Workshop on Debt, Finance and Emerging Issues in Financial Integration

Financing for Development Office (FFD), DESA
8 and 9 April 2008

Crises and International Policy Coordination

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March 19, 2008

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The financial sector of the world economy seems utterly convinced that the world is currently descending into a major crisis. This crisis was clearly prompted by the financial sector and the practices that had come to flourish in it. The imbalances about which some of us had worried for some years, particularly the US current account deficit and the disequilibrating capital flows centered on the yen carry trade, have not in the event (at least up to this point) triggered a crisis. Can one still argue that international policy coordination should be a powerful instrument in avoiding crises, or does the form of coordination need significant reform to address new threats?

The plan of the present paper is as follows. It starts by examining the recent financial turbulence, and what contributed to it. This is followed by an analogous discussion of the global imbalances and how they have evolved in recent years, and of the threat that they have been perceived to pose. There is then a discussion of the yen carry trade and of the conditions that need to be satisfied for those who engage in it to make profits. The next section asks whether the past form of international policy coordination could have hoped to do anything about the dangers posed by these developments. The final substantive section asks whether any form of international coordination might be relevant to diminishing the risks of crisis, and if so what form of action would be called

[1] A paper to be presented at a UN Workshop on Debt, Finance, and Emerging Issues in International Financial Integration in New York on April 8-9, 2008. The author is indebted to Benu Schneider and Edwin M. Truman for comments on a previous draft, but absolves them of any responsibility for the opinions expressed.

for. A short concluding section summarizes and briefly considers implications for developing countries.

Financial Turbulence

As is well known, the current financial difficulties originated in the sub-prime market in the United States. This is a market where prospective home-owners who do not satisfy the traditional conditions for being granted a mortgage could hope to borrow to finance home ownership. The traditional conditions involved being able to put down a deposit of a fair proportion (traditionally 20%) of a house's value, and having a regular income that was some multiple (traditionally four times) of the value of the monthly mortgage payment, in order to qualify for a 30-year mortgage. Many of those who have been critical of what went on in the subprime sector are highly supportive of the aim of enabling those who are not in a position to qualify by the traditional criteria to start on the ladder of home ownership. The criticisms relate rather to the use of high-pressure tactics to persuade people to take out mortgages; the failure to emphasize to borrowers that the cost of the mortgage was due to increase in the future; the locking in of borrowers to larger mortgages than they were in a position to service comfortably on the basis of their actual income, or that they would be able to service when costs increased in accord with the terms of the loan; and reliance on increases in the capital value of the house to permit a mortgagor to take out a larger loan in the future which would enable them to maintain debt service.

Trouble started when house prices stopped rising and started falling, as should have been expected since booms do not go on for ever and the existence of a boom must have been clear even to central bankers (some of whom assert that they cannot be expected to identify bubbles). One of the mechanisms that had previously enabled borrowers to continue servicing debts that were large relative to their net worth then ceased functioning. Under old-fashioned financial arrangements this would have led to financial difficulties for the borrowers and some of the lenders that had made these imprudent loans, but lower earnings or at worst their bankruptcy would have ended the matter. Moreover, in many cases the lenders would have found it in their own interest to renegotiate the terms of the loan to enable the borrower to maintain debt service.

However, most of the mortgages had been sliced, diced, and packaged, and moved off the balance sheets of the originators. The credit rating agencies had bestowed their imprint of AAA status on many of the resulting securities, with only the junior tranches carrying higher interest rates and sold as involving much risk. As defaults rose many of the holders of the more senior securities found that, despite the AAA credit ratings, they stood to lose money. Worse still, financial intermediaries did not know where many of the losses would end up, and to avoid unpleasant surprises they aimed to stop lending even to counterparties that would normally have been regarded as rock-solid. The result was the seize-up in the interbank market. Banks (or other financial intermediaries) that had cash to spare hung on to it, so as to ensure that they would not suffer losses or illiquidity. The result was that banks that would normally have borrowed to balance their books found themselves either squeezed or forced into borrowing from the central bank.

