A remedy for financial turbulence?

Apr 15th 2004
From The Economist print edition

In the first of a series of articles on the Copenhagen Consensus project*, we look at financial instability

THE severity and frequency of financial crises, especially the combined currency and banking collapses of the past decade, have made financial instability a scourge of our times, one that bears comparison with damage inflicted by famine and war. In a new paper for the Copenhagen Consensus, Barry Eichengreen, from the University of California, Berkeley, has reviewed the literature, attempted to count these costs, and to weigh them against the costs of a particular proposal for remedial action.

The costs can be reckoned in stalled growth and stunted lives. The typical financial crisis claims 9% of GDP, and the worst crises, such as those recently afflicting Argentina and Indonesia, wiped out over 20% of GDP, a loss greater even than those endured as a result of the Great Depression. According to one authoritative study, the Asian financial crisis of 1997 pushed 22m people in the region into poverty. For developing countries, currency crises are an important subset of financial crises. Mr Eichengreen, while cautioning against taking the precision of such estimates too seriously, reckons that the benefit which emerging-market countries would reap if such crises could be avoided altogether would be some $107 billion a year.

One ready way to secure those benefits, you might think, would be to stifle financial markets. In impoverished parts of Africa, for example, credit crunches are relatively rare, because credit is always hard to come by. But as a rule such a solution would be more costly than the problem. Wherever financial markets are absent or repressed, savings go unused, productive economic opportunities go unrealised and risks go undiversified. If India's banks and stockmarkets were as well developed as Singapore's, India would grow two percentage-points a year faster, according to one study.

To grow fast, and keep growing quickly, countries need deep financial markets—and the best way to deepen financial markets, most economists agree, is to liberalise them. Does this mean that countries must open their financial markets to foreign capital, thus exposing themselves to the risk of currency crises? Or should they impose capital controls, confining the perversity of financial markets to national borders, where the central bank retains the power to offset it? Foreign direct investment aside, China's capital markets are still largely closed to outsiders. Yet it has no shortage of credit. For other countries, though, the evidence is mixed. A fair reading of the studies, and there have been many, suggests that, for most countries, opening up to foreign capital will deliver faster growth in most years—punctuated by a damaging financial crisis about every ten years. Some economists argue that periodic credit crunches are the price emerging markets must pay for faster growth.

What might be done to make financial crises less common? The answer depends on the causes of financial meltdown. Governments bring some crises on themselves by pursuing fiscal and...
monetary policies that are inconsistent and unsustainable. Such self-defeating policies may be
the symptom of deeper flaws in the body politic. If so, there is little outsiders can do. But some
countries’ financial fragility results simply from their need for foreign investment. In the most
susceptible countries, firms and banks borrow heavily in dollars, while lending in local
currencies. If the value of the local currency wobbles, this mismatch between domestic assets
and foreign liabilities is cruelly exposed.

Why are the assets and liabilities of emerging markets so ill matched? Perhaps because poorly
supervised and largely unaccountable managers have scant reason to be careful with other
people’s money. But Mr Eichengreen offers another reason. International investors are very
choosy about currencies. Most consider only bonds denominated in dollars, yen, euros, pounds
or Swiss francs. This select club of international currencies is locked in for deep historical and
structural reasons. Thus, poor countries that want to borrow abroad must bear currency
mismatches through no fault of their own.

**Match-making**

If this is the problem, possible solutions follow naturally: either create a common world
currency, used by rich and poor alike, or invent a liquid, international market for bonds
denominated in the pesos, bahts and rupiahs that emerging markets are obliged to use. The
first solution, even if it were desirable, is politically impossible; the second is merely very
difficult. Mr Eichengreen spells out in his study an ingenious plan to make it a little easier.
Briefly, he proposes the creation of a market for lending and borrowing in a synthetic unit of
account, a weighted basket of emerging-market currencies. Such bonds would be popular with
investors, since the currency would be more stable than the sum of its parts and, at first at
least, carry attractive yields. Importantly, such a market, if it could be established, would
eventually let emerging-market economies tap foreign capital without currency mismatches.
This is because those, such as the World Bank, that issued such bonds would be keen to reduce
their exposure to the basket by lending to the countries in that basket in their own currencies.

However, there is a cost: the extra yield that the Bank and others would need to offer to
attract buyers of the new instruments. Mr Eichengreen estimates that this initial cost would be
no more than $545m a year—a small sum compared with the $107 billion that would be saved
if currency crises could be avoided.

* The Copenhagen Consensus project, organised by Denmark’s Environmental Assessment Institute with the co-operation of
The Economist, aims to consider, and to establish priorities among, a series of proposals for advancing global welfare. The
initiative was described in our Economics focus of March 6th. That article can be read [here](http://economist.com/PrinterFriendly.cfm?Story_ID=2597313), along with other material,
including an article on disease published only online this week.

Copyright © 2004 The Economist Newspaper and The Economist Group. All rights reserved.