

***“CONTAGION IN EMERGING MARKETS:
WILL NEXT TIME BE DIFFERENT?”***

GAZİ ERÇEL

Governor

The Central Bank of Turkey

Prague, September 24, 2000

As John Wilmot says, “Before I got married I had six theories about bringing up children; now I have six children and no theories.”

Before we observed crisis in Latin America, South Asia and Russia, we had several theories about crisis in financial sectors. Now, we have several countries deeply affected from the crisis and no theories but experiences. One definition of experience is that she is a hard teacher because she gives the test first and the lesson afterwards.

Particularly, the series of crises in emerging market economies in the late of 1990s has served as an empirical laboratory for distilling lessons for policy-makers.

On the other hand, contagion and vulnerability are inevitable mainly because of the globalization process which grows with the integration of markets for goods and services. We are going to be one integrated and competitive one market.

Taking into account of both accumulated knowledge from crises and risk reduction policy orientation in a global world, emerging market economies, industrial countries and investors have different responsibilities and policy orientations.

In general, the reasons for the contagion can be divided into two groups:

1) Fundamental reasons: common reasons related to unsustainable macroeconomic policy orientation or global shocks such as major economic changes in industrial countries that can affect commodity prices, interest and exchange rates, trade links and financial links.

2) Investor's behavior, whether rational or irrational, may leads to shocks spilling from one country to another.

In my view, the emerging markets should take actions in the five following areas to reduce their vulnerabilities to external contagion:

- External liability management
- Exchange rate systems
- Structural reforms in the financial system.
- Transparency of the data
- Credibility

The coordinated work of external liability management, exchange rate system and structural reforms in the financial system is necessary to be protected from financial contagion.

External liability management: Although international capital flows have contributed enormously to the growth and prosperity of countries, excessive capital flows, especially short-term liabilities, have become a major factor in international financial crises. Currently, the amount of short-term debt or the ratio of short-term debt to foreign exchange reserves are shown as one of the leading indicators of recent crisis. For that reason, effective monitoring and managing of external liabilities could reduce countries' vulnerability to crises and lead to more stable and prosperous global economy.

This issue has been discussed in G-20 meetings and, it has been agreed that comprehensive strategy for prudent

external liability management would include effective management of public sector liabilities, appropriate consideration of the external position of private sector and coordination of monetary and regulatory policies in certain areas.

Exchange rate system: The adoption of an appropriate exchange rate system can greatly reduce the crisis risk. Recent financial crises showed us that a soft fixed exchange rate system is not appropriate. The fixed exchange rate system contributed to the spread of the Tequila crisis and, together with highly leveraged institutions, has been shown as the cause of spilling financial contagion from Russia to Latin America. Now, a new consensus seems to merge the two extreme exchange rate systems, flexible exchange rate system and hard fixed system or in other words, currency board.

As we already know there is no unique exchange rate arrangement that is suitable for all the countries or one country at all times. Also, we have to distinguish between exchange rate regime as a component of a temporary stabilization program or the choice of a permanent exchange rate regime. Moreover, we have to take into account appropriate monetary policy with exchange rate regime. Arguments in the exchange rate regimes in the emerging market countries clearly indicate that strong recommendations on the choice of exchange rate regime are difficult to make.

Now, I would like to mention the Turkish case, which is a good example of a unique exchange rate regime.

Within the context of the disinflation program supported by a Stand-by Arrangement for three years, **we announced our monetary and exchange rate policy principles for the next three years at the end of 1999.**

According to the program, in the first 18 months, the exchange rate basket which was composed of 1 US dollar + 0,77 EURO has been announced on a daily basis covering one-year period. A pro-active role was assigned to monetary policy based on a reduced rate of exchange rate depreciation in line with the targeted inflation, providing a nominal anchor for inflationary expectations. The exchange rate commitment was supported by strong fiscal adjustment and consistent income policies in the government sector.

Pre-announced exchange rate mechanism were to bring credibility to government's efforts which was in fact the most important variable affecting the overall market sentiment. It was also believed to be the most appropriate tool to break inflationary inertia. The pre-announced quarterly targets would create market confidence to adopt the official inflation target, which in turn would help to lower the inflation rate.