The biggest disaster to befall a financial institution as a result of the seizing up of the interbank market occurred to the British provincial bank Northern Rock, whose business model was based on engaging in mortgage lending but borrowing a large part of the necessary cash in the short-term markets. Northern Rock had in fact made reasonably solid mortgage loans, but it was unable to continue raising the finance needed to balance its books. Thereupon the first bank run in British history for over a century ensued. This was not ended by a Bank of England guarantee, presumably because the British system of deposit insurance covered 100% of losses only for the first £2,000 and then only with the likelihood of a long delay in payment. The run was only stemmed by a Treasury guarantee of all deposits up to £35,000, to be paid within a week. After much delay, the authorities have now bowed to the inevitable and announced a decision to nationalize the bank, so that the public will benefit from any upside that may in due course emerge and not simply carry all the downside risk. (Unfortunately this action was not treated as a precedent by the US authorities when Bear Sterns faced bankruptcy.)

Many of the banks had increased their earnings by parking many of their AAA assets in special investment vehicles (SIVs), which were off their balance sheets and therefore did not carry a legal requirement to hold a certain percentage of non-earning, and therefore non-remunerative, capital assets. This would doubtless have been fine if the assets had really been riskless, since capital is pointless where this is the case, but when

they were downgraded the banks found that they would have had to pump in cash to keep their SIVs afloat. Legally they could have walked away from them, but they did not do so because the harm to their reputations would have been devastating. So many of them decided they might as well end the charade and take the assets back on their balance sheets. This naturally added to liquidity pressures, because these assets had to be backed by capital.

Many financial institutions suffered losses as a result of these developments, and a number of the chief officers of financial institutions have lost their jobs. Despite these facts, aggregate bonuses in the financial sector fell remarkably little at the end of last year. These bonuses now seem to have been consolidated as an expected part of the remuneration of those in the sector. One has to observe that the pay seems extraordinarily high in the light of the disasters that are so frequently generated.

In the months that have followed the outbreak of the crisis in August 2007, it has spread and deepened. While the first impact was on the mortgage and interbank markets, many additional assets have now been affected. The process of contagion seems fairly similar to that which has been observed in previous crises. A fall in the value of certain assets triggers (because of mark-to-market accounting) calls for increased collateral to be posted by those who have used those assets as collateral; to meet this obligation, the affected institutions are forced to sell other assets, whose prices therefore fall; and that in turn sets the stage for the further propagation of the crisis. Up to now, however, there seems to have been remarkably little fallout beyond the financial sector. (Construction is suffering, but it is not clear that it is suffering much more than it would have done anyway.)

Global Imbalances

The current imbalances involve a concentration of the major current account deficit in the United States and the corresponding surpluses in parts of East Asia and the oil-exporting countries. The latter reflect the recent increases in the oil price, and the IMF has argued that the oil exporters tend to eliminate most of their surpluses in due course. If that is right, it implies that the adjustment problem is essentially between the United States and certain East Asian countries. China inevitably comes to mind, but Hong Kong, Malaysia,

Singapore, and Taiwan also have highly-managed exchange rates and have been building up reserves, and are therefore natural candidates for adjustment. Japan is more debatable, since it also has a large current account surplus but allows its exchange rates to float. This floating has been reasonably free for the past several years, so it is sometimes argued that Japan does not need to adjust, but ought to be allowed to remain with the large surplus that reflects the savings preferences of its citizens.

How did the imbalances grow so large? In my view this was a joint result of the oil price, the East Asian crisis, a macroeconomic policy that reflected a determination not to have any prolonged excess supply in the United States, and the policy of a fixed dollar exchange rate by some of the East Asian economies. This led to chronic and prolonged undervaluation of several of the East Asian exchange rates.

