The Future of the International Financial Architecture

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When the crisis first struck Asia last summer, many viewed it as a confirmation of their favourite theories. Some drew the lesson that the crisis was the inevitable result of government interference in the economy, and that by destroying once and for all the "East Asian model", the crisis proved that free-market capitalism is the only viable economic system. The only way to extricate themselves from the crisis and build the foundation of strong economic growth in the future was to follow the standard approach of avoiding inflation and budget deficits while opening markets to the free movement of goods and capital.

The spreading crisis has had a much more jarring affect on our thinking. One year ago, virtually no one anticipated that Indonesian GDP would contract by more than 15% in 1998 and that the South Korean and Thai economies would contract by between 5% and 10%.

Furthermore, the crisis is now seriously threatening the future growth of Latin America, a region that followed our advice and carried out some of the most successful macroeconomic stabilisation programs the world has ever seen. Finally, the problems in Russia have led some to wonder whether the strategy of attempting to create a market economy by focusing on privatisation above competition and prior to the development of the institutional infrastructure essential for the proper functioning of markets, was the best approach to the transition.

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As a result of one of the worst years in the post-World War II global economy, most observers are no longer repeating the same old mantras about the best approach to economic development, crisis prevention and crisis response.

In some areas a new consensus is beginning to form, a consensus about broader objectives as well as the use of more instruments. Financial institutions matter as much as fiscal deficits. There are widespread calls for greater inhibitions on the flow of short-term capital, and especially hot money. These emanate from people as diverse as Paul Krugman, Jeffrey Sachs, George Soros, and Paul Volcker. In other areas there are widely shared goals, like the desirability of effective international workout procedures in which the creditors share the burden, although little agreement of how to accomplish this objective, or even if it is possible.

Was East Asia to Blame?

Although most observers now see the ongoing international economic crisis as a new problem requiring new solutions, some continue to castigate East Asia for what they describe as its extensive government controls, corruption, and macroeconomic mismanagement. These explanations—and their implication that the simple recipes of the 1980s are sufficient to face today's problems—are completely wrong.

First, they are inconsistent with the past success of East Asia. For the last three decades, per-capita GDP has consistently grown at 5% or more annually in Indonesia, South Korea, Malaysia, and Thailand. These gains, it is important to remember, have brought with them extended lifespans, increased educational opportunity, and a dramatic reduction in poverty. In 1995, 20% of East Asians were living on less than $1 per day; in 1975, the number was 60%. Whatever else one says about "crony capitalism", no one can draw a parallel between leaders like President Suharto, who oversaw a decline in the poverty rate from 64% in 1975 to 11% in 1995, and Mobutu Sese Seko, who looted Zaire, leaving its per-capita income at the end of his reign at half of the level it was when he began.

Second, some of the claims about macroeconomic policy are nothing more than prejudice—such as the belief that "ill-mannered" poorer countries necessarily have worse policies than "well-behaved" richer ones. This view does not survive even a casual acquaintance with the data. Indonesia, South Korea, Malaysia, and Thailand all save over one-third of their GDP, behaviour from which the United States, which saves only 17% of its GDP, could well learn. The United States is justly proud that it managed last year to bring up its (federal) fiscal surplus to roughly

$60 billion, less than 1% of GDP. But compare that to Indonesia, Malaysia, and Thailand, which all had (general government) surpluses above 2% of GDP in 1995. Inflation, another warning sign that countries are trying to push beyond their capacity, was low and drifting still lower in the months before the crisis.

Third, the claims about transparency are just a form of blame shifting. We are accustomed to leaders, from Harold Wilson to Prime Minister Mahatir, blaming international speculators for all of their problems. In the last few years we have seen the emergence of a new form of blame shifting, the claim by investors that they are not to blame for making bad loans because the countries lied to them. If only they had been told the truth, they would not have gotten into the problems they did. Most of the supposed problems in East Asia, including the "lack of transparency", were not news. They were widely known prior to the crisis. Indeed, there is a serious question about whether all of the available information was even being used. There is no systematic evidence linking lack of transparency to economic crises; the last major banking-cum-currency crises were in Scandinavia—models of transparency. Even if there were, there is no evidence that corruption or transparency were significant problems in all of the East Asian countries affected by the crisis. According to a number of ratings of transparency and corruption, Indonesia was one of the worst middle-income countries. But Thailand and the Philippines were about average (and substantially above average compared to developing countries as a whole). South Korea and Malaysia were consistently rated among the least corrupt and most transparent of any developing country.