To avoid being locked in the rigid monetary framework beyond the disinflation stage, a pre-announced exit strategy

had been incorporated into the program. The transparent, forward-looking exit strategy would allow increasing exchange rate flexibility over the time within a predetermined path and a specific time horizon.

The gradual shift towards a more flexible exchange rate regime (with widening symmetric bands around the pre-announced exchange rate path) would be introduced in July 2001. This band will be gradually enlarged, as the total width of the band reaches **7.5** percent by the end of 2001, **15** percent in mid-2002 and **22.5** percent at the end of 2002. During the "band" practice, the central bank would scrutinize exchange rate fluctuations as long as they would stay within the "band" and would use interest rates more actively in order to provide stability in the market. This program could be described as a quasi-floating exchange rate regime.

The sequencing for the exchange rate mechanism, i.e., the transition from relatively fixed to increasingly flexible exchange rates, represents a credible approach to the trade-off between inflation reduction and competitiveness. The program correctly assumes that an exchange rate-based stabilization approach supported by fiscal and income policies is the most convenient approach to breaking inflationary inertia decisively at the beginning. Later the preferred choice is a quasi-floating exchange rate system.

I do hope that our new exchange rate practice would be an appropriate solution for other countries.

Structural reforms in the financial system: The financial structure should be diversified. The development of capital markets is essential for the existence of long-term instruments. The stock market development is necessary to protect minority shareholders' rights. Prudent regulation and supervision improves the soundness of the banking system.

Transparency of the data: Lack of adequate and accurate statistical information on the economy and financial system may increase the severity of crises. The release of timely and adequate information contributes to well-functioning financial markets and increases investors' confidence in the markets. In this way, irrational investors' behavior that may cause contagion may decrease.

Credibility: Maintaining and enhancing credibility of macroeconomic policies and related institutions are essential not only to reduce the effect of contagion but also to differentiate the country from others which are less credible.

How could the industrial countries, international community and private creditors minimize their contribution to financial contagion? Recent crises also have shown us that domestic policies may not be able to cope with external contagion by themselves. So, industrial countries and international financial institutions are expected to play an

important role in preventing and managing financial contagion. Sharp and sudden changes in industrial countries' economic policies can create global shocks in the world economy. Hence, they should try to avoid such radical policy changes for the sake of global economic stability.

In addition, the international community could help minimize financial contagion in the following ways:

- development of international financial standards and codes of conduct to improve transparency and accountability of economic policies of emerging markets. The adoption of international standards would help countries identify their institutional weaknesses and take corrective actions earlier.

- the provision of liquidity to crisis countries through different policy instruments. This can be achieved through international financial institutions or the private sector

Within this framework, the international financial architecture is aimed at reducing the risk of contagion. A stronger and more stable international financial system will make the world less vulnerable to financial crises. The IMF and other international financial institutions have already made significant progress towards increasing the transparency of economic information that the government and other institutions make available to the public and towards implementation of codes of good practices to ensure that economic policies function properly.

Given these parameters, the Basel Committee prepared the Core Principles for Effective Banking Supervision, the IMF prepared Special Data Dissemination Standards and Code of Good Practices on Transparency in Monetary and Financial Policies, the International Accounting Standards Committee (IASC) prepared International Accounting Standards, and the International Organization of Securities Commissions (IOSCO) prepared Objectives and Principles of Securities Regulation. The implementation of international standards by emerging markets is very important for crisis prevention.

Moreover, the IMF started to provide Contingent Credit Lines (CCL) that are available to member countries with strong economic policies in order to prevent problems that might arise from financial contagion.

Now, the international community is working on other topics to increase the strength of the international financial system, for example the Financial Sector Assessment Programs, which help countries to develop and implement strategies to manage external liabilities and prepare a framework for private sector involvement in prevention and resolution of crisis.

Consequently, all related and responsible parties should work closely and develop sound policies and practices in order to avoid severe contagion.

