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Introduction

International economic policymakers are currently confronted by two urgent problems. One is to contain and resolve the macroeconomic and financial crisis threatening much of the world. The other is to reform the institutions, structures, and policies—the international financial architecture—through which crises are predicted, prevented, and dispatched. This book addresses the second of these tasks.

There is no shortage of proposals for reforming the international financial architecture. The French government has one, the German government has one, the Canadian government has one, the US government has one. The Group of 22 (G-22), an ad hoc grouping of developing and advanced industrial countries, has released three reports on the reform of international financial institutions and arrangements. Group of Seven (G-7) ministers have issued a separate declaration about how to renovate the international financial house. International Monetary Fund Managing Director Michel Camdessus has made a series of speeches with titles such as "Toward an Agenda for International Monetary and Financial Reform." Voices from academia and the markets have chimed in with yet additional schemes.

Many of these proposals are contradictory and mutually incompatible. Some recommend that policymakers renew their efforts to liberalize international capital markets, while others plump for the reimposition of capital controls. Some insist on the need for greater exchange rate flexibility, while others regard nothing as more important than the reestablishment of stable, even fixed, rates between currencies. Some suggest that the international community should respond more forcefully to crises, while others recommend that it stand back and let nature, in the form of the markets, take its course. Some emphasize the need for more funding for the International Monetary Fund (IMF, or the Fund), while others call for the abolition of the institution. Some suggest that the Fund must root out corruption and compel countries to install the institutional prerequisites for stable financial markets, while others insist that it should limit its advice to monetary and fiscal policies and refrain from meddling in the internal affairs of its members.

Different observers offer such radically different recommendations because they define the problem differently and because they have different views of how the international economic and financial system works. Thus, anyone writing on this subject must lay his or her views on the table. The recommendations in this book follow from six assumptions that I make about the operation of the international financial system.

First, liberalized financial markets have compelling benefits. They encourage savings mobilization and efficient investment allocation while allowing consumption smoothing and portfolio diversification. Financial markets do not work perfectly, to be sure, but to paraphrase Winston Churchill, they are the worst way of allocating resources except for all other forms that have been tried. Compared to the earlier era, when developing countries repressed private financial transactions and governments employed policies of directed credit to dictate resource allocation, there are clear efficiency gains from relying on the market. This is especially true in an age when growth depends so heavily on product and process innovation. In other words, the days when East Asian governments could "pick winners" simply by following the Japanese example—allowing them to minimize the role of the market mechanism—are long past.

Second, international financial liberalization and growing international capital flows are largely inevitable and irreversible. Domestic and international financial liberalization go hand in hand, in the sense that it is extremely difficult to keep a lid on international financial transactions if domestic financial transactions are freed. And, as explained above, the logic for domestic financial liberalization is compelling. In addition, financial liberalization, both domestic and international, is being driven by powerful changes in information and communications technologies that make it far more difficult to restrict the financial transactions in which market participants engage. Controls on international transactions, to retain their effectiveness, must therefore become more onerous and distortionary. For all these reasons, capital mobility is the wave of the future. This does not mean that capital-account liberalization must be embraced before banks have upgraded their risk-management practices, supervisors have strengthened their oversight of financial institutions, and governments have corrected their macroeconomic policies; to the contrary, there are compelling arguments against precipitous liberalization. But greater capital mobility is coming, like it or not.[1]

Third, notwithstanding the manifest benefits of financial liberalization, capital markets are characterized by information asymmetries that can give rise to overshooting, sharp corrections, and, in the extreme, financial crises. Even in the age of the information revolution, information remains costly to obtain and evaluate. Some of the relevant "data," such as whether a government will follow through on reform and maintain its commitment to monetary and fiscal discipline, are unavoidably based on opinion and conjecture as much as hard evidence. This encourages imperfectly informed investors to draw inferences from one another's actions and to move in a herd. This behavior can precipitate sharp market moves and, in the extreme, financial crises. Distress can cascade through the financial system, because of the widespread use of leverage and because information asymmetries prevent banks and other financial intermediaries from raising liquidity in a crisis.

Fourth, this instability provides a compelling argument for erecting a financial safety net despite the moral hazard that may result. History shows the need for deposit insurance and a lender of last resort to contain systemic risks to the financial system. To be sure, provision of this safety net encourages market participants to take on additional risk, heightening the need for vigorous supervision and regulation of the recipient institutions. In a world of global financial markets, there is an argument by analogy for an international lender of last resort, although there are questions as to whether the IMF or any other candidate for this role has either the capacity to carry it out or the ability to contain the moral hazard that results. And if there are good political reasons why there will be no international lender of last resort, then countries need to take measures to protect themselves from the consequences of its absence.

