GOVERNING THE GLOBAL ECONOMY:

DOES ONE ARCHITECTURAL STYLE FIT ALL?

Dani Rodrik
Harvard University

John F. Kennedy School of Government
79 Kennedy Street
Cambridge, MA 02138
(617) 495-9454
Fax: (617) 496-5747
E-mail: dani_rodrik@harvard.edu
http://www.ksg.harvard.edu/rodrik/

April 1999

Paper prepared for the Brookings Institution Trade Policy Forum conference on Governing in a Global Economy, April 15-16, 1999.

GOVERNING THE GLOBAL ECONOMY:

DOES ONE ARCHITECTURAL STYLE FIT ALL?

Introduction

Financial market deregulation sets off a credit boom and an explosion in equity and real estate prices. Private sector debt shoots up from 85 percent of GPD to 135 percent within five years. The economy becomes overheated, generating sizable current-account deficits. Unable to borrow long-term abroad, the private sector accumulates a large stock of short-term foreign debt in foreign currency. Foreigners are happy to lend in order to take advantage of high domestic interest rates. A real appreciation of the currency leads to the weakening of export performance. Meanwhile, the government denies rumors of impending devaluation, and insists that it will maintain the currency peg.

A devaluation in a nearby country reveals how vulnerable the economy is to the loss of international confidence. All of a sudden, foreign creditors curtail their short-term credit lines. At first, the central bank tries to hold the exchange rate. But eventually it has to yield, and lets the currency float. The cutoff in lending and the currency collapse trigger a huge wave of bankruptcies. In a matter of three years, the private sector is forced to transform its external deficit from 8 percent of GDP into a surplus of 11 percent--a turnaround of almost 20 percent of GDP. The loan losses incurred by the banking system amount to 12 percent of GDP. The economy is faced with the most severe economic crisis it has faced in a long time.

Thailand or South Korea in 1997-1998? It could be, but it is not. The country in question is Sweden in 1992-1993.[1] The similarities are striking, and they are a reminder that financial crises can overwhelm even those countries that lack the structural defects that (with the

[1] I have relied here on the account by Bäckström (1997).

benefit of hindsight) are presumed to have left the East Asian countries vulnerable to external shocks. Crony capitalism, corruption, weak rule of law, lack of transparency, inadequate financial regulation and prudential supervision, poor corporate governance, non-enforcement of bankruptcy procedures, an insufficiently open capital account, overly-ambitious industrial policies--these are hardly the characteristics that one associates with Sweden, or for that matter Finland and Norway (two other countries that experienced severe financial turbulence in 1992-1993). Nonetheless, the official view that has emerged is that such structural elements have played a key role in precipitating the Asian financial crisis.

The result is a remarkable development: the international community has now taken on with great vigor the task of redesigning developing economies in East Asia and elsewhere. The current IMF programs in East Asia proscribe structural reforms in minute detail in the areas of business-government relations, banking, corporate governance, bankruptcy laws, labor-market institutions, and industrial policy. A key component of the new International Financial Architecture is a set of codes and standards--on fiscal transparency, monetary and financial policy, banking supervision, data dissemination, corporate governance and structure, accounting standards--designed for application in all countries, but targeted especially on developing countries.

An unappreciated irony in this is that conditionality on developing countries is being ratcheted up at precisely the moment when our comprehension of how the world economy works and what small countries need to do to prosper within it has been revealed to be sorely lacking. It wasn't so long ago that East Asia's export-orientation and high investment rates were assumed to provide protection against the kind of external crisis that periodically rocks Latin America. A common exercise in the aftermath of the 1995 tequila crisis was to compare the two regions in

terms of their current-account deficits, real exchange rates, export-GDP ratios, and investment rates to show how East Asia, for the most part, looked "better." East Asia had its critics of course, but what the critics had in mind was a gradual running out of steam and not the meltdown that transpired. "I have learned more about how this new international financial system works in the last twelve months than in the previous 20 years," Alan Greenspan acknowledged recently.[2] Can anyone claim to have had a better understanding of financial markets than Greenspan?

