

Comment

RICHARD PORTES

1. Crises will always be with us

If we observe no corporate bankruptcies, then we must infer that capital markets are not functioning well. Investors should take risks – for which risk premia compensate them. That is, built into the return on investment is a premium that assumes that some proportion of investment decisions will prove mistaken – they will fail. If none fails, investors have been too conservative, and there are many profitable – though risky – opportunities that are not being exploited. This is why we have bankruptcy laws that provide for ‘orderly workouts’ when investments and the firms that made them do fail.

Similarly, we should expect that if the international capital markets are functioning well, from time to time mistakes will be made, and one or another country (or the aggregate of its private sector borrowers) will fail. This country will experience a financial crisis. History records many such events. We should not expect or even wish to prevent them all: if we did, that would be at the cost of insufficient, excessively risk-averse investment. The issue for economic analysis and policy-making is therefore how to minimize the costs of such crises, with appropriate economic institutions and policies, both *ex ante* and after the crisis hits.

2. Every crisis is different

The title of *Crisis? What Crisis?* (Eichengreen and Portes 1995) recalled the words of the UK Minister of Finance in Britain’s current account

□ London Business School and CEPR, London (Great Britain).

crisis of 1976, which was resolved with IMF intervention. We cannot imagine a crisis with similar characteristics occurring now. And we read daily of how the current Asian crises are so different from Mexico 1994-95, or indeed from the sovereign debt crises of the 1980s.

That is true. These are primarily private-sector crises, in economies with high aggregate savings, sound fiscal positions, open and outward-looking policies, and relatively low sovereign debt. Rather than high inflation, the serious feature of the crises is debt deflation. The economies in crisis do have weak banking systems and started with somewhat overvalued exchange rates (some but not all pegged); and those are indeed common features of financial crises. But the causation, manifestation, and current appearance of these crises is different from previous episodes.

The lesson is that we cannot predict financial crises – or if we try, we predict many more than actually occur. The search today for ‘early-warning indicators’ is just a continuation of the effort that goes back over 25 years in the literature to find variables that would ‘predict’ debt rescheduling. Data-mining can always produce a good equation, and they all perform miserably out of sample.

For example, take Argentina in the spring of 1995. With an apparently overvalued real exchange rate and a fragile banking system, subject to tequila effect contagion, it ‘should’ have gone under. But the early-warning indicators do not and cannot include the credibility of policy-makers.

Does the IMF perform any better than early warning indicators? The Fund maintains it was warning Thailand over a year ago. But its December 1996 published *Report* on that country raises no suspicions; and its 1997 *Annual Report* does not find fault with Thai or Korean macroeconomic management. To go back a bit, the 1995 *Capital Markets Report* was not critical of Asian policies towards capital inflows (on the whole, rightly so).

We are told that the difference between the current crisis and those that have preceded it is the virulence of contagion. True, the tequila effect was brief and not disastrous. But for a historical example of widespread, disastrous contagion, go back to the successive defaults that began in Latin America in 1931, spread to Central and Eastern Europe in 1932, and culminated in Germany in 1933.

3. All crises are the same

In 1987, Barry Eichengreen and I published an essay on “The anatomy of financial crises”. A decade later, I stand by the skeletal framework we explored, in which all crises involve a nexus of debt default, foreign exchange market disturbances, and banking system failures. The widespread securitization of debt in recent years does not alter the analysis – after all, one of our major historical examples was the 1930s crisis of defaults on sovereign bonds.

In that case, defaults on their (developing countries’) securitized debts hit our (advanced countries’) banks and currencies. In 1982, moratoria on their bank debt threatened our banks. In Mexico 1994-95, a major feature was the weakness of their banks. Today, both their banks and ours (in particular, Japan’s) are distressed.

All crises raise the problem of distinguishing between illiquidity and insolvency. Today, some say that the ‘Asian miracle’ economies are actually ‘hollowed out’, ‘zombie’ economies – that all that investment just went into creating excess capacity, unprofitable activities, or driving real estate prices up to unrealistic, unsustainable levels. Others argue that the miracle was real growth, that these economies should still top the tables in the *World Competitiveness Report*, that the problem is simply the classical ‘run’ – a self-fulfilling crisis of liquidation of short-term loans. In fact, we will not know for a long time which view is correct. But that need not paralyse policy, as I shall argue below.

