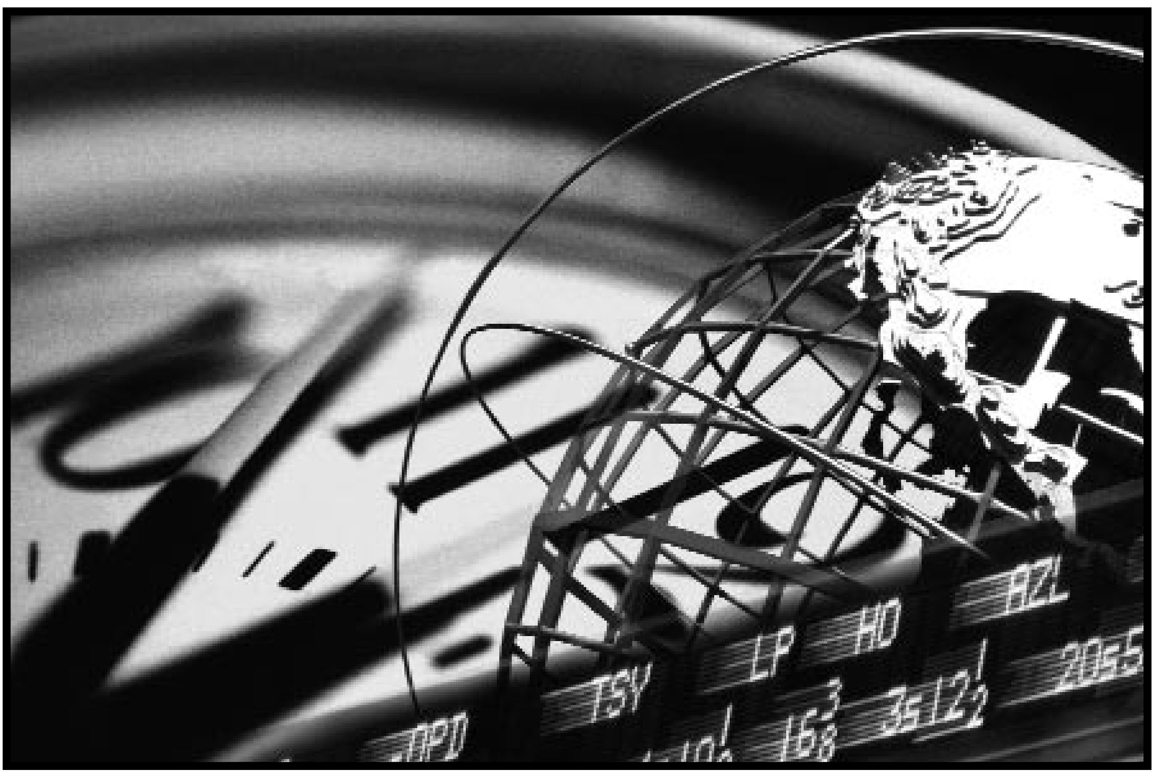
International Financial Reform
The Morning After

By Albert Fishlow

Muddling through is less painful than clean-slate change

Y2K arrived, and forecasts of apocalypse when the computers decided that William McKinley was still living in the White House proved overwrought. Much the same could be said about global financial reform. For despite a stream of jeremiads in the wake of five years of crises – think Mexico, Thailand, Indonesia, Korea, Malaysia, Russia, Brazil, Ecuador – the powers that be have not been moved to rewrite the rules of international finance. And they aren't about to anytime soon.



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It's not hard to see why: despite the occasional whiff of chaos, the global economy is in remarkably good shape. The United States prospered through most of the 1990's, allowing it to serve as the world's engine of growth when it was needed most. Happily, as higher interest rates begin to take the edge off the rate of growth in the United States economy, other countries seem ready to pick up the slack.

Europe has converted to a single currency and, thanks in part to the unexpected erosion of the euro's exchange value, seems destined to continue its expansion in the next few years. Japan, after almost a decade of stagnation, is finally showing signs of recuperation. And not least, virtually all of the victims of the 1990's financial crises are on the mend.

In contrast to the crunch of the 1980's, which took Latin America more than a decade to shake off, these crises have proved short-lived. Moreover, each has set in motion political as well as economic forces that promise to reduce national economies' vulnerability to financial shocks. Indeed, these changes, in the wake of the dramatic fall of the Soviet bloc in 1989, have decisively altered the rules of the game. Some may still speak of a third way, but capitalism reigns.