Ignorance calls for humility. The central theme of this paper is that there are dangers in throwing at developing countries a Washington-consensus view of economic policy, even if this consensus is now refurbished with new international codes and standards and with "second-generation reforms." The dangers arise from several sources. First, the new set of external disciplines come hand-in-hand with a particular model of economic development of doubtful worth, and will foreclose some development strategies that have worked in the past, and others that could work in the future. The narrowing of national autonomy in the formulation of development strategy is a cost for which developing countries are unlikely to receive an adequate reward. Second, it is doubtful that the new policy agenda will make the international financial system itself much safer. As long as capital flows remain large relative to the liquid assets held by national governments and are easily reversible, the international economy will be hostage to spectacular boom and bust cycles. Indeed, by focusing attention on internal structural reforms in the developing world, the current approach leads to complacency on short-term capital flows, and could increase rather then reduce systemic risks. Finally, the practical difficulties of implementing many of the institutional reforms under discussion are severely underestimated.

---

[2] Quoted in Thomas L. Friedman, "A Manifesto for the Fast World" New York Times Magazine, March 28, 1999, p. 71.

Today's developed countries did not get their regulatory and legal institutions overnight. It would be nice if third-world countries could somehow acquire first-world institutions, but the safe bet has to be that this will happen only when they are no longer third-world countries.

My argument is not against the substance of specific standards or codes. No one can be seriously against the introduction of proper accounting standards or against improved prudential supervision of financial intermediaries. While, as I will argue below, some of the standards are likely to backfire in practice, the more serious concern is that the standards are the wedge with which a broader set of policy and institutional preferences--in favor of open capital accounts, deregulated labor markets, arms-length finance, American-style corporate governance, and against industrial policies--will be imparted on the recipient countries. In effect, the approach privileges freedom of international capital mobility in the name of "sound" economic policy, and does so at the cost of ignoring other goals of development policy that may potentially clash with it.

The plan for the paper is as follows. The next section discusses the appropriateness of the new-style IMF conditionality. This is followed up by an analysis of the issue of market confidence, especially as it relates to the questions of structural reform and IMF conditionality. Next, I discuss some of the practical difficulties in implementing the G7 approach to the international financial architecture, emphasizing the diversity of needs and circumstances in developing countries. The penultimate section questions whether international capital mobility is an appropriate objective for the international community in designing the new architecture. The final section presents some concluding thoughts.

The new conditionality

The international financial architecture envisaged by the G7 will entail enhanced conditionality on developing countries for at least three reasons. First, as mentioned previously, one of the official lessons drawn from the Asian crisis is that the structural features of the Asian economies played an important role in precipitating the crisis, and that preventing future crises will requires reforms that undo these features. Second, the new codes and standards that are being promulgated will need to be adopted by each country, and an international agency will have to certify that countries are in compliance. Third, access to the IMF's new short-term contingency facility will be available only to those countries that submit themselves to higher-order conditionality. *Faute de mieux*, it is the IMF that will dish out the conditionality.

The IMF program in South Korea provides a window to the world of conditionality of the future. In late 1997, the IMF organized a rescue package for Korea of $57 billion, with $21 billion coming from its own resources. In return, the Korean government accepted an extensive program of reform that, carried to its fruition, would completely overhaul the structure and governance of the Korean economy. The program included:

- tight money policies, higher interest rates, and a fiscal retrenchment initially equivalent to about 2 percent of GDP (the latter requirement was significantly relaxed in subsequent programs as the Korean economy deteriorated more than anticipated);
- a comprehensive financial-sector restructuring, including independence of the central bank and the suspension of the operations of nine merchant banks;
- the dismantling of “nontransparent and inefficient ties among the government, banks, and businesses,” including the phasing out the system of cross guarantees within conglomerates;
- a program of trade liberalization, including the phasing out of trade-related subsidies, of restrictive import licensing, and of the import diversification program;
- capital-account liberalization, including the lifting of all capital-account restrictions on foreign investors’ access to the Korean bond market; and

- labor-market reforms, aimed particularly at making layoffs easier while enhancing social safety nets.[3]

The Korean government has signed a total of seven letters of intent with the IMF between December 24, 1997 and March 10, 1999 (the date of the most recent agreement). The general thrust of these agreements has been to relax the fiscal stance over time (in order to counter the decline in domestic demand) and to impose an increasing range of responsibilities in the areas of financial reform, corporate restructuring and governance, and capital-account liberalization. The latest memorandum of economic policies submitted to the Fund (on March 10th, 1999) contains one-and-a-half pages on macroeconomic policy, and twelve densely-packed pages on privatization, financial sector restructuring, prudential regulation and supervision, corporate restructuring, trade and capital account liberalization, and transparency, monitoring and data reporting.