One common feature I would add now is that all crises are ‘crises of success’. The initial capital inflow that ultimately proves unsustainable (and perhaps unprofitable) is both a sign and – for a time – a cause of economic promise and success. But we have not yet learned how best to cope with the capital inflows, so success may lead to failure.

4. Moral hazard cuts both ways

In the 1980s, the creditor banks and their spokesmen – as well as the official sector – denied debt reduction for years (until the Brady Plan), resting upon the incantation of ‘moral hazard’. Only a few of us then argued that creditors too were subject to moral hazard and had to

take some share of the cost of mistakes, so they would lend more carefully next time around. In practice, they did not take much of a hit: some studies have calculated that the banks' *ex post* returns on the loans of the 1970s were quite reasonable, just as Barry Eichengreen and I had calculated that the bond issues of the 1920s were on average profitable, despite the defaults.

There is only one answer: no bailouts. Only that will induce market participants to cooperate with moderate, sensible proposals to facilitate 'orderly workouts', which they have hitherto resisted on the grounds that this would just encourage debtors to default. What nonsense! – and it is the more pernicious nonsense for being taken seriously by officials.

5. Policy lessons for borrower countries

To avoid or minimize crises:

a) Be wary of short-term capital inflows; consider controls or discouragements as in Chile.

b) Accommodate persistent long-run capital flows (which need not mean only FDI) by permitting real exchange rate appreciation through nominal appreciation, rather than pegging the nominal rate. Use a managed float of some variety, probably a crawling band basket peg. If you wait until the markets attack a nominal peg, it will invariably and inevitably be too late to avoid the crisis by floating.

c) Impose tougher bank standards than in developed countries (of course this may be politically impossible ...).

When the crisis hits:

a) Give up immediately: float the exchange rate. The 'interest rate defence' of a currency peg will not work in the presence of financial fragility – even in developed countries (e.g., European ERM crises of 1992-93).

b) Do not 'socialize' private debt. To accept responsibility for private sector obligations to foreign creditors will ultimately result in a bailout for the latter. Do not connive in that.

c) If the problem is debt deflation and a credit crunch, do not impose a monetary squeeze. The last thing a highly geared economy needs is high real interest rates!

d) Even if many debtors are insolvent rather than illiquid, that does not mean that they should close down. Especially with (now) undervalued exchange rates, most of the productive capacity in these firms will be profitable – what is needed is financial restructuring. Shareholders should lose capital, some management should go – and creditors should either accept losses or convert debt into equity.

6. Policy lessons for the International Financial Institutions and creditor countries

To avoid or minimize crises:

a) The IMF should not act as a credit rating agency, but neither should it conceal its concerns – if in fact it has any – and it certainly should not mislead the markets, by commission or omission.

b) It is too late now for the current crisis – but all the more important for the future: the Fund should not orchestrate bailouts of creditors, even if the United States government wants it to do so. The authorities should reflect now on whether the Mexican bailout – however 'successful' they may claim it to have been – was really necessary to avoid systemic risk; and whether, if there had been no bailout, we would have seen anything like the same extent of unwise lending to the Asian countries now in crisis.

c) Go back to the recommendations of Eichengreen and Portes (1995) – and indeed of the G-10 *Deputies (Rey) Report* – for 'orderly workouts', adapt them in the light of current experience, and put political weight behind them – even in the face of opposition from market participants.

In the current crisis:

a) Relax the absurdly, dangerously tight macroeconomic policies that are being imposed in the name of 'conditionality'.

b) Similarly, it is hardly obvious that financial distress will be reduced if the IMF requires capital flow liberalization before institutional reforms and recapitalization of the domestic financial sectors.

c) It certainly is obvious that regardless of the economics, the domestic political response to the Fund programmes is itself dangerous and likely to be counterproductive. Reconsider urgently.

REFERENCES

- EINCHENGREEN B. and R. PORTES (1986), "Debt and default in the 1930s: causes and consequences", *European Economic Review*, 30, June, pp. 599-640.
- EINCHENGREEN B. and R. PORTES (1987), "The anatomy of financial crises", in R. Portes and A. Swoboda eds, *Threats to International Financial Stability*, Cambridge University Press, Cambridge.
- EINCHENGREEN B. and R. PORTES (1988), "Les prêts internationaux dans l'entre-deux-guerres: le point de vue des porteurs de titres", *Économie Appliquée*, 41, December, pp. 741-71.
- EINCHENGREEN B. and R. PORTES (1995), *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, CEPR, London.