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Sympathising with East Asia

Instead of playing the blame game, the events in East Asia, and now elsewhere, should inspire our sympathy. This is not just because the number of people living on less than $1 per day in Indonesia, Malaysia, the Philippines, and Thailand is expected to double to 60 million by 2000. It is also because of the extreme difficulties that their policymakers faced in trying to prevent and respond to the crisis. By pursuing rapid domestic financial liberalisation and capital-account liberalisation without developing complementary regulatory structures, the East Asian economies put themselves in a very vulnerable position. When capital flows started surging into East Asia in the 1990s, the result of changes in world-wide conditions and the liberalisation policies they had pursued, East Asia found that the standard macroeconomic policy tools were not sufficient to prevent a build-up of vulnerability. In retrospect, it is not obvious how, given their liberalised financial markets, the East Asian countries could have used the other policy instruments at their disposal to prevent the crises without imposing other costs, such as, in the case of Thailand, cutbacks in needed education and infrastructure expenditures. One could well argue that "better" policies would not have been enough; if anything, nearly perfect policies were required to prevent the crises.

This contains an important lesson. We cannot design policies (such as capital-account liberalisation) that only work well when other policies are functioning perfectly. Airplanes and nuclear plants always build in substantial redundancy so the failure of one part does not translate into a systemic failure. In economies parts are always failing, in part because the constraints of the political process lead to highly imperfect economic policies in rich and poor countries alike. In this case, it is even more important to design policies that are robust against a modicum of failure, rather than turning around and blaming the country every time it slips off of the knife-edge into a serious problem.

There has long been a broadly shared consensus concerning some of the key ingredients in constructing less vulnerable economies and a less vulnerable international system. Some of the key ingredients are better information and stronger financial institutions—steps that are more easily mentioned than implemented. Here, I want to discuss two issues that are increasingly being discussed—redefining the international architecture and designing workouts.

Stability and Growth in the International Financial System

Our goal now is to build an international financial system that is more robust against small mistakes or sudden changes in perceptions, while also promoting growth, efficiency, and the diversification of risk. In many ways these goals are complementary. One of the much-vaunted benefits of global integration is that it allows developing countries to use international financial markets to diversify and hedge against their risks. But if these same markets are prone to over-investment in good times when money has relatively little use, and sudden withdrawals when money is most needed, then the benefits of portfolio diversification will be overwhelmed. Risks are increased, not reduced. Indeed, economic crises generated by the disturbances associated with the outflows themselves lead, on average, to several years of below-trend growth, often more than offsetting the benefits of the inflows.

Clearly, to the extent that the current crises can be related to exposure in short-term foreign-denominated liabilities, countries that restricted those liabilities reduced their vulnerability. The question is, what did they give up? The ideological position is that free and unfettered markets generate higher growth. But the reality is that the East Asian countries, with their high saving rates, may have gotten relatively little additional growth from the surge in capital flows. When national saving rates are already above one-third of GDP, the additional investment that can be financed by capital inflows may contribute very little to the overall economy. More generally, it is not considered prudent to hold international reserves equal to or greater than short-term foreign debt, a policy that amounts to developing countries' borrowing from rich-country banks at high interest rates only to relend the money to rich-country Treasuries at low interest rates. While this may help growth in the United States, the effects on developing countries are more problematic.

Perhaps for these reasons, several systematic empirical studies have failed to find any relationship between capital-account liberalisation and growth or investment.

The question then is, what policies should countries and the international institutions pursue? I do not think that the blanket objection sometimes heard to the government's intervening in international capital markets is a very good way to begin this discussion. The roughly $110 billion package for East Asia is clearly a major intervention in the workings of the free market. The international community justifies this support because it is worried about the potential for contagion and systemic risk in these types of crises. There are three general policies that may prove helpful.

First, we need to eliminate the tax, regulatory, and policy distortions that may, in the past, have stimulated short-term capital flows. Examples of such distortions are evident in Thailand, where the tax advantages for the Bangkok International Banking Facilities encouraged short-term external borrowing, but subtle examples exist almost everywhere. Without risk-based capital requirements for banks, for instance, incentives for holding certain assets and liabilities will be distorted. Second, several countries have imposed prudential bank regulations to limit the currency exposure of their institutions.

Third, these measures may not go far enough, especially once it is recalled that corporate exposure may itself give rise to vulnerabilities. Two-thirds of Indonesia's foreign indebtedness was corporate. And the systemic risks to which such exposure can give rise provide ample justification for taking further measures. Among the ideas currently under discussion are inhibitions on capital inflows. In thinking about how to accomplish this, we should look to the lessons of the Chilean experience. Chile has imposed a reserve requirement on all short-term capital inflows—essentially a tax on short-maturity loans. The overall efficacy of these controls is the subject of much discussion, but even most critics of the Chilean system acknowledge that the reserve requirement has significantly lengthened the maturity composition of capital inflows to Chile without having adverse effects on valuable long-term capital.

Still other measures employ tax policies, such as limiting the extent of tax deductibility for interest in debt denominated or linked to foreign currencies. The problems of implementing these policies may in fact be less than those associated with the Chilean system.

In evaluating these proposals, we must be clear what the objectives of the interventions are. Two seem uncontroversial: reducing (though not eliminating) the volatility of flows and reducing (though not eliminating) the discrepancy between private and social returns.

