Erkki Liikanen: External financing condition, the exchange rate and policy tradeoffs for central banks

Speaking notes by Mr Erkki Liikanen, Governor of the Bank of Finland, for the second high-level seminar of the Eurosystem and Latin American central banks, Rio de Janeiro, 26 November 2004.

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Let me start by saying that the debate on appropriate exchange rate regimes has been surprisingly lively over the last few years. My impression is that this debate is partly boosted by the fact that economic theory has proved to be rather lame in guiding policymakers on exchange rate regime choice and many countries have experienced severe foreign exchange crises in recent years. In this connection, the role of free capital movements in determining the performance of exchange rate regimes appear to have been at the core of recent policy discussions.

In the 1990s, too many economies, I believe, were victims of economic crises. The fall of tightly managed exchange rate regimes in East Asia, Russia, Brazil, Turkey and Argentina resulted in a massive decline in living standards in these countries. These crises also brought the issue of optimal exchange rate regimes to the core of the international policy agenda.

While there are no simple recipe for the optimal choice of a currency regime in any country, one can safely emphasise the importance of consistency within the exchange regime and its underlying macroeconomic policies and economic fundamentals. It is easy to agree with those who have pointed out that no regime can ultimately substitute for sound macroeconomic policies.

In this short talk I will try to argue that, in the current environment of high capital mobility, sound fiscal policy and the choice of exchange rate regime are even more important. I will illustrate my point by highlighting the general developments in emerging markets and by two examples from Finland's neighbouring countries.

I believe that free capital mobility is the key factor underlying not only the appropriate choice of exchange rate regime, but also understanding the recent crises in emerging markets. There is a broad consensus today that the sudden reversal of capital flows played a central role in triggering recent crises. Compared to more advanced economies emerging markets seem to be more prone to institutional and financial sector weaknesses. Consequently, they are less capable to manage these large capital flows. Capital flows often depend not only on domestic fundamentals and policy management, but also on external variables. Higher interest rates in the US or crises in other countries can bring about abrubt changes in financial conditions and trigger crises in emerging markets.

But domestic policy management is very important as well. Recent studies, including one made at the Bank of Finland, show that excessive borrowing by the government or private banks seem to be key reasons for the recent crises. Today - with free capital mobility - high level of indebtedness of the government or domestic banks make countries highly vulnerable to changes in investor confidence and may easily lead to sudden capital outflows and a subsequent crisis. Indeed, public debt, foreign indebtedness of banks or even M2 to reserves are all important indicators of crisis vulnerability.

Here I would like to stress the importance of sustainable fiscal policy. To illustrate my point, I would like to discuss the positive developments in Estonia. The country has used succesfully a currency board arrangement through the turbulent period in the 1990's. In Estonia, the average budget deficit was less than 1% of GDP in the period between 1992 and 2001, and the public debt level was only 4% of GDP. As the appetite for risk declined and many emerging market countries ended up in crises, in Estonia there were practically no assets from which the sudden capital outflows were able to occur. Indeed, Estonia even navigated nicely through the crisis in the neighbouring Russia.

Interestingly, Estonia - along with the two other Baltic countries - have all been able to combine 1) a fixed exchange rate, 2) liberalisation of the capital account before having a well-functioning financial system, and 3) very large current account deficits. At the same time they have gone through deep structural and institutional change. This raises an interesting question. How have they been able to manage such a combination that would usually be regarded as inconsistent?

In addition to sound fiscal policy, small domestic financial markets have been crucial. In Baltic countries there are hardly any inter-bank markets. The banking sectors have been sold to foreigners, and, consequently, banking supervision has been outsourced to a large extent. After the boom and bust of 1997, the Baltic stock exchanges have generally stagnated. Not only are these economies extremely small, but their degree of monetisation is very low. As mentioned, public debt is absent or very small. As a result, there are very few assets and markets for speculative capital flows in Baltic countries. Partially, this reflects sound fundamentals, but mostly it is an unintended consequence of policy decisions. Unfortunately, I don't know how easily these Baltic experiences can be repeated in other countries.

Let me continue with fiscal policy and by discussing another interesting example. Namely, the recent economic developments in Russia. The crisis in 1998 was mainly caused by excessive government borrowing. Before the crisis, budget deficits in Russia were between 5-12% and the public debt level exceeded 50% of GDP. Again capital flew away from government bonds and other Russian assets, and the crisis materialised.

But since 2000, the Russian government has run fiscal surpluses and the debt level has been decreased to less than 30% of GDP. Today nobody seriously predicts a currency crisis in Russia, and the economy has grown comfortably between 5 and 7% per year. Of course high oil prices have a played an important role. In fact the Russian authorities have used the windfall oil revenue fairly wisely. For example, the Russian authorities have recently established a oil stabilisation fund.

Our beautiful host country seems to be following a similar path to recovery. After the crisis in 1999, successive Brazilian governments have run up sizeable budget surpluses and the public debt level has been decreased. Maybe more remarkably, the authorities have improved the institutional framework of fiscal policy. The fiscal responsibility law and the voluntary fiscal commitments have improved the credibility of the fiscal policy nicely. Consequently, the interest rates have fallen, investments are rising, and GDP is growing satisfactorily by around 5%. Hopefully, this tight fiscal policy will continue now when the capital inflows and economic growth are recovering. If the fiscal consolidation continues and is imitated by others, this Brazilian success story will contribute positively to the stability of the whole region.

Given the capital mobility and the need for sound macroeconomic policy, how should emerging economies chose their exchange rate regime? Rigid exchange rate regimes may enhance monetary policy credibility and lower inflation with little costs particularly in countries with low exposure to international capital movements. But as a recent IMF study indicates, these economies are often developing countries.

Nevertheless, in emerging economies with relatively large financial markets and large capital movements, rigid exchange rate systems might be quite a risky choice. As we have seen, fixed and other rigid exchange rate regimes are highly vulnerable to sudden capital outflows and crises. Especially if the domestic fundamentals are not perfect.

Nowadays many emerging market countries have chosen a regime where the currency floats but the authorities, in practice, still target an exchange rate level. This fear of floating may well be a adequate exchange rate regime for many emerging economies. In these countries credibility is still low, dollarisation is high and the intermediation of monetary policy is unstable. But as the countries develop economically and institutionally, a more flexible exchange rate and proper inflation target may well represent a less costly regime choice.

To conclude, it is difficult nowadays to isolate oneself totally from external shocks and sudden capital movements. But the authorities in emerging markets can render their economies less vulnerable by running sustainable fiscal policies and choosing a suitable exchange rate regime. To build a sounder banking sector might be more challenging. Again it is very difficult to isolate the banking sector from capital movements, but the authorities can demand large capital requirements. Authorities could also supervise the currency mismatches in the banking sector properly. More capital and less foreign currency liabilities might render the economies less vulnerable to sudden capital movements and crises.