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FINANCIAL MARKET STABILITY AND MONETARY POLICY: REMARKS ON STIGLITZ'S SPEECH

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Let me begin by saying how pleased I am to be here at the First Biennial Conference of the Hong Kong Economics Association (HKEA). The organisers are to be congratulated for bringing together an impressive array of conference participants and for inviting Professors Robert Mundell and Joseph Stiglitz to speak at this opening session. The conference promises to be a very fruitful and productive one with many interesting presentations scheduled over the next couple of days.

The organisers have asked me to respond to the many issues Professor Stiglitz has raised regarding the appropriate role of monetary policy during financial crises. Given my background, it should come as no surprise that I will disagree with some of the more provocative criticisms of IMF policies made by Professor Stiglitz. What may be surprising, however, is that there are many points with which I agree. Indeed, in seeking to make his case against the Fund's (so-called) high-interest-rate policies, Professor Stiglitz has tended to exaggerate the differences between himself and the Fund and has masked a number of areas of common ground.

Let me begin by briefly summarising my position on the major issues in the interest rate debate before addressing some specific areas of contention. In line with Professor Stiglitz, I have concerns about the costs of allowing interest rates to rise to high levels during financial crises and believe it would be desirable if high interest rates could be avoided. Where we differ, however, is that I do not believe that there any magic bullets to deal with kinds of simultaneous external and internal financial pressures seen in Asia in 1997–1998. Countries in such situations are in an unfortunate predicament for which there do not seem to be simple low-cost solutions. Short of resorting to across-the-board controls on capital outflows, a period of high interest rates seems necessary to help stabilise the external situation, although there are some measures – such as external debt restructuring – that may help alleviate the extent to which interest rates need to rise. Professor's Stiglitz's low-interest-rate policy, in my view, carries major risks.

With this as introduction, let me briefly outline the three major questions addressed in Professor Stiglitz's paper. Those of you who have followed the

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very public debate on the IMF's handling of the Asian crisis will know that Professor Stiglitz has already written extensively on these questions, and taken relatively strong position on the 'answers'.[1]

The three questions addressed are the following.

(i) What is the 'appropriate' role of monetary policy during the kind of crisis Asia experienced in 1997–1998?

(ii) Why did the IMF push for a high-interest-rate policy during the crisis when (at least according to Professor Stiglitz) such a policy makes things much worse?

(iii) What institutional factors account for the evolution of the IMF away from promoting global stability towards advocating policies (such as the high interest rates) that, in Professor Stiglitz's view, can be rationalised only if the IMF focuses narrowly on ensuring that scheduled external debts are paid.

In what follows, I will focus my remarks on the first and second questions. This is not because the last question is unimportant. Rather, it is because it becomes relevant only if one accepts the argument that the Fund unambiguously adopted the wrong monetary policy advice in Asia. At least in my view, and until such time as feasible alternative approaches to managing financial crises can be identified, the jury is still out on this issue.

Very obviously, it is not going to be possible to do justice in this short note to all the issues involved in the interest rate defense issue. For a more complete discussion the reader will have to study the various Fund papers that address many of the points raised by Professor Stiglitz, and present the 'official' view.[2] In particular, the Fund has made clear why it believes countries cannot stand back when their balance of payments are under severe pressure and it has addressed the question of the costs associated with high interest rates versus weak currencies. For my part, I would begin with two points that have not, I believe, received sufficient attention in the debate.

First, it is important to distinguish between monetary policies and monetary conditions in thinking about the determination of short-term interest rates. Given a sudden reversal of capital inflows, short-term domestic interest rates, other things being equal, will tend to increase to reflect the higher cost of external funds as well as associated increases in risk premium. Upward pressure on interest rates was therefore as much a consequence of the crisis Asia faced, as it was the outcome of decisions about monetary policy. As a result, care is needed in seeking to characterise the stance of monetary policy solely on the basis of interest rates. Much of the upward pressure on interest rates in the Asian economies hit by the crisis in late 1997 and early 1998 very likely resulted directly from the external crisis. Expansionary monetary policies would have been required to avoid high interest rates.

