



# The Challenge of Financial Instability

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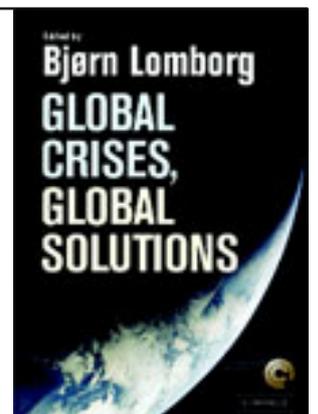
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**Comments on: Financial Instability**  
**by Barry Eichengreen**

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The paper by Eichengreen provides a masterly overview of our understanding of financial instability. It advances four proposals, three of which serve as strawmen to provide support for the fourth one, previously presented in Eichengreen and Hausman (2003). Given the impressive costs of financial instability presented in the early part of the paper, support for the Eichengreen and Hausman (EH) proposal should be nothing else but enthusiastic.

My assessment will be less enthusiastic. I will argue that the EH proposal is a good idea, one of many similar recent proposals to “complete incomplete markets”, but that it is not the panacea that Eichengreen makes it look like. In particular, I will argue that the benefits of the proposal are lower, the costs higher and the net benefits considerably more uncertain than asserted. I will also provide an alternative that shares with the EH proposal the intention of creating a missing market – an insurance market – as well as the use of CPI-indexed bonds.

## **1. Methodology**

The paper provides numerous estimates of the costs of financial instability and of the net benefits of proposed remedies. These estimates are based on existing studies rather than on new purpose-built models. This is a sensible strategy. Eichengreen correctly notes that large scale models unavoidably rest on an unknown but large number of assumptions that cannot be assessed. He might have added that when these models are statistically estimated, the estimating procedures are usually open to serious criticisms that force us to be highly skeptical; as a result, the standard errors of the estimates are usually very large, in fact larger than their authors indicate (when they report any standard error at all). This is why a tendency is not to estimate models but to calibrate them, using “plausible” numbers; unfortunately it is impossible to evaluate the relevance of these numbers and the associated standard errors. The results may look precise, but we know they are not.

Eichengreen’s approach is to draw on the literature to obtain estimates used for simple calculations. This procedure has three advantages: it is transparent (in a limited sense, see below), it does not pretend to be precise, and it allows to scan the range of plausible estimates. These advantages should not be exaggerated, though. Its transparency is limited; unless we carefully read the relevant papers, we do not know which assumptions are made by the primary estimate authors. Nor do we know how precise the estimates are

when several studies are combined, as is the case in Eichengreen's paper. The solution would be to provide upper and lower bounds of the estimates found in the literature. Eichengreen instead selects those estimates that he regards as reasonable. In the end, therefore, the paper falls in the trap that he wants to avoid, giving a misleading sense of precision even though, to his credit, he does not present many decimals. This is specially the case for the crucial net benefits/costs of various proposals, obtained by netting out estimates each of which is subject to sizeable standard errors.

## **2. The costs of financial instability**

### 2.1. Principles

The paper correctly notes that instability is part and parcel of financial markets. It briefly discusses the reasons for the phenomenon, essentially the fact that financial markets are necessarily forward looking. This features puts uncertainty at center stage, including the volatility of expectations, moral hazard, adverse selection, all of which result in phenomena like herding and bank runs or crises, credit rationing and original sin, multiple equilibria that result on self-fulfilling crises and gambling for resurrection.

These observations provide a fundamental rationale for public intervention. Eichengreen correctly notes that such interventions can either improve or worsen the situation. This is a ubiquitous consequence of the second best theory: removing some failures while others exist, in both financial and other markets, does not necessarily result in an improvement. But then he tends to forget the lesson when mooted his own proposal.

These observations are not controversial. They set the ground for the hard part: how bad is financial instability and what is to be done about it? The answer has to be informed by empirical estimates, which were many controversies lie.