Are the imbalances dangerous? There is a school of thought (e.g. Cooper 2007) that argues that since the imbalances have (at least up to now) been easily financeable they must be seen as in the mutual interest of deficit and surplus countries, and therefore they cannot be dangerous. At some stage the surplus countries will choose to consume or invest a larger part of their income, and at that time adjustment will be triggered, without any need to fuss about matters at this stage. The contrary view is that time consistency is not one of the abiding virtues of financial markets, so that what is accepted today may prove unacceptable if it is prolonged too long. One has to extrapolate into the future, and while it is conceivable that the markets may accept deficits that cumulate into massive debts, it is unwise to rely on this. The larger the debts become, the greater the likelihood of a crisis developing. At the same time, the arguments against initiating adjustment advanced by the “do-nothing” school are not convincing. There is, for example, the contention that adjustment would be paralyzed by the acute conflict of national interests that would be ignited. The main exhibit here is the export-led growth of China, which do-nothing advocates argue to be indispensable to rapid growth in China (e.g. Dooley, Folkerts-Landau, and Garber 2003). This is wrong, because it ignores the possibility of expanding domestic demand to fill the gap that would result from lower external demand. In fact, since non-tradables are more labor-intensive, one expects such a policy switch to lead to a faster fall in unemployment (including disguised unemployment in the countryside), which would be very much in the national interest of China.

What sort of crisis is it that is envisaged by those who are anxious to head off its likelihood? It is not so much that the Fed will be forced to raise interest rates in order to check the inflation following a dollar decline (a traditional interpretation), but that the US economy will suffer a crisis of confidence (e.g. Williamson 2008). This would involve an exogenous decline in investment (like in East Asia in 1997). It means that the US economy is not completely forecast by the traditional models. The dollar collapse would in due course bring expenditure switching to the rescue of the United States, but in the rest of the world expenditure switching would reinforce expenditure reduction in a deflationary spiral.

The gratifying fact is that the financial turbulence has not to this point ignited this particular type of crisis. Even though the financial turbulence was initiated by some of the securities into which funds flowed proving much less solid than investors had been led to believe, the investors mainly sought alternative dollar assets rather than switching out of the dollar altogether. Of course the dollar has fallen, and such a fall is a part of most of the doomsday scenarios, but this has not been associated with a loss of confidence that brings a major fall in investment.

The Yen Carry Trade

One of the facts about the present international monetary situation is that the yen has remained highly competitive (at least until March 2008) despite the fact that it is a freely floating currency, in whose market Japan has not intervened since March 2004. It is a part of the current macroeconomic equilibrium of Japan, which sustains the large current account surplus that transfers abroad the excess savings that find no home in Japan. The current account surplus prevents underemployment and a waste of resources in Japan, despite restrained domestic demand. The mysterious part of the picture is why the yen long remained at such a cheap (many of us would say undervalued) level.

The answer is of course to be found in the large capital outflow from Japan. In part this occurs because Japanese households recognize that they can get higher yields by buying foreign assets instead of Japanese assets. Presumably they recognize that they are taking a certain risk (of yen appreciation) in order to earn these higher yields, but with Japanese interest rates so low it is a reasonable decision. But in part the capital outflow is

caused by the yen carry trade (see Galati, Heath, and McGuire 2007 for an account of this). Foreign investors borrow yen at the low interest rates prevailing in Japan, then sell the yen in order to buy the currency in which they wish to invest, and then make the investment (at a higher interest rate, obviously). When the investment matures they expect to buy yen and repay the loan. They will make a profit on the series of transactions provided that the yen has not appreciated by more than the interest differential between the currency in which they invested and the yen, which they expect to do since they do not believe in uncovered interest parity. (If the investors covered they would lose their profit, since forward rates are determined by the interest differential.)