The extent to which the conditionality imposed on Korea departs from the IMF's traditional approach--with its focus on quantitative macro and financial policy indicators--is striking. Moreover, this conditionality reaches beyond the difficult, but otherwise unambiguously desirable objective of improving capital-adequacy standards, prudential supervision, and data dissemination. In effect, the reforms in labor-market institutions, trade and capital accounts, and government-business relations entail a remolding of the Korean economy in the image of a Washington economist's idea of a free-market economy. If Korea, a mid-size country with an exemplary development record, is subject to such intrusive conditionality, one can imagine what is in store for small countries with more checkered economic histories.

---

[3] See http://www.imf.org/External/np/exr/facts/asia.HTM (Box 4) and http://www.imf.org/external/np/oth/korea.htm. The text of the latest Letter of Intent is at http://www.imf.org/external/np/loi/1999/031099.htm.

Martin Feldstein (1998) has trenchantly criticized this departure. Feldstein argues that the IMF's primary goal should have been to help Korea gain renewed access to capital markets, and that most of the structural changes imposed by the IMF were not required to meet that objective:

> Although many of the structural reforms that the IMF included in its early-December program for Korea would probably improve the long-term performance of the Korean economy, they are not needed for Korea to gain access to capital markets. They are also among the most politically sensitive issues: labor market rules, regulations of corporate structure and governance, government-business relations, and international trade. The specific policies that the IMF insists must be changed are not so different from those in the major countries of Europe: labor market rules that cause 12 percent unemployment, corporate ownership structures that give banks and governments controlling interests in industrial companies, state subsidies to inefficient and loss-making industries, and trade barriers that restrict Japanese auto imports to a trickle and block foreign purchases of industrial companies.

The IMF's response is that new crises require new approaches. According to Stanley Fischer (1998)[4], the Feldstein criticism neglects the roots of the crisis. In his words:

> Financial sector and other structural reforms are vital to the reform programs of Thailand, Indonesia, and South Korea because the problems of weak financial institutions, inadequate bank regulation and supervision, and the complicated and non-transparent relations among governments, banks, and corporations were central to the economic crisis. IMF lending to these countries would serve no purpose if these problems were not addressed. Nor would it be in the countries' interest to leave the structural and governance issues aside: markets are skeptical of halfhearted reform efforts.

Note the two-pronged response. First, the structural reforms are needed because it was structural problems that instigated the crisis. Second, they are necessary to signal to markets that the governments are doing the right things and therefore deserve their confidence. The second of these, I believe, is the more weighty argument, and I shall examine it below. Here I deal with the relationship between economic structure and financial crisis.

---

[4] See http://www.imf.org/external/np/vc/1998/073098.HTM.

The claim that East Asian-style institutions[5] made the countries of the region particularly prone to financial crises is hard to support on the basis of evidence.[6] The point of the Swedish example that opens this paper is precisely to indicate that financial markets can misbehave even in climates where cronyism does not breed. Every financial crisis entails reckless borrowing as well as reckless lending, and to that extent the Korean, Thai, Indonesian, and other Asian borrowers who ran up short-term liabilities are surely at fault. But there is simply no evidence to suggest that countries with a particular development model are more prone to financial crises than others.[7]

The proximate cause of the Asian crisis was the excessive accumulation of short-term debt in excess of liquid assets, which left these countries vulnerable to self-fulfilling crises (Radelet and Sachs 1998, Furman and Stiglitz 1998, UNCTAD 1998, Chang and Velasco 1999). The reasons behind rapid short-term debt accumulation do not seem related to simple generalizations in terms of development strategies. To the extent that there is a common element, however, it is this: countries that undertake financial liberalization are more likely to end up with large short-term external liabilities and to end up in banking and/or external crises (Kaminsky and Reinhart 1998). The evidence suggests that high shares of M2 in GDP tilt the maturity composition of external debt toward the short end, and that high ratios of short-term debt to reserves increase the probability of financial crises (Rodrik and Velasco 1999). Hence, one can plausibly argue that premature financial deregulation during the 1990s contributed, at the

---

[5] This is a misnomer, of course. There is a great deal of institutional variety even within East Asia.

