above all, an independent central bank committed to price stability, an independent judiciary and the rule of law, a government sector that – apart from following a truly sound fiscal policy – is accountable and transparent, and last but not least efficient banking supervision. Admittedly, external surveillance by the IMF plays an important role in crisis prevention and resolution. However, the basic principle that "stability begins at home" should be taken to heart by emerging market economies (and the IMF). In this respect, Martin Feldstein was right when he recently wrote that "Argentina doesn't need the IMF".[1]

Financial stability is an important precondition for a sound economy. The significance of financial stability could particularly be demonstrated against examples of financial instability, as the social and economic tragedy in Argentina proves. However, a lesson to be learnt from developments in Argentina includes that – to end with a statement by Rogério Studart with which I fully agree – "improvements in regulation and supervision were necessary, but not sufficient to mitigate the instability problem".

1 Feldstein, M., "Breaking the Habit: Argentina Doesn't Need the IMF", In: *Wall Street Journal Europe*, May 29th, 2002.