Recent Crises in Post-Crisis Perspective

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GLOBAL FINANCIAL CRISES
Implications for Banking and Regulation

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Now that the crisis atmosphere of the second half of 1998 has passed, scholars and practitioners can begin to put recent events into perspective. The questions to be answered include: How deep and serious was the crisis? How well was it managed by the IMF, other international institutions, and leading central banks and governments? Can we improve our crisis management? Can we reduce the frequency and severity of international financial crises?

In the time available, I can only touch on some of these issues. My conclusions may well be reversed. The issues are broad and complex, and they have not received the detailed study on which final conclusions should rest. Further, the full record of policy decisions, and the reasoning that drove these decisions, will not be available for several years, if then.

Two related points should be kept in mind. Interpretations of the past change as we learn more and as we change the models or frameworks that we use to sift through the past. Also, events often look very different to contemporary observers than to those who come later. I will cite only one example. When President Truman called the Federal Open Market Committee to his office in 1951, he told them that the Korean War was a climactic struggle on a par with World War II. Although the President had read a lot of history, and took pride in his knowledge, I have no doubt that this statement reflected the intense pressure he felt, not a careful assessment of past and present. Few would agree with his assessment now. At the time, it influenced some of the decisions he took. The same error of judgment is repeated in other crises.

I. Severity of the Crisis

With those warnings in place, let me turn to the severity of the 1997-98 crisis. We have to distinguish three groups: first, the Asian and Latin American countries that experienced severe banking and currency crises; second, Russia; and third, the U.S. and other developed countries.

By almost any measure one might choose, Indonesia, Thailand, Korea, and Malaysia experienced large losses of income relative to GDP, bad loans relative to banking assets, or devaluation relative to previous currency values. One lesson from this experience and many others is that weak banking systems, heavily dependent on short-term foreign loans denominated in foreign currencies, and pegged exchange rates are an unstable combination.

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Jeffrey Sachs and Paul Krugman argue that the International Monetary Fund (IMF) should have protected employment by lowering interest rates, expanding demand and letting the exchange rate fall, as needed. The IMF acted on classical principles by raising interest rates and insisted on a budget surplus to limit the decline in the exchange rate. The conclusion I draw is that this discussion misses a main, perhaps the main, reason for the severity of the collapse. Foreign lenders and domestic owners of capital, faced with a collapsing banking system, were unlikely to wait to see whether either higher interest rates and reduced domestic demand or lower interest rates and increased domestic demand would restore stability. Neither policy proposal dealt with a core issue. Exchange rates were pegged—neither permanently fixed nor floating. The peg could change, as it did. Further, the principal banks had made bad loans to favored borrowers. Their capital was impaired to such a degree that bankruptcies and losses were likely to be widespread. No matter what the finance minister said, or what he guaranteed, the prudent action for a lender was to get his assets out, salvage what could be saved, and hold hard currency.

My view finds support in what didn't happen in Hong Kong, Australia and New Zealand, and later in Chile and Argentina. These countries were able to restore stability either by raising interest rates to defend a fixed, not a pegged, rate or by letting the exchange rate adjust if it was floating. Unlike Thailand, Korea, and Indonesia, all of the countries I named have either permanently fixed or floating rates. Classical policy worked; higher interest rates prevented a run on the currencies with fixed exchange rates, and exchange rate changes protected the countries on floating rates from major recessions. Australia, for example, is a primary producer, with 60% of its exports to troubled Asia. Yet, it adjusted without a recession. Further, the countries that did not collapse had better banking systems. Banking systems in Australia, New Zealand, Argentina and Chile have been greatly strengthened. Taiwan's and Hong Kong's banks remained strong.

Russia does not have the rule of law, private property, a solvent banking system, transparent accounting, or most other requirements for a functioning market system. The IMF wastes money by offering loans for promises of piece-meal reforms. Loans, or grants to Russia, should be treated as political decisions, to be approved by the Congress and the parliaments of donor countries. If the IMF continues, its lending should be available only to countries that require banks to meet standards for safety and soundness.