[6] For an account of the rise and fall of the crony-capitalism hypothesis to explain the East Asian crisis, see MacLean (1999).

[7] One of the (now-discredited) lessons of the debt crisis of the 1980s was that an outward-oriented trade strategy guards against external crises. It is hard to imagine a more outward-oriented set of countries--in the sense implied in that earlier discussion--than the East Asian countries.

very least, to the East Asian crisis.[8] Interestingly, in a country like Korea, financial liberalization was undertaken in no small part in response to U.S. pressure and to satisfy the requirements of OECD membership. This is indeed a poignant example of how ill-advised external pressure--grounded in partial economic theory and inadequate evidence (but solid mercantilist reasons)--can prove harmful to the recipient.

It is all the more ironic that this should have been the fate of a country like South Korea, which grew rich by doing all sorts of things that it would have been prevented from doing by today's rule book. Close links between the government and the *chaebol*, credit subsidies, investment guarantees, protected domestic markets, restrictions on inward FDI, domestic-content requirements, public enterprises, mild financial repression--these too were features of the Korean model alongside outward orientation, conservative fiscal policies, and an emphasis on education. The debate over the extent to which these policies contributed to (or perhaps hindered) growth is a legitimate one. The point is that there <u>is</u> a debate. Its existence reminds us that our understanding of what makes for a successful economic strategy remains limited.

In the end, I believe Feldstein (1998) has it exactly right when he writes:

> Imposing detailed economic prescriptions on legitimate governments would remain questionable even if economists were unanimous about the best way to reform the countries' economic policies. In practice, however, there are substantial disagreements about what should be done. Even when there has been near unanimity about the appropriate economic policies, the consensus has changed radically. After all, the IMF was created to defend and manage a fixed exchange-rate system that is now regarded as economically inappropriate and practically unworkable. Similarly, for a long time the advice to developing countries that came from the World Bank, the IMF's sister institution, and from leading academic specialists emphasized national plans for government-managed industrial development. The official and very influential U.N. Economic Commission for Latin America preached the virtues of protectionist policies to block industrial imports in order to encourage countries to develop their own manufacturing industries. Now the consensus of professional economists and

---

[8] See Ito and Krueger (1996) for an early analysis of financial deregulation in East Asia and of the risks involved, and especially the chapter by McKinnon and Pill (1996).

> international agencies calls for the opposite policies: flexible exchange rates, market-determined economic development, and free trade… Even if it were desirable for Korea to shift toward labor, goods, and capital markets more like those of the United States, it may be best to evolve in that direction more gradually and with fewer shocks to existing businesses.

As Feldstein recognizes, the fact that fashions in economic policy change frequently should make us more humble in prescribing detailed structural programs on developing countries—especially on those that have developed by eschewing conventional wisdom and espousing heterodox policies. The reality is that our prescriptions often go considerably beyond what can be supported by careful theoretical reasoning or empirical demonstration. We know a lot less about what makes for good economic policy than we recognize.[9] Economies that have done well in the postwar period have all succeeded via their own particular brand of heterodox policies. Macroeconomic stability and high investment rates have been common, but beyond that many details differ (Rodrik 1999). Trying to fit all developing nations into a straitjacket of policies that have only recently become conventional wisdom is undesirable.

In pursuit of market confidence

The second argument for structural reforms is that they are needed to regain (or maintain, as the case may be) "market confidence." In a world where capital is internationally mobile and short term liabilities have exploded thanks to financial liberalization, confidence becomes the sine qua non of macroeconomic stability, and hence a prerequisite for economic development. Without confidence, money flees, interest rates shoot up, and the currency plummets. And the culprits are not just wicked foreign speculators. Domestic investors can crash the economy equally well, by converting their short-term assets (bank deposits, government bills) into foreign

[9] The need for humility in policy prescription is underscored also in Stiglitz (1998).

currency and taking them out of the country. Hence there is little question that governments and the IMF have to target their policies on market confidence.

But where does confidence come from? In the best of all possible worlds, it would be common knowledge which policies work and which do not, and hence all that governments would need to do is adopt the policies of the former type and rescind the policies of the latter type. Confidence would be restored, capital would flow back in, and everyone would live happily ever after. Is this the model under which IMF conditionality--and all advice emanating from Washington--works? Yes and no. There is, as I have discussed, an augmented Washington consensus: "everyone" knows that industrial policy is terrible, that deregulated labor markets are good, that open trade and capital accounts are even better, that improved prudential supervision and corporate governance can prevent financial crises, and so on.

