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Crises and International Policy Coordination[1]

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The financial sector of the world economy seems utterly convinced that the world is currently descending into a major crisis. This crisis was clearly prompted by the financial sector and the practices that had come to flourish in it. The imbalances about which some of us had worried for some years, particularly the US current account deficit and the disequilibrating capital flows centered on the yen carry trade, have not in the event (at least up to this point) triggered a crisis. Can one still argue that international policy coordination should be a powerful instrument in avoiding crises, or does the form of coordination need significant reform to address new threats?

The plan of the present paper is as follows. It starts by examining the recent financial turbulence, and what contributed to it. This is followed by an analogous discussion of the global imbalances and how they have evolved in recent years, and of the threat that they have been perceived to pose. There is then a discussion of the yen carry trade and of the conditions that need to be satisfied for those who engage in it to make profits. The next section asks whether the past form of international policy coordination could have hoped to do anything about the dangers posed by these developments. The final substantive section asks whether any form of international coordination might be relevant to diminishing the risks of crisis, and if so what form of action would be called

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for. A short concluding section summarizes and briefly considers implications for developing countries.

Financial Turbulence

As is well known, the current financial difficulties originated in the sub-prime market in the United States. This is a market where prospective home-owners who do not satisfy the traditional conditions for being granted a mortgage could hope to borrow to finance home ownership. The traditional conditions involved being able to put down a deposit of a fair proportion (traditionally 20%) of a house's value, and having a regular income that was some multiple (traditionally four times) of the value of the monthly mortgage payment, in order to qualify for a 30-year

However, most of the mortgages had been sliced, diced, and packaged, and moved off the balance sheets of the originators. The credit rating agencies had bestowed their imprint of AAA status on many of the resulting securities, with only the junior tranches carrying higher interest rates and sold as involving much risk. As defaults rose many of the holders of the more senior securities found that, despite the AAA credit ratings, they stood to lose money. Worse stil they were downgraded the banks found that they would have had to pump in cash to keep their SIVs afloat. Legally they could have walked away from them, but they did not do so because the harm to their reputations would have been devastating. So many of them decided they might as well end the charade and take the assets back on their balance sheets. This naturally added to liquidity pressures, because these assets had to be backed by capital.

Many financial institutions suffered losses as a result of these developments, and a number of the chief officers of financial institutions have lost their jobs. Despite these facts, aggregate bonuses in the financial sector fell remarkably little at the end of last year. These bonuses now seem to have been consolidated as an expected part of the remuneration of those in the sector. One has to observe that the pay seems extraordinarily high in the light of the disasters that are so frequently generated.

In the months that have followed the outbreak of the crisis in August 2007, it has spread and deepened. While the first impact was on the mortgage and interbank markets, many additional assets have now been affected. The process of contagion seems fairly similar to that which has been observed in previous crises. A fall in the value of certain assets triggers (because of mark-to-market

Singapore, and Taiwan also have highly-managed exchange rates and have been building up reserves, and are therefore natural candidates for adjustment. Japan is more debatable, since it also has a large current account surplus but allows its exchange rates to float. This floating has been reasonably free for the past several years, so it is sometimes argued that Japan does not need to adjust, but ought to be allowed to remain with the large surplus that reflects the savings preferences of its citizens.

How did the imbalances grow so large? In my view this was a joint result of the oil price, the East Asian crisis, a macroeconomic policy that reflected a determination not to have any prolonged excess supply in the United States, and the policy of a fixed dollar

What sort of crisis is it that is envisaged by those who are anxious to head off its likelihood? It is not so much that the Fed will be forced to raise interest rates in order to check the inflation following a dollar decline (a traditional interpretation), but that the US economy will suffer a crisis of confidence (e.g. Williamson 2008). This would involve an exogenous decline in investment (like in East Asia in 1997). It means that the US economy is not completely forecast by the traditional models. The dollar collapse would in due course bring expenditure switching to the rescue of the United States, but in the rest of the world expenditure switching would reinforce expenditure reduction in a deflationary spiral.

The gratifying fact is that the financial turbulence has not to this point ignited this particular type of crisis. Even though the financial turbulence was initiated by some of the securities into which funds flowed proving much less solid than investors had been led to believe, the investors mainly sought alternative dollar assets rather than switching out of the dollar altogether. Of course the dollar has fallen, and such a fall is a part of most of the doomsday scenarios, but this has not been associated with a loss of confidence that brings a major fall in investment.