### 2.2. The empirics of financial markets

Dealing with financial market failures calls either for the suppression of financial markets or for their regulation. Many developing countries have suppressed financial markets – as did many developed between 1945 and the early 1980s. The question is whether the cure is worse than the symptoms, i.e. whether man-made policy distortions hurt growth more than the market distortions that they intend to suppress or attenuate.

The literature on this question is voluminous, yet it does not yield clear-cut answers. Eichengreen provides a nearly exhaustive overview of the literature on the effects of capital account restraints, some of which is summarized in Tables 3 and 4. He correctly breaks down the question into two parts: what are the effects of policy restraints on financial market development? And what are the effects of financial development on the growth performance? His own assessment is that capital account restraints do prevent financial market development, which can be restated as saying that these policies are effective, and that financial development boosts growth. I find this conclusion too sharp for five reasons that Eichengreen in fact acknowledges:

- a. Studies that bypass the development of financial markets, for example those that try to estimate the effect of financial liberalization on growth, vary greatly on whether the effect is positive or negative, as a quick look at the paper's Table 3 readily confirms.
- b. Eichengreen slips from financial liberalization to capital account liberalization, i.e. to the external component of the process. However capital account liberalization is often part of a larger liberalization move, a change in domestic politics which includes not only domestic financial liberalization but also goods market liberalization, possibly associated with similar moves on the labor markets. Few studies are careful enough to attempt to disentangle the effects of these simultaneous moves, so that it is not clear what is the source of enhanced growth and, at any rate, the effect of capital liberalization can be exaggerated.<sup>1</sup>
- c. The results, quoted by Eichengreen, that tend to show that the benefits from financial liberalization mostly accrue to already relatively well-off countries further underlines the importance of taking into account a broad array of policies and of being very careful with causality as distinct from simultaneity. Economic growth tends to cause the development of domestic financial markets, which in turn raises the likelihood that capital account liberalization will boost growth. Put differently, is it capital account liberalization that causes growth or growth that makes it possible to dismantle capital controls? The empirical literature is obviously concerned with the causality question but the verdict is not available yet.
- d. Much of the literature on capital account liberalization shows that such a move is often followed by a currency crisis, sometimes also including a banking crisis, before favorable effects set in. Thus, timing matters a great deal in passing judgment. Long run effects may indeed be favorable but the early costs can be huge, as documented in Eichengreen's paper.
- e. Crisis episodes are typically associated with huge income and wealth redistribution, with widespread increases in poverty. Inequality is a topic too often overlooked in aggregate studies. In the present case, beyond their traumatic implication on well-being, sudden and widespread increases in poverty may lead to long-lasting effects, including deep political opposition to liberalization.

### 2.3. Financial instability and crises

The main theme of the paper is that reducing financial stability is a big-ticket item that ought to be on the Copenhagen Consensus. Yet, it quickly restricts its attention to the need to eliminate banking and currency crises, shown to involve large costs. Eichengreen is well aware, of course, that crises are just one symptom of financial instability, which suggests that overall instability is even costlier.

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<sup>1</sup> Among those that do, see Arteta et al. (2003) and Bekaert et al. (2001).

Focusing on one aspect of financial stability is understandable. Some degree of instability is, as previously noted, unavoidable; indeed, the function of financial markets is to absorb and price unavoidable pre-existing uncertainty. Not only it is impossible to eliminate this amount of unavoidable volatility, it is also undesirable. Indeed, countries that lack financial markets usually exhibit a high level of output volatility that affects the population at large while financial market volatility, when moderate, affects agents that are better equipped to deal with its consequences. Since we are unable to separate out unavoidable and intrinsic volatility, and therefore to draw a border between unavoidable and excessive volatility, focusing on banking and currency crises may make sense. This will be the case under two conditions: 1) that crises reflect intrinsic financial market instability; 2) that it entails the bulk of the costs of financial instability. Unfortunately, neither condition is met in practice.