Fifth, information and transactions costs can prevent decentralized markets from quickly and efficiently resolving financial problems. These costs create coordination problems that can encourage creditors to scramble for the exits and make it prohibitively difficult to restructure defaulted debts. They are why countries have insolvency and bankruptcy codes that give the courts the power to impose an automatic stay, coordinate restructuring negotiations, and, if necessary, cram down settlement terms. They are why the absence of an international bankruptcy court with

1. That all of today's mature, advanced industrial economies have liberalized international financial flows is evidence that most emerging markets are ultimately heading toward capital-account liberalization. This reality is similarly evident in the growing number of IMF member countries that have taken steps to liberalize their capital accounts and in the fact that reversals in this trend, whether associated with the Latin American debt crisis of the 1980s or the crisis now infecting emerging markets generally, have been limited and no more than temporary.

comparable powers is a problem. They are why international debt crises are so protracted.

Sixth and finally, economic policy is framed in a politicized environment. It cannot be assumed that regulators and other economic policymakers will carry out their tasks without allowing themselves to be influenced by political considerations. To the contrary, lobbying and pressure politics inevitably shape the policies that are pursued. Realistic policy advice requires acknowledging these pressures and not assuming, for analytical convenience, that policymaking institutions such as the IMF can be made to follow rigid apolitical rules. Moreover, national governments are jealous of their prerogatives; aside from special cases such as the European Union, they remain reluctant to cede control of domestic economic affairs to an international body. Realistic policy reform requires recognizing these uncomfortable facts.

My recommendations for reforming the international financial architecture flow from these assumptions. They are predicated on the notion that international capital mobility is now a financial fact of life and that the problem for policy is to ensure that the benefits of capital mobility exceed its costs rather than pretending that it can be made to go away. They are based on the belief that financial markets can malfunction, creating a case for a financial safety net and therefore a role for the IMF, but also posing problems of moral hazard that must be addressed. They acknowledge that crises will still occur and that there is a need to create institutional mechanisms to overcome the information asymmetries and collective-action problems that prevent them from being rapidly resolved. They acknowledge the existence of political limits on the practicable; because they lack political feasibility, I do not devote much attention to pie-in-the-sky schemes for a world currency, a world central bank, a world financial regulator, or a world bankruptcy court.[2] My recommendations may seem unambitious in comparison, but they at least have a chance of being implemented. In effect, I stake out a middle ground between the overly ambitious and politically unrealistic schemes of independent commentators and the excessively timid and ambiguous reports of international bodies and organizations. Academics should be bolder than bureaucrats, but their recommendations should take the political realities into account.

My conclusions have most in common with the three reports on preventing crises and reforming the financial architecture issued by the G-22 in October 1998 (1998a, b, c).[3] But while these reports adopt a generally sensible approach to the crisis problem, in the end they back away from the important implications. The do not go far enough.

2. I do, however, take a critical look at some of these ideas in chapter 6.

3. I compare the recommendations of these reports with my own conclusions in appendix A below.

Just as I am critical of these international reports for backing away from the important implications, others will criticize me for rejecting radical proposals to fundamentally alter the international financial architecture. Radical therapy is required, they insist, because international financial markets are ''coming apart at the seams,'' creating a ''crisis of global capitalism'' (Soros 1998). This is not my view. To be sure, the current crisis in emerging markets has revealed serious flaws in the structure of financial markets and in the ways they are regulated that urgently require correction. The urgency of reform is evident in the severity of the crisis that has infected emerging markets in the last two years. But that crisis comes at the end of an extended period of growth and prosperity for many parts of the developing world, which has benefited enormously from the advantages of liberalized markets, including international financial markets. Those gains can now be secured by following a strategy of robust incrementalism, not by throwing the baby out with the bathwater.

Unlike other schemes, mine are not primarily proposals for reforming the IMF, although I will have something to say about the topic. A theme of this book is that the most important changes in the international financial architecture involve not changing the way that the Fund goes about its business but rather modifying the environment in which it operates. Appropriately reformed, the IMF can make the world a safer financial place, but even the most ambitious schemes to remake the Fund will, by themselves, provide only limited traction on the crisis problem. In large part, the solution lies elsewhere.