Let me turn to the United States and some other developed countries. Much has been written and said about financial market meltdown and a global panic in the world's money markets. Data for Germany, Japan and the U.K. show a modest increase in spreads, beginning in mid-to-late October, following the near failure of Long-Term Capital Management. Spreads in the U.K. and Germany declined slightly following the Russian collapse in mid-August, perhaps for reasons unrelated to the collapse. By early October, spreads between private and public borrowers were back to the July level. They then rose by 1/4 percent or slightly less.

The United States shows a much larger change in spread between commercial paper and Treasury bills. The spread rose following the Russian default, then increased by 60 or 70 basis points in October after problems at Long Term Capital became known.

The spread data explains part of the difference between U.S. markets and markets in other developed countries. The United
States received a large capital inflow at about this time. Much of it sought safety in U.S. government securities. These yields fell substantially. U.S. Treasury bill rates fell by 1.3 percentage points between early September and mid-October. Commercial paper rates did not rise. They just declined much less than Treasury bill rates.

To continue the international comparison, German Treasury bill rates fluctuated during September and October, but they do not show any direction of change until mid-October when they declined by about 20 basis points for a few weeks. The U.K. shows a larger decline than Germany, but smaller than in the United States. Labor rates fell also, but by smaller amounts.

One conclusion is that capital flows to the United States, seeking safety, worked to drive down yields on Government securities (at all maturities). One note of caution is that I do not have the volume of transactions in commercial paper and other private markets, so I cannot say how resilient or deep the private markets remained. I consider the policy issue below.

Widening spreads between commercial paper and Treasury bills is typical in periods of uncertainty and market stress. One measure of the severity of the 1997 period is the size of the spread relative to earlier periods of stress. I chose three other periods for comparison. The first is 1970, a commercial paper crisis following default by the Penn Central Railroad, a large issuer of commercial paper. The second is 1973-74, the period of the first oil crisis. Third is the breakdown of the Louvre Accord in October 1987 and the worldwide stock market decline that followed. Fourth is the recent disturbance.

Judged either by the peak spread or by the change in the spread from two months earlier, the data suggest that the market ranked the 1974 crisis as most severe. The most recent crisis ranks near the bottom; that is, least severe.

Another way of analyzing the data looks at how the spread changed by comparing absolute changes in commercial paper and Treasury bill yields before and after the peak in the spread. These data show that in each of the previous disturbances, commercial paper rates rose in the month in which the peak occurred while Treasury bill rates fell. The most recent disturbance shows both rates falling at different rates of change. The spread widened not, as in the three prior disturbances, because rates moved in opposite directions but because bill rates dropped much more than paper rates. These data suggest that there was much less flight from commercial paper than in earlier disturbances. Capital inflow and increases in bank reserves pushed down all short-term rates, especially Treasury bill rates. Weekly data show a similar pattern with one exception. There is a modest increase in the paper rate in the week ending October 9. The rate remained far below its pre-crisis peak. Table 2 shows the monthly data.

One possible explanation of these differences is that the Federal Reserve’s response was more rapid or more effective in some periods than in others. Policy actions differed. In 1970 and 1987, the Federal Reserve opened the discount window, offering to lend, against collateral, to prevent disruption to the payments system. In 1998, the Federal Reserve lowered the Federal funds rate by 3/4% in three steps, flooding the markets with bank reserves and base money.

Growth of the monetary base -- bank reserves and currency -- shows three distinct patterns. In 1970, the base accelerated sharply following the crisis then decelerated when the crisis passed. In 1974 and 1987, base growth did not increase, but it remained at its prevailing high rate for several months. In 1998,
base growth increased moderately, declined for a few months, before rising again. This policy is inflationary.

There is no evidence in the data I presented that recent action was more successful than the responses to earlier crises. The Federal Reserve was correct to respond promptly to the increased demand for liquidity. I have only praise for their prompt action. My criticism is limited entirely to the way they responded and their delay in reversing their excessively easy policy.