Eichengreen identifies four classes of explanations for crises: unsustainable macroeconomic policies, fragile financial systems, institutional weaknesses and financial market failures. The first and third explanations refer to policy mistakes and are unavoidable as far as financial markets are concerned, the second and fourth are generated by the markets themselves. How many crises and much cost is explained by policy mistakes has not been studied. A ballpark guess is that mistakes lie behind most crises but not necessarily the costlier ones. Thus Eichengreen's focus on crises may be a poor proxy of financial instability as far a frequency is concerned while capturing a significant share of the costs.

#### 2.4. Overall

In assessing the net benefits of the proposals, the paper uses estimates of the financial restraints on financial market development, and the effects of financial market development on growth. The literature finds both effects to be significant, but it also finds that the direct effects of financial restraints on growth are ambiguous.<sup>2</sup> This high degree of imprecision should be reflected in the calculations, for example by presenting a range of estimates drawn from the extensive survey of the literature that is presented.

In assessing the costs of financial instability, Eichengreen focuses on banking and currency crises, partly because it is impossible to draw a border between unavoidable and avoidable instability, partly because this is where the literature provides estimates. While reducing the frequency and impact of crises is certainly an opportunity to provide the world with massive welfare and economic gains, this focus directs attention to only parts of the policy challenge that financial instability poses. In so doing, it may lead to misestimate the net benefits of the four suggested proposals and, quite possibly, to ignore other proposals. For example, the first two proposals (re-regulate financial markets, re-impose capital controls) stand to bring more benefits and more costs than suggested in the paper, with an uncertain impact on the balance.<sup>3</sup>

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<sup>2</sup> As noted by Eichengreen, these findings are not necessarily contradictory. The second best theory provides a quite plausible interpretation.

<sup>3</sup> In estimating the net benefits of re-regulation, Eichengreen only looks at the gross benefits of eliminating banking crises while he looks at the overall costs of financial repression. The same applies for the re-

### 3. The Eichengreen-Hausmann proposal

#### 3.1. The currency mismatch problem

The EH proposal addresses the currency mismatch problem. There is no doubt that the developing countries' inability to borrow in their own currencies is a major source of financial and economic instability. Not only is currency mismatch the source of many currency and banking crises, its impact is pervasive throughout developing countries.<sup>4</sup> It leads many countries to accumulate huge amount of unproductive foreign exchange reserves, in effect preventing them to become net borrowers, thus wiping out a key benefit from financial liberalization. Eliminating currency mismatch is therefore a serious challenge candidate for the Copenhagen Consensus.

There is some debate on the causes of the currency mismatch problem. One view, defended by Reinhart et al. (2003), is that markets have learnt to be cautious with countries that have a history of inflating away their debts, an easy way of *de facto* defaulting. A related view, presented by Goldstein and Turner (2003), is that poor public and private governance provides insufficient protection to international investors contemplating lending in the domestic currency. These views imply that solving the currency mismatch problem is matter left to the developing countries: they should adopt sound institutions and be patient. In a series of papers, Eichengreen and Hausmann have developed an alternative interpretation. They argue that the problem lies instead in a market failure. Characterized by entry costs and network externalities, financial markets limit their attention to a handful of international currencies. The others are simply kept out, with no chance of overcoming their late-comer and small-size handicaps. The EH view implies that a public intervention is justified, that it is desirable given the size of the expected benefits, and their proposal is a one way of dealing with the problem.

It is too early to determine which side of this fledgling debate is right. In fact the two are not mutually exclusive and each may hold some explanatory power. To borrow an example provided by EH, it is troubling that a country like Chile, which has put in place solid domestic institutions and has built up an impressive record of good policymaking, still cannot borrow in its own currency. On the other side, many countries are just bad risks with poor rating; they are barred from market access, in any currency, like any other bad risk. The currency mismatch problem therefore affects a limited number of emerging market countries with proper governance structures. Table 3 in Eichengreen and Hausmann (2003) provides a list of the 22 largest countries whose currencies would be

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imposition of capital controls, except that Eichengreen his calculation of the gross benefits is based on the elimination of currency crises.