A good measure of capitalism's triumph is the expansion of world trade. Trade has continued to grow at twice the rate of output. And despite the recent meeting of the World Trade Organization in Seattle, where labor unions and environmentalists aspired to build a popular front in opposition to globalism, further reductions of trade restrictions are very likely. That conclusion follows from a simple reality: the only remaining superpower is a major beneficiary of trade expansion, and not merely through rapidly expanding exports. United States investment would be lower were it not for the fact of our large, continuing dependence upon foreign savings that is the flip side of our import surplus.

Lenders not only will know less than borrowers, but will be competing for the opportunity to take advantage of the ignorance of other lenders.

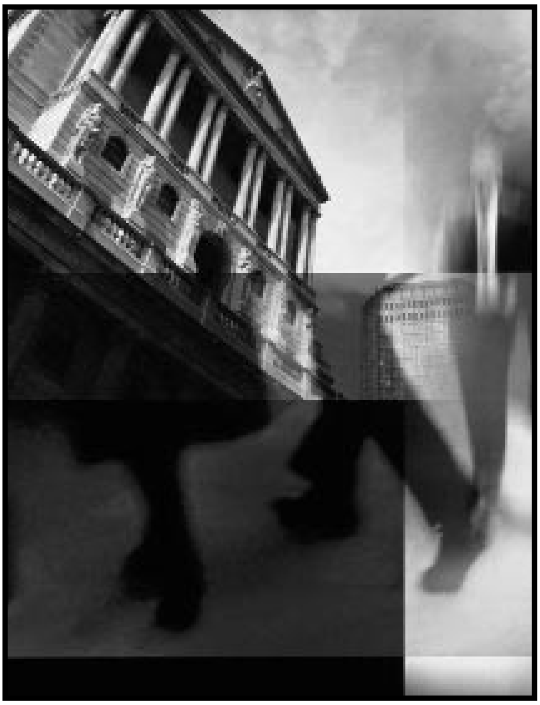
Lawrence H. Summers, the Secretary of the Treasury, did turn up the heat on financial reform at the meeting of the G-20 in Berlin, but nothing can really happen until the International Monetary Fund appoints a new director to replace Michel Camdessus. And Summers' apparent enthusiasm for tinkering may have been purely tactical – an effort to steal the thunder of a forthcoming report from a Congressional commission headed by Allan Meltzer that will offer a Republican twist on events and policy.

WHAT YOU SHOULD KNOW AND WHEN YOU SHOULD KNOW IT

Are we missing an opportunity to change global capital markets for the better? Are we, in effect, fiddling while Bangkok, Sao Paulo and Moscow smolder? Read on.

In the wake of the Asian meltdown, the importance of delivering more reliable and up-to-date information to the public has

AL FISHLOW is senior economist at Violy, Byorum & Partners in New York and a visiting professor at Yale's School of Management.



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become a bromide of the financial lecture circuit. Indeed, resistance to collecting and sharing data is even waning at the secretive IMF. Many of the heretofore-well-guarded IMF country agreements are now promptly posted on the Internet. Meanwhile, national ministries of finance are getting in the habit of publishing fiscal and balance-of-payments data on a timely basis. That represents an about-face since 1994, when the size of Mexico's foreign-exchange reserves was a state secret. Thailand's born-again transparency is equally radical: this, after all, was the country that hid the fact that its reported reserves in 1997 were wholly offset by unreported liabilities in the form of forward currency contracts.

The Special Data Dissemination Standard – banker-speak for financial transparency rules – is the order of the day. Although the standard dates back only to 1996, there are now 47 countries committed to it. The idea is to set a high norm for countries wishing to maintain access to the global capital market. To help out, the IMF operates an electronic bulletin board with links to the national subscribers.

But despite this advance, and despite Summers' emphasis on printing all the news that fits, one should not exaggerate the role of information in preventing financial crises. After all is said and done, lenders not only will know less than borrowers, but will be competing for the opportunity to take advantage of the ignorance of other lenders.