The Federal Reserve made two errors, one less important than the other. They overstated the severity of the problem they faced, prodded by agitation and anxiety in the New York financial markets. This would not be damaging, if the excessive easing had been reversed promptly. It has not been.

The second mistake, more serious I believe, was to misjudge the problem. Money growth was high and rising. The problem was mainly in the distribution of reserves between Wall Street and Main Street. The proper response was to shift the distribution without changing the growth rate of the monetary base by lowering interest rates in a rapidly expanding economy. The result has been faster growth of money and output, more imports, and a booming stock market. The Federal Reserve has watched this surge in output without responding.

II. What Should Have Been Done?

More than a century ago, Walter Bagehot set out the proper response of a central bank to a market panic or crisis. Lend freely, against collateral at a penalty rate, he said. Bagehot did not complain that the Bank of England failed to follow that policy. In fact, his book discusses the success of the Bank's actions in previous crises. His criticism of the Bank is for failing to announce its policy in advance. Bagehot argued that panics and crises would be less severe, if the market knew the Bank's policy in advance. More than a century before economists and central bankers recognized the importance of expectations and credibility, Bagehot's classic work used this type of reasoning to improve crisis management. All central bankers should read, and reread, his book.

Bagehot's rule does more than manage the crisis effectively. It disciplines the central bank and separates liquidity problems from problems of solvency. Some central bankers deny that it is possible to make this distinction in the midst of a panic or crisis. That claim is false. Borrowers who have acceptable collateral and are willing to borrow at a penalty rate—a rate above the pre-crisis market rate—are solvent borrowers. Lending to them against collateral supports the market, avoids bailing out insolvent banks and financial institutions, protects the central bank and the public from losses, and alters the distribution of reserves without necessarily changing the total.

The Federal Reserve followed some main parts of Bagehot's rule in 1987, when it announced that the discount window was open. In 1998, it lowered rates and relied on monetary expansion.

One reason for the difference, I suspect, is that Long-Term Capital Management was close to failure in 1998. Bagehot's policy would have permitted the failure, if Long-Term Capital was insolvent. The Federal Reserve would have discounted actively for all solvent borrowers to prevent the failure from causing bankruptcies at solvent firms.

The difference of supplying reserves in different ways may seem slight, but the long-term effects are very different.
Preventing the failure of any large non-bank financial institution extends "too big to fail" in new directions, encouraging mergers to achieve the requisite size and encouraging excessive risk taking by financial institutions that reach that size. Discounting avoids these biases and implications.

To avoid misunderstanding, let me emphasize that the Federal Reserve did not use open market operations to rescue Long-Term Capital Management. But, if the Federal Reserve had relied on the discount window instead of open market operations, Long-Term Capital would have had to offer collateral to the Federal Reserve or would have failed.

Size is not the only criterion the Federal Reserve uses to decide which firms live or die. Subjective judgments enter. In an earlier period, Drexel, Burnham, Lambert was allowed to fail. Markets stabilized after the failure. Drexel Burnham’s so-called junk bonds had a bad press. Its competitors wanted, and soon after took over, its market niche. Long-Term Capital had a former Treasury and Federal Reserve official among its principals. I do not claim that this difference influenced decisions. No outsider can be certain; I want to be explicit that I have no reason to question anyone’s integrity and no interest in doing so. My point is different. Following Bagehot’s rule avoids such problems and is no less effective.

III. What Should Have Been Done Abroad?

Earlier, I distinguished between countries with sound and fragile banking systems. The largest, most costly and enduring problems in Asia occurred in the latter group. One lesson to be drawn from this experience is the need to improve the safety and solvency of banking systems. No one disputes this conclusion. Differences arise when we consider how to produce this desirable change.

One way, chosen by the IMF, the World Bank, the U.S. Treasury and other governments ties lending to promises of reform. Countries receive loans conditional on their promises to reform. Evidence on the success of this method is very mixed; the IMF, the World Bank and other international institutions have not, and I believe cannot, produce evidence that their lending conditions constrain countries’ behavior.