Two conditions must be satisfied for this activity to be profitable to investors. First, it is necessary that the foreign interest rate remains higher than the Japanese rate, which is not a big gamble. The second condition is that the yen does not appreciate too much relative to the currency in which they invest. This necessarily involves an element of gambling. No one knows how currencies will move in the future. The expectation is that at some date the yen will appreciate relative to just about all currencies, except the RMB and its satellites. The profitability of the yen carry trade is contingent on this appreciation not occurring while the carry remains open. If investors can rely on intervention slowing down any appreciation, the risks are much reduced.

It is not clear that the carry trade accounts for the dominant share of the capital outflow from Japan. There are no statistical data which provide a breakdown between capital exports by Japanese residents and the outflow of borrowed funds by foreigners. To the extent that the outflow represents a desire by Japanese residents to acquire higher-yielding (though more risky) assets than are currently available in Japan, it would be difficult to impede the flow without threatening the basic principles of capital mobility that have come to be accepted in the world economy. But to the extent that the capital outflow is generated by the carry trade, it is difficult to feel the same conviction that an interference with flows that appear undesirable would pose a similar threat to individual liberty. And there is no doubt that the flows being generated by the yen carry trade are widely regarded as undesirable: not only do they sustain the undervalued yen, but they are also instrumental in producing the highly overvalued rates of countries like New Zealand and Peru.

If one wishes to discourage the yen carry trade, one needs to increase the expectation that the yen will appreciate enough to wipe out the profitability of the trade. One way of doing this is for the Japanese government to diminish expectations that it will intervene if strong appreciation occurs. It could, for example, give a categorical undertaking that under no circumstances would it intervene before the yen hits a certain level. Perhaps a principal obstacle to making such declarations is the belief that fast currency changes are inherently destabilizing and therefore to be avoided, which points to intervention being undertaken exactly when the possibility of squeezing those in the yen carry trade is greatest. Someone who believes that the people in charge of intervention policy are worried by fast currency moves will be alert to the possibility of a sharp yen appreciation, and will rely on such intervention to bail them out if they sell promptly when intervention occurs.

What would be the macroeconomic implication if the yen carry trade were to be eliminated by such a change of policy? The yen would appreciate; the current account surplus would diminish; and the level of demand in Japan would decline. So long as the last consequence appears undesirable, it is necessary to accompany action to squeeze the yen trade with a willingness to expand demand in Japan. Corresponding changes would be needed in countries like New Zealand that have been experiencing strong capital inflows financed in part by the yen carry trade, which would therefore be forced to deflate demand when their capital inflows declined.

Traditional Policy Coordination

The literature on international policy coordination became very active in the late 1980s (see Bryant 1995 for a summary of what was argued), and actual policy coordination peaked at the time of the Louvre agreement of 1987. The idea of the policy coordination of the period was to have the seven major powers, which thought of themselves as a closed system, agree on demand management and exchange rate policies, so as to produce a set of consistent and mutually satisfactory outcomes. The objectives were internal and external balance, and the fear was that in the absence of policy coordination the countries with active exchange rate policies would choose exchange rates that would

deprive the residual country (the United States) of the ability to secure a satisfactory (sufficiently strong) payments position.

The main ground for opposing policy coordination at that time was a conviction that countries would never change their policies for the benefit of other countries. Such changes may well have been unrealistic, but they were not advocated by the more sophisticated supporters of coordination. What was envisaged was that each country would commit itself to abiding by a set of rules that it would expect to find advantageous in the long run. It might be that such a rulebook would require occasional sacrifice of short-run gains, but this is something that countries would be far more likely to find acceptable than sacrificing their perceived interests to those of others in a one-off agreement.

The idea of policy coordination went out of fashion as it was argued that the floating exchange rate system that had come into being meant that the exchange rate was not a policy instrument. Each country pursued internal balance as best it could, and passively accepted the exchange rate and balance of payments that was generated by the system. So far the world has stuck with this "system", though the results of it have at times been close to the limit of what countries have been willing to accept. If there is ever a real crisis that is clearly the result of these arrangements there will almost certainly be the desire to build something better, though the adoption of an alternative will surely depend upon the availability of a model perceived to be better.