What's more, the value of information as a tool of self-regulation is undermined by adverse selection: the riskiest debtors are the ones most likely to continue to borrow when interest rates are raised in response to credit worries. Didn't financial institutions know that with Russia still selling paper after short-term rates reached 70 percent, there was likely to be a Russian failure? Did it stop them from lending?

THE REALLY HARD PART

Once everyone has raised a glass to financial transparency, the real fun begins. Some analysts, typically those more sympathetic to developing-country problems, call for new international institutions capable of making a heavily regulated system work better. They wish for greater international capital flows, but in a form that insures that the cash will be used toward socially desirable ends.

On the other side are those with an ax to grind with established financial institutions such as the IMF. Lenders, they say, should be no more protected from loss than the owners of equity. If this means higher interest rates and diminished capital flows, so be it.

Grand proposals for reform from the first group of analysts come in three flavors. At the top of the list is a new international regulatory authority in one form or another – a central bank, a central insurance agency, a credit rating agency. Second is an international bankruptcy statute that gives defaulters a chance to stay open for business. Third (a favorite of the United Nations) is the construction of regional and sub-regional institutions to help developing countries adapt to the new realities of global capitalism.

I will spare readers a detailed review of these interventionist approaches. In broad terms, they all amount to efforts to extrapolate to the international level what now seems to prevent financial panic at the national level. But scaling up successful national institutions would be no small feat. Reformers face the same sovereignty issues that have dogged every effort at world government. And even if the reforms with real teeth could be put in place, they might well undermine the more desirable effects of market forces.

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On the other side of the divide are free-market types inclined to emphasize the evils of moral hazard – the tendency for borrowers to give short shrift to credit risk if somebody stands ready to bail them out. The solution to moral hazard is to eliminate the implicit or explicit protection against default by curbing the role of the IMF. Thus, in the world imagined by these reformers, loans would still be made, but lenders would be on notice to charge more on riskier projects and to demand good collateral.

Stripped to essentials, this is a back-to-the-future fix not unlike the invisible hand that regulated the 19th-century global economy through the gold standard. One might wish to add a modern twist in the form of global private banks that could lend more because their diversified portfolios would be less vulnerable to regional shock.

While this approach is compatible with current efforts by the United States to alter the terms on lending from the IMF's Supplementary Reserve Facility, the proposals go well beyond those efforts. At root, they are anti-Keynesian: they call for limited future official action, and place considerable faith in markets to cope with risk through credit analysis and diversification.

Neither grand approach will be followed, because each presumes failures greater than have been realized. Markets simply haven't taken the sort of beating they endured in the Great Depression. Moreover, in contrast to the debt crisis of the 1980's, recovery has been relatively quick. Smaller and less dramatic alterations are in the cards, though, and for good reason: transactions involving developing countries are now more than $1 trillion annually, up from less than $200 million in the 1980's. And global market transactions of all types come to more than $2 trillion a day.

Consider some recent incremental changes. Repeal of the restrictions in the Glass-Steagall Act that limited the financial services banks in the United States will permit consolidation within the financial sector. Increases in reserves mandated by the Bank of International Settlements will toughen the big banks' capacity to withstand currency shocks. The so-called Basel II standards go a step further, officially factoring in the riskiness of lending portfolios in setting minimum reserve requirements.

Note, too, that the recent default by Ecuador broke a longstanding precedent: the IMF is apparently no longer rigidly opposed to doling out cash to defaulters before they have signed formal workout agreements with private creditors. This will increase the pressure on lenders to assess international credit risk with the care they use to assess domestic risk. Last, but not least, creditor countries are well on their way to writing off the unpaid – and unpayable – debts of very poor countries, permitting them to start afresh in global capital markets.

THE REST OF THE AGENDA

That still leaves two big topics on the global financial agenda. One is exchange-rate regimes. Formerly, there were three types: fixed, floating and "pegged" somewhere in the middle. Now, with recent changes in Latin America, the world seems to be moving rapidly to the two extremes. The other issue is capital controls: should there be limits on short-term flows?

Exchange Rates

The exchange-rate issue is as much about macroeconomic stability as it is about trade competitiveness. A fixed rate with free movement of capital implies a need for rigid monetary and fiscal discipline. Protecting exchange-rate stability sometimes requires heavy sacrifice in terms of employment and output.