In a joint paper, Charles Calomiris and I recommend that IMF lending be restricted to crisis lending for countries that have sound banking systems. The criteria for soundness are a few observable requirements. Principal among them are (1) that private lenders, mainly financial institutions, must accept the risk that a bank will fail by holding uninsured claims and (2) foreign banks must be permitted to compete in local markets to reduce risk by diversification. Also, greater reliance on fluctuating exchange rates would help to shift some of the costs to the lenders.

It has long been accepted that risk is reduced in domestic financial markets if a lender of last resort prevents occasional market panics from becoming economic crises. The same would be true of international lending, if the IMF were a properly designed stand-by lender. The problem is to design a system that reduces risk to a minimum and assigns costs appropriately to both lenders and borrowers.

The present system does not do that. The costs borne by Mexicans, Thais, Koreans, and others have been disproportionately large. The costs borne by investors in emerging market equities have been large also. Banks and financial institutions that have been repaid out of the proceeds of IMF loans have avoided losses disproportionately.
The current system distorts financial flows. It encourages short-term capital flows that the IMF protects at the expense of other types of investment. It perpetuates weak banking and financial systems and government direction of lending to favored firms and industries. It too often looks the other way when it finds corruption and favoritism.

These problems will not be remedied by exhortation or goodwill. Incentives are far more powerful than exhortation. And diversification is more effective at reducing risk than any system of regulations and supervision that has been devised.

Whatever the merits of the Bretton Woods System may have been in 1944-45, the institutions created there were designed for a pegged exchange rate world with modest private capital flows. Neither premise—universal pegged exchange rates and modest private capital flows—characterizes today’s international financial markets. International institutions must be redesigned to reduce risk and contribute to stability under current, and expected future, conditions.

Footnote

'Charles Calomiris and Allan H. Meltzer, "Reforming the IMF." The National Interest (forthcoming), 1999.'
### TABLE 1

Short-Term Interest Rate Spreads*

<table>
<thead>
<tr>
<th>Period</th>
<th>Peak Spread</th>
<th>Change to Peak Spread**</th>
<th>Months to Return***</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969-71</td>
<td>1.84%</td>
<td>0.45%</td>
<td>2</td>
</tr>
<tr>
<td>1973-75</td>
<td>4.40</td>
<td>1.80</td>
<td>2</td>
</tr>
<tr>
<td>1986-88</td>
<td>1.80</td>
<td>1.10</td>
<td>4</td>
</tr>
<tr>
<td>1997-99</td>
<td>1.13</td>
<td>0.53</td>
<td>2</td>
</tr>
</tbody>
</table>

*90-day AA commercial paper minus Treasury bill rate  
**Change in spread from two months earlier  
***Months until two months prior spread restored

### TABLE 2

Interest Rates in Four Crises

<table>
<thead>
<tr>
<th>Crisis Month</th>
<th>Change from Previous Month</th>
<th>Change in Following Month</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Paper</td>
<td>T bill</td>
</tr>
<tr>
<td>July 1970</td>
<td>+0.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>July 1974</td>
<td>+0.7</td>
<td>-0.3</td>
</tr>
<tr>
<td>October 1987</td>
<td>+0.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>October 1998</td>
<td>-0.2</td>
<td>-0.6</td>
</tr>
</tbody>
</table>

a = less than 0.5
CHART 1
Spreads between Short-Term Private Rates and Short-Term Treasury Rates, July 1998-November 1998
CHART 2

Change in International Asset Position of the US, 1995.I-1998.IV
(Private Assets Only)

Billions of Dollars


- Private Foreign Assets in the US
- Private Assets Abroad
CHART 3

Spreads between 3-Month Commercial Paper Rates and 3-Month T-Bill Rates, US

August 1969-August 1971

August 1973-August 1975

August 1985-August 1988

August 1997-March 1999
CHART 4

Annualized Monthly Growth, Nominal Base, US

January 1970-January 1971

March 1987-March 1988

February 1998-February 1999

January 1974-January 1975