Why the Interest in Reform? Discussion

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I congratulate Jane Little and Giovanni Olivei for a very thoughtful paper. It covers the key issues of the crisis at hand and analyzes the trade-offs with great care. It also concludes that more research is needed and, being a Director of our Research Department at the Inter-American Development Bank, I thank you for the justification of my budget—but obviously, as Toyoo Gyohten mentioned, it is no consolation to policymakers to say "Wait until we have a clear idea of what to do." I will try to organize what I think are the competing views of what is wrong with the world, what is "broke" and what needs fixing, and what explains the different views people are taking on the issues discussed in the Little-Olivei paper.

It is clear that something is "broke" in the world. We have too many crises, too much volatility in both capital flows and asset prices in emerging markets. More important, that huge volatility is highly correlated among disparate countries, with a lot of co-movement in asset prices and in capital flows across countries like Bulgaria and Brazil or Morocco and Mexico (in which case you could even assume there may be some alphabetical theory for those correlations). In any case, the correlation is just too great to be attributed to national vices. The problem must be something in the market, and not just in the countries.

The dominant view of what is wrong with the world blames moral hazard. That view would argue that poor domestic regulation, international bailouts, and fixed exchange rates generate a situation of implicit guarantees on capital flows. These implicit guarantees result in excessive and poorly allocated capital flows, which are crisis prone. Consequently,

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the solution would be to improve domestic financial regulation, substitute workouts for the international bailouts, and adopt floating exchange rate regimes. If all this cannot be done adequately, then impose capital controls to limit the amount of flows that would otherwise respond excessively to these implicit guarantees.

I find this view very coherent, but basically wrong. As has been said, many a beautiful theory has been killed by an ugly fact. From a historical point of view, surprisingly little capital is flowing across national borders—less now than a century ago, when investors had neither the Internet nor electronic wire transfers. From a theoretical point of view also, surprisingly little capital is flowing across borders. Capital/labor ratios in Latin America are less than a third of those in the United States. Yet capital flows to Latin America in the ’90s have averaged less than 5 percent of GDP—less than 2 percent of the capital stock of Latin America. At those rates, capital/labor ratios will tend to equalize only over the course of the next few centuries.

So, if more capital is not moving across borders, it has to be hitting some constraint that is preventing it from flowing more abundantly. That constraint cannot be moral hazard. Moral hazard would explain why too much capital is flowing across borders, not too little. I would put to you an alternative paradigm—the fundamental problem of the world is not moral hazard, but original sin. Let me define original sin. It occurs when a promising country has a national currency with two fundamental flaws: It cannot borrow abroad in its own currency, and cannot borrow domestically long term in its own currency.

This situation characterizes the broad majority of emerging markets and it is enough to generate a mess, one that is very comparable to what we observe in the world today. Why? Because these promising countries will want to invest, and investment will imply either borrowing in dollars and having a currency mismatch or borrowing domestically, short-term, and having a maturity mismatch. The two mismatches feed on each other and generate twin crises, a banking crisis and a currency crisis. If an attack occurs against the currency and the central bank defends it, domestic liquidity will contract and maturity mismatches will jump at you. Let the currency go, and currency mismatches will bite you. It really does not matter what exchange rate regime you are under.

It has become popular to say that the problem in the world is fixed exchange rates, and that we should go to floating. While it is fashionable to say that the East Asian crisis proves that floating exchange rate regimes are the answer, let me remind you that in the 1982 debt crisis it was said that borrowing to finance public deficits is wrong. In the 1994 crisis in Mexico, it was said that borrowing to finance private deficits is wrong if you do not have sufficiently high savings, and the reason why Latin America got into trouble was because of low domestic savings.

Now we have crises in countries that have high domestic savings, in East Asia, and the new pet theory is that the problem is fixed exchange rates, and that floating exchange rates would not be subject to these crises. I would argue that this is unlikely to be the case. Floating exchange rates would generate a lot more exchange rate volatility and, in good times, even much more real appreciation. That is, floating regimes are likely to generate a situation in which the currency appreciates in good times and depreciates in bad times. That means the currency will have the wrong correlation with income, in terms of portfolio diversification, and domestic residents will not want to hold the currency if it floats.

The evidence is also in to show that countries with floating exchange rates have less monetary autonomy, not more. Studies I have done and studies by Jeff Frankel show that domestic interest rates react more to movements in, say, the federal funds rate in countries with floating currencies than in countries with fixed exchange rates. So there is no more monetary autonomy and there is no more anti-cyclical behavior. Monetary policy in floating-rate countries tends to be even more procyclical than in countries with a peg. And, you can see that if you have a floating exchange rate arrangement with an inflation target, it would lead to an even more procyclical monetary policy.

So, I put it to you that the answer may not be floating rates, but rather the elimination of original sin. Since the original sin is a weak national currency in a globalizing market, I would say that the solution to these problems lies in the adoption of supranational currencies. National currencies are a phenomenon of the twentieth century; supranational currencies are the solution for the future. With a supranational currency we will not face the problem of the international lender of last resort, except in the context of the monetary union or association. And at that level members will forge agreements about sharing, about putting up collateral to access lines of credit, and about adequate provision for an international lender of last resort facility. In the context of regional supranational currencies, the basis for the IMF would disappear, except perhaps to deal with the exchange rates of the few supranational currencies.

And if we are trapped by the symbolism of national currencies, let me point out that we do not associate any national symbolism with Visa or Mastercard. Historically, we have put only national heroes of independence on our dollar bills and our peso bills. Never women. That may be one explanation for the symbolism. If in the future we put a Nobel prize winner or a poet or a scientist on dollar bills, people may have less trouble accepting the notion that a currency is not necessarily a symbol of national political autonomy.