The most important and feasible actions, especially in the near term, are all at the national level—either by developed countries or developing countries. But there is currently a very active dialogue at the international level also. At a minimum, international groups and institutions can play an important role in encouraging the adoption of sound policies; and especially by persuading investors that the adoption of some restraints on capital flows is not necessarily a sign that a country is unfriendly to investment, but simply that it wants to insulate itself against some risk.

Responding to Crises: The Challenge of Orderly Workouts

A keystone in the development of modern capitalism has been limited liability and bankruptcy laws. Modern bankruptcy laws attempt to balance two sometimes conflicting considerations: promoting orderly workouts so that business values can be retained and production losses kept to a minimum; and providing appropriate incentives so that those engaged in risky behaviour bear the consequences of their actions. In the international context, the flight of capital or withdrawal of short-term debt does not remove any of the actual factories. The goal is to ensure that the factories continue to produce and that the assets are not stripped.

In the absence of orderly workout procedures, countries may worry that, unless they issue guarantees or assume private debts, the disruption to the economy will be unbearable.

Similarly, the international community has long complained about the problem of moral hazard, the fact that lenders have been at least partially bailed out. To be sure, in many cases the bailout has been far from complete and lenders have lost money. Still, to the extent that there is any bailout, they have not been forced to bear the full risks associated with their investment. And the belief that in the future this might again be the case can give rise to the moral hazard. Again, the international community faces a dilemma in that it often sees no alternative to a bailout—the risks of not undertaking an action seem unacceptable. After each crisis, we bemoan the extent of the bailout and make strong speeches saying that never again will lenders be let off the hook to the same extent. But, if anything, the moral-hazard problem has increased, not decreased, with each successive crisis.

While the experiences of the last 20 years suggest that lenders can be forced to bear more of the costs than they have in at least some of the more recent crises, the middle of the crisis may not be the right time to deal with these issues. We can, however, prepare for the next crisis. There is more that we can do to facilitate orderly workouts, to reduce moral hazard, and to make those investors who are most likely to reap the benefits of a bailout pay part of the costs. More broadly, we can reduce the discrepancy between social and private returns to certain forms of risky international lending. One aspect of this may be a greater willingness to accept standstills that temporarily stop the outflow of money and create the time necessary to negotiate orderly workouts. Another may be recognising that proper burden sharing is necessary both for equity and efficiency. Ultimately the goal of these policies is to create space for the very difficult job of a workout in the context of private-to-private capital flows with many lenders and borrowers. Imposing standstills and worrying about appropriate burden sharing prior to bailouts, rather than the recent practice of waiting until after the fact, may be a key to designing equitable and efficient workouts.

Creating a Truly Global Economy

It has become a cliché to refer to the new globalised economy. Yet the fact is that reductions in transport and communication costs have been accompanied by reductions in government-created impediments to the free flow of ideas, goods, and capital. We do live in a more integrated international economic community.

Somewhat more than a century ago, when nation-states were being formed, there was a recognition that the new nation-states needed a new set of economic institutions to realise their full potential. In the United States in 1863, in the midst of the Civil War, as Congress grappled with the challenge of providing the foundations of a new, stronger, unified country, it established the world's first financial sector regulatory body, the Office of the Comptroller of the Currency. It has taken more than a century for the country to feel comfortable with a system of national banking—and even today, there are misgivings in many parts of the country.

We stand today on the edge of a new world economy. But we do not have international institutions to play the role that the nation-states did in promoting and regulating trade and finance, competition and bankruptcy, corporate governance and accounting practices, taxation and standards, within their borders. Navigating these uncharted shoals will be a great challenge. But just as much of the prosperity of the past 150 years can be related to the expansion of markets that those transformations afforded, so too the prosperity of the next century will depend in no small measure on our seizing the opportunities afforded by globalisation.

In approaching the challenges of globalisation, we must eschew ideology and over-simplified models. Today, with the continuing decline in economic activity in East Asia, with the new crisis in Russia, with the contagion threatening economies elsewhere, faith in the market economy is eroding in many parts of the world. It is now clear that the emphasis on privatisation, liberalisation, and macroeconomic stability that dominated thinking about developing economies, neither fully captured the essentials of a market economy, nor provided a recipe for growth and stability, let alone for the broader goals of democratic, sustainable, and equitable development.

Our challenge today is to prevent the pendulum from swinging too far to the other side. A sound market economy integrated into the global system is the key to economic success. But this requires sound institutional infrastructure, which in turn requires an effective and efficient government focusing on the essential functions of the public sector. We have a huge task in redesigning the international architecture. But if we set our sights high, if we keep our objectives broad, if we keep our instruments wide, if we eschew ideology but use effectively all of the limited knowledge that we have, we can make progress.

We must not let the perfect be the enemy of the good. In a downpour, it is better to have a leaky umbrella than no umbrella at all. There are reforms to the international economic architecture that can bring the advantages of globalisation, including global capital markets, while mitigating their risks. We are beginning to see a new consensus forming around ways to restrain the risk of "hot money" and the goal of developing procedures for orderly workouts. Hopefully the continuing international dialogue on these and other issues will continue to make progress in these and other areas. ◆