While policy coordination was abandoned, the idea of surveillance persisted. Even if countries should not be expected to change their policies in the light of the wishes of others, it remained accepted that countries had a duty to bear in mind the interest of the global community in making their choices. Surveillance came in two forms, bilateral and multilateral. Bilateral surveillance involves the IMF raising questions with the authorities of individual countries about whether their policies are consistent with a satisfactory global outcome. A revision of the terms of reference for bilateral surveillance introduced last year requires the Fund to take into account the implications of each member's policies for the functioning of the system. However, since successful adjustment generally requires mutually supporting actions by several countries, one would expect multilateral surveillance to be of greater relevance. The Fund's initiative in this regard

involved the convening of talks among the five major players (the US, Euroland, China, Japan, and Saudi Arabia) with a view to their agreeing a set of policies that each would pursue and that would in due course achieve the desired aim. In the end the outcome of these talks proved disappointing, since each of the participants merely promised to persist with its existing policies and the IMF sanctified their inaction by publishing their G7-like promises.

It would be necessary to do better than this in order to achieve real policy coordination. In the first place, one might expect this to involve an attempt to plan where countries are going. There is not much scope to plan where output is going, since that is largely determined by the maintenance of internal balance, though there may be scope to marginally vary the investment ratio and other growth-input variables in the interest of spurring growth. There is more scope for choice over current account outcomes, which steers the evolution of external wealth. Second, this presupposes a determination to use all available policy instruments to pursue those targets. The main way in which this differs from current arrangements is that it would involve an attempt to influence the exchange rate. It should be taken as read that influencing the exchange rate is not the same thing as determining it, and that the latter is infeasible in the world as it is today. But influence is less ambitious and may be possible. It would presumably start with official announcement of a set of consistent target exchange rates. Given that it is now accepted that intervention is more likely to be effective when it is internationally coordinated (Sarno and Taylor 2001), which fact is most obviously explained by a willingness to be swayed by official actions when the official world shows itself to be agreed, one would expect such an official announcement to carry more credibility than the isolated announcements of recent years (e.g., “we believe in a strong dollar”).

Would a system that was based on these principles have helped head off the three sources of financial problems now threatening the world? I cannot see that it would have been of any relevance in preventing the financial turbulence. This has resulted from imprudent financial practices within countries, practices that ideally might have been diagnosed by FSAPs, although I am not aware of actual FSAPs having been concerned with these issues. On the other hand, it could have helped avoid the buildup of the global imbalances to their present threatening level, assuming that countries would have been

called on to manage their demand and to influence their exchange rates in a way that would have curbed the current account imbalances of recent years. Similarly, it would surely have called on (or maybe prohibited) Japanese intervention in support of a gross undervaluation of the yen, and would thus have given exactly the signal that it was argued above was needed to limit the yen carry trade. This would have given the IMF a central role in the process of avoiding traditional crises. For it to gain an equivalent role in the prevention of future episodes of financial turbulence, as appears to be envisaged (see the remarks of John Lipsky 2008), it would need to use future FSAPs in order to investigate the extent to which financial actors in the IMF's developed member countries were taking imprudent positions.

Can Policy Coordination Help?

If it is agreed that policy coordination of the traditional type could help address the problems of global imbalances and the yen carry trade, then any proposals for a reformed system could benefit by incorporating such provisions. But the fact that they would have missed completely the financial turbulence implies that it will be necessary to add something less traditional. What?

Let us go back and reconsider the turbulence and what caused it. It seems to me clear that the problems emerged from the sort of issue that regulators are expected to be aware of and take action to prevent. One might have hoped that regulators would have realized that unscrupulous salesmen were foisting unsuitable mortgages on borrowers who were likely to default when the going got rough, as it was bound to do. (The problem may arise from the fact that, at least in the United States, mortgage lending is unregulated.) Regulators should have prevented the resulting mortgages being securitized and distributed to a thousand lenders who had no idea what risk they were bearing, but thought they were buying a risk-free asset because it had been awarded an AAA-credit rating. They should have prevented banks setting up SIVs to avoid the need to hold capital against risks that had not really disappeared. There is also a question as to whether regulation that is undertaken by national governments is still adequate in the age of globalization.