Second, Professor Stiglitz's characterisation of the IMF's approach to the external sector as involving only efforts to limit currency depreciation is too

[1] (See, for example, Stiglitz 1999).

[2] See Managing Financial Crises – The Experience in East Asia by Boorman *et al.* (2000).

narrow. What the Fund was seeking in the early stages of the crisis was to stabilise badly haemorrhaging balance of payments positions that appeared to be out of control. Although collapsing currencies were a manifestation of the problem, the Fund did not have any particular target for the exchange rate. The immediate challenge was to halt or reverse the rush to the 'exits' by both foreigners and domestic residents in order to re-establish external stability. The focus on external stabilisation reflected the view that overall stability could not be achieved until the balance of payments had been stabilised. Rather obviously, the IMF needed to think about whether the stance of monetary – and other policies – was consistent with this objective.

Let me now make the following personal observations on Professor Stiglitz's paper.

First, and most importantly, I do not know of anyone who does not share Professor Stiglitz's concerns about the possible damaging effects of high interest rates on the domestic financial sector and economic activity, especially when they are sustained for long periods. Faced with only a domestic financial crisis, it would clearly be helpful if monetary policy could be targeted on providing needed domestic support and sustaining economic activity. The problem in several Asian economies in 1997–1998, however, was the simultaneous occurrence of both domestic and external financial pressures. In these circumstances, one policy instrument (monetary policy) could not simultaneously help stabilise both the external situation and the domestic economy. External stabilisation called for high interest rates while domestic stabilisation called for lower rates. Accordingly, there was a policy assignment issue and the correct decision was taken, in my view, to initially assign monetary policy to the external situation. The expectation was that it would be possible for interest rates to decline to levels that were more appropriate from an internal balance perspective once the external situation had stabilised.

External stability (broadly defined), of course, was not sought only through allowing interest rates to rise temporarily to high levels. Comprehensive reform programs in the crisis-affected countries – with support from the international community – were intended to address the underlying problems behind the financial crisis, help turn around investor confidence and contribute to restoring external and internal stability. For a number of reasons – including concerns about the commitment to reform in some of the crisis countries as well as the sheer scale of investor panic – the stabilisation of confidence took longer than many had hoped. The delay resulted, in some cases, in a prolonged period of high interest rates. The most desirable outcome would have been a quick turn-around in investor sentiment – related among other things to the policy reforms introduced – and an associated rapid easing of interest rates.

This takes me to my second observation. The Fund's approach obviously depends on high interest rates – together with supporting reforms – being successful in stabilising the external situation. Here I would agree with Professor Stiglitz that the evidence on the short-run effects of high interest rates on the exchange rate is unclear. Part of the problem is that it is difficult to sort out cause and effect because exchange rates and interest rates are simultaneously determined and many things are happening during a financial crisis. There is also a fundamental problem that it is difficult to know whether a failure of exchange rates to stabilise is because high interest rates do not work, or is due to weaknesses in the design or implementation of other parts of the policy package. As noted earlier, interest rates are as much influenced by overall economic conditions, as they are an influence on them.

What I think one can argue on the basis of the evidence is that high interest rates, together with other policy adjustments, do eventually stabilise the external situation. They do so to some extent, however, by bringing about a sharp cut-back in domestic demand and output and improving the external current account (rather than the capital account). Be that as it may, however, this does not necessarily imply that they were the wrong 'medicine'. I have yet to see evidence that lower interest rates would be helpful in this regard.

My third observation follows rather naturally from the points above. If high interest rates improve the external situation primarily through creating a recession-induced improvement in the current account then, as Professor Stiglitz suggests, we should certainly consider whether there are any other lower-cost policy instruments to stabilise the external situation. Professor Stiglitz does not seem to support blanket controls on capital outflows so I will not discuss this option here. On the other hand, he appears to favour restructuring external debt payments in 'appropriate' circumstances (the 'default option'). Somewhat surprisingly, no acknowledgement is made of the fact that external debt restructuring played an important role in helping stabilise the external situation in at least one of the crisis-affected Asian economies (Korea). The international community has not been as blind to this option as Professor Stiglitz would have us believe.