<sup>4</sup> For instance, Brazil faced a rapid currency depreciation and a massive increase in its interest rates in anticipation of the late 2002 election of Ignazio Lula da Silva to the presidency. The original sin translated these understandable market reactions into a sudden increase of the public debt that forced the newly elected administration to adopt tight fiscal and monetary policies, avoiding a crisis but bringing the Brazilian economy to a standstill for more than one year.

promoted by their proposals:<sup>5</sup> it is doubtful whether countries like Argentina, Indonesia, Turkey or Venezuela, to name a few, would be able to borrow even in the absence of a market failure.

In addition, the EH interpretation, plausible as it may be, needs detailed scrutiny. Are fixed costs and network externalities large enough to explain the currency mismatch problem? Two counter-examples spring to mind. First, most currencies that are not subject to strict capital controls, are freely traded on exchange markets. These markets many not have the depth and breadth of the major currencies, yet they are reasonably efficient. Second, stock markets deal in thousands of large and medium-sized firm shares with no apparent difficulty. The key in these markets is that floating shares is subject to strict rules edicted by the local regulator. Even firms from “exotic” countries are able to raise resources on US exchanges through the specially created American Depository Receipts (ADR) facility. Nothing prevents regulators in the major markets to specify a set of rules that borrowers would have to fulfill to issue debt in their own currencies. That this has not happened yet, in spite of the potential for a large market, could be due to fixed costs and network externalities, as EH argue, but suspicions about policy management in the developing countries must also loom large.

### 3.2. The proposed solution

Under the assumption that the currency mismatch problem is a symptom of a missing market due to fixed costs and network externality, the policy objective is to jump start this market. The task requires defining the product that will be traded and finding willing market participants, possibly offering a temporary subsidy to overcome the fixed costs. This is precisely how Eichengreen frames the fourth option.

#### The EM index

The asset to be dealt with is a synthetic unit of account, the Emerging Market (EM) index. This index would be a weighted average of some twenty countries’ exchange rate corrected for the CPI ( $P_i/E_i$  where  $E_i$  is country  $i$ ’s dollar exchange rate and  $P_i$  its CPI).<sup>6</sup> The EM index has a number of important advantages:

- from the lender viewpoint, the dollar value of the debt is protected from inflation in the borrowing countries as long as the exchange rate depreciates proportionally ( $P_i/E_i$  remains constant). Inflating away the debt is therefore impossible unless the national authorities are able to sustain for a long time an overvalued exchange rate. Since exchange rate overvaluation is costly for trade reasons, the incentive to do so is weak.

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<sup>5</sup> The 22 countries are, by declining GDP weight: Brazil, Korea, India, Mexico, Argentina, Indonesia, Turkey, South Africa, Thailand, Poland, Singapore, Malaysia, Israel, Colombia, Philippines, Chile, Venezuela, Pakistan, Peru, Czech Republic, Hungary and Uruguay.

<sup>6</sup> Let  $b_i$  be the local currency real debt. Its local currency nominal value is  $b_i P_i$  and its dollar nominal value is  $b_i P_i / E_i$ . The dollar real value is  $(P_i / E_i P^*) b_i$ . Note that the nominal exchange rate  $E_i$  is defined as the number of local currency units needed to purchase one US dollar.

- from the borrower point of view, the debt is fixed in real terms, which means that the instability associated with exchange rate fluctuations – the main problem associated with currency mismatch – is eliminated.

- bad policies that lead to long term real exchange rate depreciation ( $P_i/E_i$  decreases) reduce the dollar value of the index, providing incentives to lenders to closely monitor their customers, much as shareholders do with the firms that they own.

- the Balassa-Samuelson effect implies a long term real appreciation ( $P_i/E_i$  increases), allowing lenders to share in productivity gains in the developing countries, again setting the incentives right.

- as a weighted average of some twenty countries indices, the EM is bound to be more stable than any single country index. This is partly the result of the law of large numbers, but EH claim that it also follows from complementarities between developing countries. At any rate, the relative stability of the index means less risk for the lenders and therefore a lower interest charge, another benefit to the borrowers.