The fact is that the regulators did none of these things, in some cases for the compelling reason that the activities were unregulated. Accordingly, this crisis appears to me to be principally attributable to failures in supervision. I am not saying that one cannot criticize central bankers for keeping the punch bowl available too long, but that failing seems to me to have been exaggerated compared to the failures of the regulators.

That conclusion may point to the irrelevance of the traditional form of policy coordination in generating this particular crisis, but it certainly does not point to the conclusion that international coordination is an irrelevance. To begin with, as pointed out above, different types of crisis are conceivable, and in some of them the traditional form of policy coordination is still highly relevant. But even the avoidance of this type of crisis is dependent on international coordination of regulatory principles. One reason for the easy regulation of recent years has presumably been the fear of driving financial business (and its profits, and its employment) abroad, perhaps to less well regulated markets. Even if this fear was not uppermost in their minds, it is a danger that needs constantly to be safeguarded against. The worst of all worlds would be if the financial firms took all their value-added abroad, but the fear of a financial crisis still drove the Fed to bail out a financial firm because of the consequences its failure would have for domestic activity.

It was not a fear of driving financial firms abroad that was directly responsible for the failures of regulation that caused this crisis, but in this day and age regulation can only hope to be effective if it cannot be evaded by a simple shift of location. Any regulation needs to apply to all the principal financial centers. The world has in fact created a mechanism to secure this type of consistency in regulation, which operates through the Financial Stability Forum located at the Bank for International Settlements in Basel. This was set up in response to the Asian crisis of 1997. It has established a Working Group on Market and Institutional Resilience that has been preparing a Report (to be completed by April this year) to the G7 Finance Ministers and Central Bank Governors. This has already issued Preliminary and Interim Reports (FSF 2007, 2008) on the subject of how to strengthen the system in response to the financial turbulence.

These two reports make it clear that the authorities are contemplating tinkering rather than fundamental changes. They take it for granted that securitization and the

originate-to-distribute model are here to stay[2]. International comparisons may suggest that this should not be taken for granted. In a recent speech, Anoop Singh (2008) of the IMF is reported to have said:

> It has helped that in many countries, including here in Brazil, regulatory frameworks have made it difficult for banks to either buy the kind of structured products that have been at the center of events in the United States or accumulate significant off-balance sheet exposures.

The Reports of the FSF are not as complacent in applauding the practice of parking assets off-balance sheet in SIVs as they are in endorsing securitization, arguing rather that the implementation of Basel II will in any event reduce the regulatory arbitrage that generated large off-balance-sheet risk exposures. But there is no discussion of potential additional sources of vulnerability: for example, many of those who have taken one side of the market in credit default swaps (like Bear Sterns) might not be able to afford to honor the liabilities they have incurred if many of them came into the money.

It seems to me that the recommendations of the FSF are unlikely to suffice to prevent further crises. One needs to ask whether securitization and the originate-to-distribute (OTD) model are worth preserving. If the answer is no, they could be eliminated by (joint) regulatory action. It is common to read assertions that there are great benefits from securitization (which would not be possible without OTD, so the two go together), but what are these? Presumably the main advantage is that borrowing is somewhat cheaper. This is not an inconsequential advantage, but if it is bought at the cost of a greater vulnerability of the financial system to crisis one needs to ask where the balance of advantage lies. The increased vulnerability to crisis is due to lenders holding less transparent instruments, the blunting of their incentive to restructure when times turn difficult, and the incentive of the loan originators to maximize volume even if this is at the cost of issuing shaky loans. The fact that securitization occurs implies that there are net *private* benefits to the financial sector, but if these rely on being bailed out of any difficulties by the official sector, the spread of securitization is hardly definitive evidence of net beneficial social effects.

