Avoiding Crises in Emerging Markets

The Czech Republic has its own experience with currency crisis. In 1997, the contagion spread from East Asia and a speculative attack was launched against the koruna. This event necessitated the adoption of stabilisation measures. The economy fell into a recession from which it is only now slowly emerging. My views on preventing and resolving financial crises can thus hardly be cut off from my personal experience. Nonetheless, I’ll try to be objective in the sense that I will separate indisputable empirical facts from my own generalisations.

A) **Empirical fact no. 1.** The Czech Republic was the only Central European economy to go through a currency crisis in 1997. It was also the only Central European economy to experience a home-made recession. But more conspicuously it was the only Central European economy which was troubled in the pre-crisis period by extensive external imbalance.

**Generalisation:** Fundamentals matter. In other words, the most effective protection against financial crisis are sound economic fundamentals.

i) If a low level of inflation is successfully maintained, interest rate differentials narrow and there are reduced incentives for any inflow of short-term speculative capital. A narrow interest rate differential also changes the structure of capital inflows in favour of foreign direct investment and to the detriment of foreign borrowing by domestic firms, which is discouraged by low domestic interest rates.

ii) Prudent fiscal policy – leading to low government debt and foreign indebtedness – is the best safeguard against the need to work out complex bond structures for the sake of greater private sector involvement in crisis resolution.

iii) If real wage and labour productivity growths are in balance it is much easier to maintain competitiveness on international markets and combat the increasing external imbalance.

It is therefore obvious that an economy with sound economic fundamentals is much more resistant to external contagion, just as a hardened human body has a much greater resistance to an influenza contagion.
It is very important not to lose the institutional memory of the close link between currency crises and unhealthy economic fundamentals. The Central European countries as candidates for EU accession are orienting their economic strategies around a pick-up in growth aimed at narrowing the performance gap between themselves and the European Union. This strategy is of course correct. But we must not forget that, notwithstanding all the priority given to economic growth, this must be balanced growth. Playing with imbalances in order to accelerate the catching-up process can result in distortions which will ultimately lead to even greater output losses.

B) *Empirical fact no. 2.* The first transition country to face the problem of unsustainable external imbalance was Hungary. As a result, the Bokros plan in 1995 adopted unpopular austerity measures. But surprisingly, Hungarian policies have been well-known by a cautious approach towards the liberalisation of capital flows, short-term in particular, and by an accommodating exchange rate policy. Looking at various other transition economies we can come to similar interesting observation: different exchange rate regimes, different monetary policy regimes, different degrees of external sector liberalisation, but one and the same prevailing problem – a tendency towards external imbalance.

**Generalisation:** There are some common reasons why the emerging European markets are exposed to heightened risks of external imbalance: i) Transition economies, after years of lagging behind, are going through a necessary restructuring, which logically increases demand for investment and imports. ii) The liberalisation of foreign trade has eliminated the barriers protecting domestic markets from highly competitive imported goods. iii) The widening current account deficits have also been fostered by a steep rise in consumer demand for imports.

Generally speaking, these reasons are of a structural and institutional nature. This is why progress in minimising the risks of external imbalance hinges on the success of structural and institutional reforms. In my opinion, seeking a solution to this problem predominantly in macroeconomic policies, despite their indisputable significance, means diverting attention away from the essence of the problem.

And there is one more specific factor here. The candidate countries are unable to benefit much from the certain resurrection of benign vies towards capital controls directed at
short-term capital. The essence of the pre-accession process is to realign the legal framework with the EU acquis communautaire. Respecting the rules of the “club” of EU countries excludes *a priori* any procedures relying on capital restrictions or trade barriers. This would be in contradiction with the commitments of the candidate countries, which prior to EU accession are required to build a functioning market economy capable of coping with competitive pressures within the Union. It would also be against the basic principles of the EU itself, which call for respect for four fundamental freedoms. Full capital flow liberalisation is one of these freedoms on which the integration process is built.

The question now is who is better off? Those who have already gone through this often painful learning process of managing their economic policies in an environment of high openness on both the current and financial account? Or those who have postponed it until later? This perspective is often forgotten when discussing the role of capital controls in transition countries.

C) **Empirical fact no. 3.** One of the key responses to the recent financial crises has been the formulation of the principles of the new financial architecture. These include in particular: i) increasing the transparency of national economic policies; ii) adopting internationally accepted standards and codes; and iii) strengthening domestic financial systems.

We can fully agree with the underlying reasons for such initiatives. If investors are better informed, the risk of information surprises that could destabilise market expectations is reduced. The sources of financial sector vulnerability can be identified at an early stage and timely corrective measures can be adopted.

But the question remains. How strong a guarantee against financial crisis is this? It is undoubtedly a step in the right direction. But some problems remain. How to deal, for example, with a sudden change in the interpretation of the very same set of data. Let us not forget just how difficult are the debates on whether the external imbalance is still within reasonable limits or whether the warning signals have started to flash. Or how endless can be the discussions about the equilibrium exchange rate.

As to the adoption of international standards, I cannot help making one maybe provocative remark. Our experience with the Czech banking and financial sector has shown that this is not only a professional, but also a political problem. Introducing stricter norms of conduct and striving for greater transparency are unpleasant policies for those entities whose activities thrive better in the dusk or most preferably in the dark. And if such entities have
strong links to the political arena, the process of standardising models behavioural patterns becomes rather complicated.

D) The debate about the new financial architecture has generated numerous suggestions on how to increase the resistance of economies to financial crises. Only time will tell whether these new ideas are effective. But voices of caution can already be heard saying that it is impossible to completely rule out the occurrence of crises in the future. Some risks have been already identified: rising oil prices, weak euro, asset bubble in US equities. However, the Central European emerging markets promising outlook - prospective membership of the eurozone. In my view, a “quick march” towards the euro is a fundamental implication of the ideas regarding the new financial architecture for candidate countries. Only integration into the eurozone and adoption of the euro can definitively prevent financial market speculation against national currencies. This brings to mind Professor Calva’s famous pronouncement that where there is no peso, there can be no speculation against the peso.

Membership of the eurozone, however, is conditional on our meeting the Maastricht convergence criteria. This is where we encounter frequent misunderstandings, as a certain part of the economic community sees in the Maastricht discipline a brake on real convergence. This stance, however, does not take into consideration the fact that a small open economy, by its very nature, cannot distance itself too far from its major trading partners. One of the major messages from currency crises should be read as that in an environment of highly mobile capital, if the necessary conditions for sustainable growth are not provided by the economic policy of a country, they are likely to be imposed at much higher cost by market forces. In this situation, then, meeting the Maastricht requirements does not mean the imposition of some heterogeneous burden restricting domestic policy-making, but a necessary exercise in macroeconomic stability in the internal interest of the applicant’s economy.

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