EH also claim that the index has nice cyclical properties. This would be the case indeed under the assumption that the real exchange appreciate during expansions and depreciates during recessions. They do not provide evidence, however, that this is the case.

### Creating the market

The proposal envisions the IFIs, especially the AAA-rated World Bank to kick start the market. The Bank would acquire a portfolio of national real bonds in the proper (GDP weights) proportion and simultaneously borrow in the synthetic bond that corresponds to the EM index. Thus the Bank would not incur any currency mismatch, it would only act as an intermediary. It would incur a country risk, but that is already the case when it borrows and lends in dollars. The currency risk would be borne by the international investors who acquire the Bank's synthetic bonds but, as argued by EH, these bonds are quite diversified. The EM-indexed bonds issued by the World Bank would be traded on the markets. Over time the market would grow, possibly supported by the G10 countries, until the private markets take over.

Conceivably, therefore, breaking the currency mismatch problem could be had at no cost to the World Bank. Indeed, this is what one would expect from the creation of a missing market; it creates opportunities that did not exist previously, it is all benefits, no cost. Yet, prudently, EH suggest that the World Bank might initially subsidize the market as they suspect that its initial shallowness might lead to an interest premium of up to 500 basis points. Fully absorbing this premium, in order to avoid punishing the borrowers would still amount to a small cost relative to the gain of eliminating currency crises.

### 3.3. Limits

There is hardly any better economic action that can be done than creating *ex nihilo* a missing market. Economists do not usually believe in finding bank notes in the street, because they know that someone will have picked it up beforehand, i.e. they usually

assume that markets will have taken care of any potential opportunity of improving the needs of economic agents. Missing markets are of a different nature, but why are they missing? The economists' gut reaction is that there must be some good reason and that creating a missing market can be an expensive and risky undertaking. Is this presumption verified in the present case?

#### Higher costs and smaller and smaller benefits

The proposal's value critically depends on EH's interpretation of the currency mismatch problem. Let us suppose that they are wrong, that the reason for the missing market is that lenders fear that borrowers will succumb to perverse incentives and inflate away their local currency debts. This becomes impossible once the debt is indexed to the CPI. Indeed, many emerging market governments already issue domestic currency CPI-indexed debt precisely for this reason. Typically, these debt instruments are of a very short maturity and limited to local markets, a reflection of international lenders' fears of implicit default through inflation.<sup>7</sup>

That is not the end of the story, however. The case of Argentina, long a darling of the IFIs and of financial markets – a country that came close to adopt Eichengreen's third proposal – serves as a useful reminder that poor governance and policy mistakes must be factored in. As markets indeed factor in the perceived risk of default, the interest premium on the EM-indexed bonds will be large. This would have two unpleasant effects. First, it would restore much financial instability, in effect undermining the purpose of the scheme.<sup>8</sup> Second, should the World Bank actually carry on with the subsidy proposal, the costs could easily escalate by a considerable amount, even though the country risk premium is economically efficient and should not be subsidized. Worse, still, since the proposal concerns a basket of country debts, doubts about a few important countries would affect the whole index, hitting all the other countries and becoming a channel of crisis contagion.

If the costs might be larger than Eichengreen allows for, what about the benefits? Eichengreen computes the benefits by assuming that the proposal would eliminate crises. But not all crises are due to currency mismatch, which means that the benefits are overestimated. Crises are bound to continue to be a feature of the world economy, with or without the EH proposal. The possibility of contagion via the index, suggested above, further erodes the magnitude of the benefits that one should reasonably expect.

The risk of contagion may be even worse. So far I have assumed that all borrowing countries intend to dutifully fulfill their debt obligations, but let us assume that one important country included in the index defaults outright. What will happen to the index?

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<sup>7</sup> This begs the question of why a *domestic* market for CPI-indexed debt exists. The answer can either be EH's view that international markets are concentrated in a few currencies, or credit rationing by large investors (a classic case of adverse selection).