<u>The Yen Carry Trade</u>

One of the facts about the present international monetary situation is that the yen has remained highly competitive (at least until Marc [illegible] caused by the yen carry trade (see Galati, Heath, and McGuire 2007 for an account of this). Foreign investors borrow yen at the low interest rates prevailing in Japan, then sell the yen in order to buy the currency in which they wish to invest, and then make the investment (at a higher interest rate, obvi

If one wishes to discourage the yen carry trade, one needs to increase the expectation that the yen will appreciate enough to wipe out the profitability of the trade. One way of doing this is for the Japanese government to diminish expectations that it will intervene if strong appreciation occurs. It could, for example, give a categorical undertaking that under no circumstances would it intervene before the yen hits a certain level. Perhaps a principal obstacle to making such declarations is the belief that fast currency changes are inherently destabilizing and therefore to be avoided, which points to intervention being undertaken exactly when the possibility of squeezing those in the yen carry trade is greatest. Someone who believes that the people in charge of intervention policy are worried by fast currency moves will be alert to the possibility of a sharp yen appreciation, and will rely on such intervention to bail them out if they sell promptly when intervention occurs.

What would be the macroeconomic implication if the yen carry trade were to be eliminated by such a change of policy? The yen would appreciate; the current account surplus would diminish; and the level of demand in Japan would decline. So long as the last consequence appears undesirable, it is necessary to accompany action to squeeze the yen trade with a willingness to expand demand in Japan. Corresponding changes would be needed in countries like New Zealand that have been experiencing strong capital inflows financed in part by the yen carry trade, which would therefore be forced to deflate demand when their capital inflows declined.

<u>Traditional Policy Coordination</u>

The literature on international policy coordination became very active obstans deprive the residual country (the United States) of the ability to secure a satisfactory (sufficiently strong) payments position.

The main ground for opposing policy coordination at that time was a conviction that countries would never change their policies for the benefit of other countries. Such changes may well have been unrealistic, but they were not advocated by the more sophisticated supporters of coordination. What was envisaged was that each country would commit itself to abiding by a set of rules that it would expect to find advantageous in the long run. It might be that such a rulebook would require occasional sacrifice of short-run gains, but this is something that countries would be far more likely to find acceptable than sacrificing their perceived interests to those of others in a one-off agreement.

The idea of policy coordination went out of fashion as it was argued that the floating exchange rate system that had come into being meant that the exchange rate was not a policy instrument. Each country pursued internal balance as best it could, and passively accepted the exchange rate and balance of payments that was generated by the system. So far the world has stuck with this "system", though the results of it have at times been close to the limit of what countries have been willing to accept. If there is ever a real crisis that is clearly the result of these arrangements there will almost certainly be the desire to build something better, though the adoption of an alternative will surely depend upon the availability of a model perceived to be better.

While policy coordination was abandoned, the idea of surveillance persisted. Even if countries should not be expected to change their policies in the light of the wishes of others, it remained accepted that countries had a duty to bear in mind the interest of the global community in making their choices. Surveillance came in two forms, bilateral and multilateral. Bilateral surveillance involves the IMF raising questions with the authorities of individual countries about whether their policies are consistent with a satisfactory global outcome. A revision of the terms of reference for bilateral surveillance introduced last year requires the Fund to take into account the implications of each member's policies for the functioning of the system. However, since successful adjustment generally requires mutually supporting actions by several countries, one would expect multilateral surveillance to be of greater relevance. The Fund's initiative in this regard involved the convening of talks among the five major players (the US, Euroland, China, Japan, and Saudi Arabia) with a view to their agreeing a set of policies that each would pursue and that would in due course achieve the desired aim. In the end the outcome of these talks proved disappointing, since each of the participants merely promised to persist with its existing policies and the IMF sanctified their inaction by publishing their G7-like promises.

It would be necessary to do better than this in order to achieve real policy coordination. In the first place, one might expect this to involve an attempt to plan where countries are going. There is not much scope to plan where output is going, since that is largely determined by the maintenance of internal balance, though there may be scope to marginally vary the investment ratio and other growth-input variables in the interest of spurring growth. There is more scope for choice over current account outcomes, which steers the evolution of external wealth. Second, this presupposes a determination to use all available policy instruments to pursue those targets. The main way in which this differs from current arrangements is that it would involve an attempt to influence the exchange rate. It should be taken as read that influencing the exchange rate is not the same thing as determining it, and that the latter is infeasible in the world as it is today. But influence is less ambitious and may be possible. It would presumably start with official announcement of a set of consistent target exchange rates. Given that it is now accepted that intervention is more likely to be effective when it is internationally coordinated (Sarno and Taylor 2001), which fact is most obviously explained by a willingness to be swayed by official actions when the official world shows itself to be agreed, one would expect such an official announcement to carry more credibility than the isolated announcements of recent years (e.g., “we believe in a strong dollar”).