A floating rate, by contrast, gives the central bank the discretion to ease credit in the face of changing domestic needs. That is what Brazil, after its currency devaluation last year, has opted for. Other countries in the region, and around the globe, are gradually moving to similar systems in which inflation targeting, rather than exchange stability, becomes the first order of monetary policy.

Still others, notably Argentina, are trying to cope with similar tensions in policy priorities by moving from a peg in which exchange rates can roll with the punches to a permanently fixed exchange rate. This is justified in much the same way the parent of a 6-year-old might justify putting a lock on the cookie jar: central bankers simply can't be expected to muster the will to make unpopular choices in a pinch.

The case for an Argentine-style currency board is only as sound as a government's commitment to allow interest rates to climb and employment to fall in order to defend the exchange rate. Not very many countries are in that position. Argentina has the considerable advantage of history on its side: it grew rapidly before 1914, when monetary authorities were effectively handcuffed by the international gold standard. But the majority of developing countries were colonial possessions then. And even in the case of Argentina, it took runaway inflation to make the conversion to a currency board palatable.

Note, too, that Argentina has been forced to weather two sharp recessions under the currency board – one accompanying the Mexican peso collapse in 1995, the other last year as a consequence of Brazil's fall from grace. Few countries would be able to sustain such costs.

Not surprisingly, then, most developing countries seem to be moving in the direction of a floating rate. The issue is in greatest doubt in Latin America, where a Free Trade Area of the Americas is supposed to be in place by 2005 and a currency area based on the dollar is a contender. Indeed, for Mexico and Canada, where trade is highly concentrated within the region, Argentine-style dollarization could be a practical option even today. All that is lacking is the creation of 13th and 14th Federal Reserve Districts in Toronto and Mexico City.

Capital Controls

There is now substantial sentiment in the developing world for freer trade and capital flows. Malaysia, with its crisis-induced controls over capital exit, is very much a case apart. There, the decision to prevent capital flight was as much a consequence of a political power struggle as it was a policy decision. And while the policy apparently worked, in the sense that it buffered Malaysia from the worst of the Asian financial crisis in 1998, the Malaysian economy had some secret assets that helped it through. Malaysia's exports amounted to a remarkable 118 percent of gross domestic product in 1998. Few economists believe that weaker economies could pull off a trick like Malaysia's without losing access to foreign capital – especially after attempts during the 1980's in Latin America proved so unsuccessful.

On the other hand, the case for limiting short-term capital inflows is a matter of lively debate. Sebastian Edwards of UCLA's Anderson School of Business argues that the widely touted efficacy of Chile's controls has been much exaggerated. And then there is the not-so-small matter of whether countries really want to make do without the benefits of cheap hot money: Chile eliminated its tax on short-term bank deposits by foreigners in 1998 as part of an effort to encourage greater inflows.

Barry Eichengreen at the University of California at Berkeley takes the opposite position. He accepts and welcomes the fact that the Chilean controls changed the maturity structure of foreign lending to Chile without having much effect on total foreign investment. That is precisely what is needed, he argues. And elimination of the tax made sense, he says, once Chile ceased to be a favorite refuge for foreigners in search of higher interest on short-term deposits.

Thus, Chile, like Malaysia, turns out to be a special case. Chile wished to avoid in the 1990's what had happened in the 1980's, when large capital inflows gave way to a major depression. And by virtually any measure, its policy of discouraging short-term investments without barring them proved a success. But short-term capital controls have been problematic elsewhere and have not survived very long. They are best thought of as a transitional tool, to be used while other domestic policies are strengthened.

NOT WITH A BANG…

The year 2000 has already begun auspiciously. And, absent a major and unanticipated reversal in the United States, the world economy should finally achieve the more balanced expansion needed to keep third world development on track. Capital flows are likely to perk up. And with commodity prices apparently poised to recover, resource-rich developing countries will have a better shot at the brass ring.

In such an environment, pleas for fundamental financial reforms are likely to lose their urgency. Goldilocks has not yet learned to speak Thai and Portuguese, however: new cyclical problems will no doubt emerge in the developing world, and there will then be a need for cash and advice from developing countries to lighten the burden. But calls to revolution, heard from the ramparts of international finance in 1997 and 1998, aren't likely to be heard again anytime soon.

Nostalgic for the years of living dangerously? Be thankful we have the chance to worry about lesser matters.