<sup>8</sup> In the case of Brazil mentioned in a previous footnote, interest rates on the CPI debts rose as much as interest on the exchange rate debts, by more than 1200 basis points.

Its value will decline and the interest rate will increase, which is likely to dampen the borrowers' incentive not to misbehave. As the markets follow this logic, the risk premium is bound to further rise, in turn affecting borrowing countries' incentives, in effect opening up the very kind of vicious circle that the currency mismatch creates. Being involved in the scheme, the IFIs – and the G10 governments that will have followed Step 3 in Eichengreen's proposal – will feel the need to intervene and dish out emergency support to the countries in the index, a group that represents 10% of world GDP. This, again, is bound to provide borrowers with perverse incentives.

Most countries left out

The proposal envisions starting with an index that covers 20 to 22 developing countries, chosen for being large, in line with EEH preoccupation with network externalities. Implicitly, therefore, the proposal will leave out the more than 100 other smaller developing countries not in the list.<sup>9</sup> The logic must be that decreasing returns to scale limit the ability of the IFIs to lend in local currencies to all countries. It may also reflect the observation that financial liberalization has positive effects on growth only in countries that have achieved a sufficient level of development.

One way out, suggested by Eichengreen, is that the regional development banks will follow the World Bank's lead and cook up their own indices, thus issuing local currency loans to more countries. Another possibility is that some of the currently emerging market countries will eventually break out of the original sin syndrome and be able to borrow directly in their own currencies, making room for the next layer of emerging market countries.

One difficulty with that view is that the countries left out will feel discriminated against and may object to the proposal. It is easy to anticipate arguments to the effect that the World Bank only helps the richest of the developing countries. Passing over their case to the regional development banks is unlikely to solve the problem. The network externality interpretation suggests that there might not be room for several EM indices. This reasoning means that drawing the border between the countries that benefit from the scheme and those that are left out, unavoidably an arbitrary decision, may be so contentious as to scuttle the proposal.

#### **4. An alternative: the creation of an insurance market**

Dealing with the currency mismatch problem is undoubtedly a worthy effort. Eichengreen's proposal is interesting and could make a useful contribution, but it rests on the view that the main source of the problem is a market failure. The alternative view emphasizes the perception by lenders that the risk involved in buying local currency bonds is excessive. Those who defend this second interpretation hasten to conclude that

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<sup>9</sup> It may be surprising that size is the criterion chosen by EH. An alternative criterion, which takes into account the alternative interpretation of the currency mismatch problem, could be the quality of national institutions, public and private.

there is no market failure and, therefore, no justification for a public intervention. Which interpretation is correct is currently being debated but it is worth noting that the conclusion that there is no market failure involved in the currency mismatch misses the fact that credit rationing is a feature of any credit market. Thus it may be that the adverse selection phenomenon associated with the perception of risk has shut down the market for local currency loans.

Assuming that both interpretations have some merit suggests a different approach, one which has already been advanced by the World Bank. Risk is normally dealt with through insurance. Yet, there is no private insurance market for developing country lending, even though many governments offer insurance for trade credit. Following Eichengreen's logic that the problem lies in a missing market suggests an alternative proposal: the public creation of an insurance market for local currency loans to developing countries.

Under this scheme, local currency loans would be provided by the private sector but lenders would purchase insurance against non-performing loans. That such an insurance scheme has not arisen spontaneously indicates that the risks are perceived too high. An international subsidy would therefore be needed to bring the cost down. The insurance could be provided by an international agency or by private insurers with access to subsidies (the World Bank could finance these subsidies). Evaluating the cost of such a subsidy is beyond the scope of these comments, but diversification could hold the tab down.

The weakness of this alternative proposal arises from the familiar moral hazard associated with any insurance scheme. Countries might overborrow, and lenders would be willing to oblige given that they would not bear the costs of borrower misbehavior. If misbehavior takes the form of inflation and currency depreciation, the EH idea of debts indexed to the CPI can be put to another good use: insurance would be available only for CPI-indexed loans. This would leave the borrower misbehavior to the case of overborrowing followed by default. In this case, the solution is the usual one, the imposition of a deductible component that would encourage lenders to act with prudence.