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[2] FSF (2008) states that the Basel Committee will take account of "the calibration of certain aspects of the securitization framework". Later it remarks that "the underpinnings of the OTD model…need to be strengthened".

So far as SIVs are concerned, I am unable to perceive the social benefits. Rather than rely on Basel II to discourage these, it seems preferable to ban them. In any event, whether one still wishes to proceed with Basel II is itself open to some doubt.

The market for credit default swaps has not yet experienced a crisis, but the newspapers have referred to the possibility that if many of the credits that have been covered turn bad, then those who took that side of the market will be bankrupted and unable to honor the outstanding instruments. This would in turn mean that many of those currently holding credits that are guaranteed via credit default swaps would be obliged either to hold distinctly more risky instruments or else that they will be forced to sell. The possibilities of further intensification of the crisis are apparent. It is not obvious that one can do much to ameliorate this situation during the crisis, but in future one would wish to see supervisors ensuring that credits are guaranteed only by those who have the net worth to honor all the guarantees that they have made. The practice of treating this as a cheap way to earn fee income needs to be ended.

Concluding Remarks

This paper has argued that the prime responsibility for the financial turbulence that is currently afflicting much of the world is to be found in inadequate supervision. The authorities welcomed the process of financial intermediation, rather than recognizing its dangers and imposing rules that would have provided a counterweight to the greed that drives the private financial sector. Securitization and its corollary, the originate-to-distribute model, do have their advantages, but these need to be weighed against the dangers they inherently bring of an increased susceptibility of the financial system to crisis. There is no sign that any such appraisal is under way; the committee that is currently considering how to reform the system is instead proposing only modest changes. While it does betray recognition of the desirability of reining in SIVs, there is no similar recognition of the dangers posed by credit default swaps.

It is desirable that any changes be introduced essentially simultaneously in all the major financial markets, for otherwise there is an acute danger of the benefits of reform being lost due to regulatory arbitrage. If that is classified as policy coordination, then coordination is central to achieving a more robust system. The more traditional form of

coordination, in which the authorities of the leading countries commit themselves to pursuing a mutually consistent set of macroeconomic policies, remains of some importance, although its benefits lie in reducing the danger of a sort of crisis that has not yet occurred. The yen carry trade is one of the factors that contribute to the danger that this system will end up in crisis, and it would be addressed as well as seems feasible by a system of traditional-style policy coordination.

As long as this remains overwhelmingly a financial crisis and does not lead to a severe economic slowdown, the widespread adoption of prudent macroeconomic policies by emerging markets in the past few years should enable them to ride the crisis out. It is only if the financial weaknesses led to an important slowdown in the world real economy that one has to fear a major impact on emerging markets and developing countries. To date there is not evidence of such a major slowdown. Most indicators of the real economy remain rather strong. This is less true in the United States than elsewhere, but one of the thrusts of US policy has been expansionary actions on both the fiscal and monetary fronts, and it is only if these—and the improvement in the foreign balance as a result of the dollar depreciation—are overwhelmed by further financial problems that emerging markets would be likely to suffer. In Europe there has been a slowdown, which happened because of the financial turbulence rather than because of higher interest rates, but it is doubtful if there was much net increase in slowdown as compared to what otherwise would have occurred. In Asia there is still little sign of a slowdown at all. The chances of avoiding a major slowdown appear quite good.

What can emerging markets and developing countries do if, despite the current outlook, a major slowdown occurs? They could do rather more than in the past, because of their stronger current position. Many of them should be able to avoid taking deflationary actions and thus actually reinforcing deflation, as they have often been obliged to do by past collapses of confidence. Some have actually built up reserves and shown sufficient fiscal prudence that they would be able to adopt expansionary policies. Few need fear a big deprecation of their dollar exchange rate, which has in the past imposed severe deflationary pressures, at least in the short run. The outlook this time around appears much less gloomy than in the past.

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