On the face of it, external debt restructuring may be an important means to limit the extent to which interest rates need to rise to stabilise the external situation. Needless to say, however, debt restructuring raises a number of issues that have to be carefully considered. These include the circumstances under which such an approach should be used, how it should be implemented, and its possible long-run costs for the countries involved. Unless I am mistaken, Professor Stiglitz clearly recognises that debt restructuring should be considered only in situations where external debt is, in some sense, a real problem. That problem, of course, can either be one of insolvency (in which case writing down the debt and allocating losses is the preferred solution), or one of illiquidity (in which case some form of rescheduling may be appropriate). In practice, of course, it is frequently difficult to distinguish between these cases and there is always the possibility of strategic default in which willingness (rather than ability) to pay is the issue.

That said, I nevertheless agree with Professor Stiglitz that debt restructuring should be considered in clear cases of insolvency or illiquidity. And, I suspect that many at the Fund would agree as evidenced, *inter alia*, by the ongoing interest in creating facilitating mechanisms under the umbrella of enhancing private sector involvement. By reducing external pressures at their source, such approaches can help limit the extent to which interest rates need to rise to stabilise the external situation. As evident from the recent work on the new international financial architecture, however, we are still some way from having mechanisms to deal systematically with the collective-action problems in pursuing such solutions. The issue is one of setting up procedures for expediting external debt restructuring when it is in everybody's collective – but not necessarily – individual interest.

There is also, however, the issue of the possible long-run costs of the debt restructuring option as reflected in the terms and conditions of future capital market access. My own view is that cross-border debt restructuring is too difficult to implement at the current juncture, contributing to crisis resolution being costlier than necessary. But one needs to recognise that it is also possible to make debt restructuring too easy. Were restructuring to become too easy, there could be an increase in strategic defaults and a risk of a drying up of international debt flows. Clearly, an appropriate balance needs to be struck that allows for restructuring when it is desirable but does not reward strategic behaviour. In addition, careful consideration needs to be given to how easier restructuring would affect the incentives to prudently manage debt, how the interests of creditors can be protected, and how losses can be transparently allocated across various parties. Addressing these issues will be difficult but not impossible. The solutions will clearly affect both the costs and benefits of restructuring, which will then need to be compared to those involved in current approaches to crisis management and resolution.

My final observation relates to the possible consequences of countries following Professor Stiglitz's advice to target monetary policy on internal objectives during a crisis. In Professor Stiglitz's view, such an approach will make the management of crises easier at only the 'small' cost of a lower exchange rate. No one knows for sure what would have happened had such advice been followed in Asia. One can conjecture, however, that the consequences could have been severe. In particular, such a policy would likely have required very substantial injections of domestic liquidity to offset upward pressure on interest rates. These, in turn, would have provided domestic residents and foreigners with low-cost 'fuel' to rush to the exits. They most likely therefore would have resulted in much larger declines in exchange rates than observed and, at some point, may have started to push up interest rates due to expectations of higher inflation. In my view, no country can afford to stand on the sidelines and continue to pump in additional liquidity in a situation in which its currency is in free-fall. My suspicion is that such an approach – followed to some degree inadvertently by Indonesia in early 1998 – would not have contributed to the restoration of stability.

Let me conclude by emphasising once again that I share many of Professor Stiglitz's concerns about the costs of (so-called) high interest rate policies during financial crises. Where I part company is with regard to the choices faced when there are simultaneous external and internal crises. In such cases, high interest rates seem unavoidable for a while before fundamental problems start to be addressed and confidence is restored. The best we can probably do is to try to reduce the extent and duration of interest rate increases through appropriate and timely policy reforms and, in some instances, external debt restructuring. There would be major risks injecting additional liquidity to keep interest rates low before the external situation has stabilised and confidence has been restored.

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