This proposal would eventually fulfill the central aim of the EH proposal, the emergence of a market for local currency loans. Once much of Brazil's debt, for instance, is issued under the proposed scheme, the insured debt instrument would amount to a size large enough for a market to emerge. A side benefit of the emergence of such a market is that it could be used as a guide for deciding when to terminate the insurance program: the elimination of a significant market-set risk premium would clearly show that the country has graduated to the rank of a regular local currency borrower.

## **5. Conclusion**

Eichengreen's makes a strong case that financial instability ought to be part of the challenges adopted by the Copenhagen Consensus. Its most visible manifestation alone, currency and banking crises, exerts a massive economic and human toll. Its less visible

manifestations, including excessively restrictive macroeconomic policies and booms followed by busts, probably add an equivalent amount to the total cost.

Eichengreen envisions four approaches to lessen financial instability. Re-regulating financial markets and re-introducing capital controls look bad under the assumption that financial liberalization raises growth. This assumption is popular but the empirical backing is still controversial, which means that estimates of the size of the effect are subject to large standard deviation. It would be desirable to provide a range of estimates of both the benefits – beyond reducing the incidence of crises – and the costs. Adopting a single world currency would eliminate currency crises but not banking crises and other manifestations of financial instability. The benefits are therefore less than those suggested by Eichengreen. Anyway, I fully concur with his judgment that this is an option whose time has not come, for a host of political and institutional reasons that a study of the European monetary union well illustrates.<sup>10</sup>

The fourth proposal is a novel idea, pretty much in line with current thinking and other proposals<sup>11</sup>: Eichengreen and Hausmann propose that the World Bank, followed by the G10 countries and assisted by the regional development banks, promotes the creation of a market for bonds indexed to the price indices of some twenty emerging market countries. The aim is to eliminate the currency mismatch problem, which has been found to lie at the root of many recent currency and banking crises in these countries. The proposal is ingenious and well crafted.

The immediate natural question is: why such a market has not been developed by the private sector? One view is that international lenders are suspicious of borrowers who have long story of poor repayment performance, largely because their public and private institutions suffer from poor governance. The solution would seem to encourage these countries to put their house in order. The other view starts from the observation that many countries with excellent institutions and a clean history of foreign borrowing still cannot borrow in their own currencies. This points to a market failure, and the EH proposal is to address this failure by having the IFIs create a missing market.

The author's evaluation of costs and benefits is inevitably subject to considerable uncertainty. To start with, under his own assumptions, it is hard to put precise numbers on the costs and the benefits of the proposal. In addition, he tends to overestimate the benefits and to underestimate the costs. Overestimation stems from the fact that eliminating the currency mismatch problem will not get rid of all currency and banking crises. It will only make them less frequent and probably less lethal. In addition, currency mismatch is not the whole story as far as financial instability is concerned. On the cost side, Eichengreen ignores a number of adverse side effects of the EH proposals. These side effects include high country risk premia that would be subsidized and contagion risk

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<sup>10</sup> In a nutshell : if the UK, Denmark and Sweden feel that they cannot join the euro area, how could they join a world monetary union?

<sup>11</sup> For references, see footnote 49 in Eichengreen's paper.

that would call for large scale interventions in an effort to salvage the market. In addition, the proposal would only concern a relatively small number of comparatively already well-off countries, making its political acceptance uncertain and certainly controversial.

An alternative proposal does not attempt to choose between the two competing explanations of the currency mismatch problem. It also observes the absence of a market, one that would provide insurance for local currency debts. This proposal is for the provision of subsidies to such insurance. Interestingly, it borrows for the EH proposal the idea that the countries affected by the currency mismatch would issue CPI-indexed bonds, this eliminating the incentive to inflate away their debts.

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