Any set of recommendations for more effectively preventing and managing financial crises should respond to the kind of crises one anticipates encountering in the future. While the assumptions laid out above provide an implicit answer to this question, it is worth being explicit.[4] Financial crises have always come in different flavors; this will be true in the future as it has been in the past. Some countries will continue to experience old-fashioned balance of payments crises as a result of pursuing excessively expansionary monetary and fiscal policies that were incompatible with their exchange rate commitments. Their currencies will grow increasingly overvalued, their current-account deficits will widen, and their international reserves will fall to the danger point where a crisis erupts. Other countries, in contrast, will experience newfangled high-tech crises driven by the interplay of domestic financial-sector weaknesses and international capital flows. In their case, a crisis will erupt when investors lose confidence in the country's banking system, stock market, or public debt management and when their scramble for the exits, facilitated by the existence of an open capital account, brings both the financial system and the

4. I lay out my view on the dominant sources of potential future crises at more length at the beginning of chapter 3. Readers preferring a purely theoretical treatment will find it in appendix B.

currency crashing down. Macroeconomic imbalances can play a part in this second class of financial crises, but theirs is not the leading role. My focus here is on this second class, for two related reasons. First, it is my judgment that financial factors have played an increasingly prominent role in recent crises not by happenstance but for fundamental structural reasons that will be felt even more powerfully in the future than in the past. Their role has been elevated by domestic financial deregulation and international financial liberalization, trends that are unlikely to be reversed in the future. Admittedly, some countries will continue to suffer crises purely because their governments follow reckless macroeconomic policies, but these old-fashioned balance of payments crises will become more the exception and less the rule. Second, there is relatively little confusion about how to treat crises caused by macroeconomic excesses, namely, by administering an appropriate dose of monetary and fiscal austerity, thereby eliminating the macroeconomic imbalances that created the problem in the first place. There is less agreement on how to prevent and manage their newfangled Asian-style equivalents. These are all justifications for focusing on so-called high-tech crises in which financial factors play the dominant role.

Before proceeding, it is important, as political scientists say, ''to clearly define the dependent variable.'' The goal here is not to construct an international financial system that is immune from crises.[5] North Korea's financial system is immune from crises because it is subject to such draconian controls, but as a result its economy suffers from worse ills. My goal instead is to suggest some practical reforms that will improve the tradeoff between financial liberalization and financial stability.[6] While the benefits of a market-led financial system are compelling, that system will inevitably remain imperfect given the information environment in which it operates, and crises will still occur. My goal is thus to identify measures that promise to minimize their incidence and to help to resolve them at lower cost, therefore making it more attractive for countries to partake of the manifest advantages of liberalized financial markets.

Outline of the Book

Following this introduction, chapter 2 summarizes my policy recommendations. Chapter 3 lays out the case for international standards as a way

5. The dependent variable, in other words, is not simply the prevalence of financial crises.

6. Reforms that, as economists say, allow societies to maximize the social welfare (rather than simply to minimize crises). Thus, the argument in the text about the benefits of a market-led financial system does not imply that countries will necessarily want to move to fully liberalized international financial markets, but that they should be able to choose their preferred point somewhere on the best possible frontier of feasible combinations of financial liberalization and financial stability.

of upgrading national financial practices that have first-order implications for international financial stability. Inspired by Morris Goldstein's work on the idea of an international banking standard (1997), standard setting has become de rigueur as an approach to reconciling national regulation with international markets. What have been overlooked in this enthusiasm are the obstacles to IMF-led standard setting and the need to rely on the resources and expertise of the private sector as the only practical way of promulgating effective standards in the relevant areas; that is my emphasis here. Chapter 4 considers the special problems of the banks and the dangers of an open capital account when risk management is inadequate, supervision and regulation are less than effective, and there is a culture of explicit guarantees. Unlike official reports, which acknowledge the problem but back away from its implications, I am explicit about the need for Chilean-style capital-inflow taxes as the only effective solution to this problem for the vast majority of developing countries.

Chapter 5 turns to the problem of bailing in the private sector. While acknowledging the desirability of having the private sector share more of the burden of crisis management, I argue that there in fact exist very serious obstacles to achieving this when a crisis hits. Unlike official reports, which invoke the desirability of private-sector burden sharing without offering specifics, I argue that the only effective way of preventing short-term bank creditors from getting off scot-free is to not borrow from them in the first place—in other words, to use taxes, controls, and exchange rate flexibility to discourage the practice—and that the single most important way of facilitating restructuring is to add renegotiation-friendly provisions to loan agreements.

Chapter 6 dismisses more radical schemes for reforming the international financial architecture as either undesirable or unrealistic. Reform, if it is to occur at all, means reform within the confines of the existing architecture, broadly defined. Chapter 7 therefore reconsiders the role of the IMF, concluding that there will remain a role for its lending, although this will be more limited than in the past, and arguing that the Fund needs to become a more active proponent of capital-inflow taxes and flexible exchange rates.

Readers will forgive, I hope, the repetition that creeps in as I approach the same issues from several different angles. This is one way of driving home the point that you inevitably arrive at the same conclusion—and the same policy recommendations—regardless of where you start.