Would a system that was based on these principles have helped head off the three sources of financial problems now threatening the world? I cannot see that it would have been of any relevance in preventing the financial turbulence. This has resulted from imprudent financial practices within countries, practices that ideally might have been diagnosed by FSAPs, although I am not aware of actual FSAPs having been concerned with these issues. On the other hand, it could have helped avoid the buildup of the global imbalances to their present threatening level, assuming that countries would have been

The fact is that the regulators did none of these things, in some cases for the compelling reason that the activities were unregulated. Accordingly, this crisis appears to me to be principally attributable to failures in supervision. I am not saying that one cannot criticize central bankers for keeping the punch bowl available too long, but that originate-to-distribute model are here to stay[2]. International comparisons may suggest that this should not be taken for granted. In a recent speech, Anoop Singh (2008) of the IMF is reported to have said:

> It has helped that in many countries, including here in Brazil, regulatory frameworks have made it difficult for banks to either buy the kind of structured products that have been at the center of events in the United States or accumulate significant off-balance sheet exposures.

The Reports of the FSF are not as complacent in applauding the practice of parking assets off-balance sheet in SIVs as they are in endorsing securitization, arguing rather that the implementation of Basel II will in any event reduce the regulatory arbitrage that generated large off-balance-sheet risk exposures. But there is no discussion of potential additional sources of vulnerability: for example, many of those who have taken one side

So far as SIVs are concerned, I am unable to perceive the social benefits. Rather than rely on Basel II to discourage these, it seems preferable to ban them. In any event, whether one still wishes to proceed with Basel II is itself open to some doubt.

The market for credit default swaps has not yet experienced a crisis, but the newspapers have referred to the possibility that if many of the credits that have been covered turn bad, then those who took that side of the market will be bankrupted and unable to honor the outstanding instruments. This would in turn mean that many of those currently holding credits that are guaranteed via credit default swaps would be obliged either to hold distinctly more risky instruments or else that they will be forced to sell. The possibilities of further intensification of the crisis are apparent. It is not obvious that one can do much to ameliorate this situation during the crisis, but in future one would wish to see supervisors ensuring that credits are guaranteed only by those who have the net worth to honor all the guarantees that they have made. The practice of treating this as a cheap way to earn fee income needs to be ended.

Concluding Remarks

This paper has argued that the prime responsibility for the financial turbulence that is currently afflicting much of the world is to be found in inadequate supervision. The authorities welcomed the process of financia coordination, in which the authorities of the leading countries commit themselves to pursuing a mutually consistent set of macroeconomic policies, remains of some importance, although its benefits lie in reducing the danger of a sort of crisis that has not yet occurred. The yen carry trade is one of the factors that contribute to the danger that this system will end up in crisis, and it would be addressed as well as seems feasible by a system of traditional-style policy coordination.

As long as this remains overwhelmingly a financial crisis and does not lead to a severe economic slowdown, the widespread adoption of prudent macroeconomic policies by emerging markets in the past few years should enable them to ride the crisis out. It is only if the financial weaknesses led to an important slowdown in the world real economy that one has to fear a major impact on emerging markets and developing countries. To date there is not evidence of such a major slowdown. Most indicators of the real economy remain rather strong. This is less true in the United States than elsewhere, but one of the thrusts of US policy has been expansionary actions on both the fiscal and monetary fronts, and it is only if these—and the improvement in the foreign balance as a result of the dollar depreciation—are overwhelmed by further financial problems that emerging markets would be likely to suffer. In Europe there has been a slowdown, which happened because of the financial turbulence rather than because of higher interest rates, but it is doubtful if there was much net increase in slowdown as compared to what otherwise would have occurred. In Asia there is still little sign of a slowdown at all. The chances of avoiding a major slowdown appear quite good.

What can emerging markets and developing countries do if, despite the current outlook, a major slowdown occurs? They could do rather more than in the past, because of their stronger current position. Many of them should be able to avoid taking deflationary actions and thus actually reinforcing deflation, as they have often been obliged to do by past collapses of confidence. Some have actually built up reserves and shown sufficient fiscal prudence that they would be able to adopt expansionary policies. Few need fear a big deprecation of their dollar exchange rate, which has in the past imposed severe deflationary pressures, at least in the short run. The outlook this time around appears much less gloomy than in the past.

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