Note, however, that under this model, the objective of regaining confidence is entirely superfluous. Confidence comes automatically to those who follow the right path. It makes no sense to justify reforms on the basis of their expected impact on market confidence. The appropriate retort to Feldstein's criticism is simply: "we (and the rest of the world) know what works and you don't."[10]

Presumably hardly anyone in Washington thinks that. So we have to entertain the idea that sound economic policy is not common knowledge, or that information sets about what constitutes sound economic policy differ.[11] Alternatively, even though the policy fundamentals

[10] There is a more subtle, signaling argument under which governments might need to frontload their reforms--or overshoot--in order to show their determination to financial markets. See Rodrik (1989) for a theoretical exposition. However, this argument works only to the extent that the frontloading is actually costly to the government in question. A costless signal is a worthless signal. If this is the real argument for deep structural reforms, the IMF would have to own up to the fact that governments are being forced to do things that are in fact harmful to the economy for the sake of sending a positive signal to financial markets.

[11] See Morris and Shin (1998) on how self-fulfilling currency attacks can arise as the unique equilibrium of a model in which fundamentals are not common knowledge.

are common knowledge, there might be multiple equilibria due to the interdependence among investors' actions. In these situations, uncertainty about others' beliefs or actions matters a great deal. We can end up in quite lousy equilibria characterized by a divorce between investor behavior and fundamentals.

Krugman (1998) has highlighted one of the possibilities. In situations of multiple equilibrium, the IMF is forced to play what Krugman calls the "confidence game":

> [C]onsider the situation from the point of view of those smart economists who are making policy in Washington. They find themselves dealing with economies whose hold on investor confidence is fragile; almost by definition a country that has come to the United States and/or the IMF for help is one that has already experienced a devastating run on its currency and is at risk of another. The overriding objective of policy must therefore be to mollify market sentiment. But, because crises can be self-fulfilling, sound economic policy is not sufficient to gain market confidence; one must cater to the perceptions, the prejudices, and the whims of the market. Or, rather, one must cater to what one hopes will be the perceptions of the market.
>
> In short, international economic policy ends up having very little to do with economics. It becomes an exercise in amateur psychology, in which the IMF … and the Treasury Department try to convince countries to do things they hope will be perceived by the market as favorable. No wonder the economics textbooks went right out the window as soon as the crisis hit.

In other words, governments might be told that they need restrictive monetary and fiscal policies, privatization, labor-market reforms, capital-account liberalization, and so on <u>not</u> because the IMF thinks these are the things they ought to be doing (not at that point in time in any case), but because the IMF thinks these are the things that the <u>markets</u> want to see.[12]

One then needs to ask: where do markets get their ideas about economic policy? One possibility is that investors, in aggregate, have a better idea about what makes economies perform than the IMF, the World Bank, and academic economists do. In this case, following the

---

[12] Krugman makes this point in relation to tight monetary and fiscal policies specifically. But his point is equally valid for the structural reforms that I have been discussing. See also Eatwell (1997) on the distortions introduced by the governments' search for "credibility," as defined by financial markets

market's guidance would of course be a perfectly acceptable and desirable strategy. On the other hand, we have no reason to believe that buying and selling an economy's currency endows a trader with any special insight on questions such as: Should capital-account transactions be taxed, and if so how? Would overall welfare rise if a government reduced food subsidies to finance tax holidays for foreign investors? Do firing costs increase unemployment? There are no invisible-hand theorems that apply here: local knowledge about the operation of particular markets does not aggregate up to a well-founded market sentiment about how national economies work and can be made to work better.

This does not mean that the market's ideas about what constitutes sound economic policy are entirely arbitrary. For one thing, investors, just like anybody else, have a tendency to associate the public interest with their private interest. So high interest rates (as long as they don't bankrupt the borrowers), open capital accounts, free entry for foreign financial-services firms are desirable because they are, well, good for foreign creditors and investors. Furthermore, bankers and currency traders study economics in, typically, Northern American or British universities (some even at the graduate level), they read *The Economist* and the *Financial Times*, look at reports by the IMF and the World Bank, listen to academic economists hired as consultants, call up their friends in international organizations, and generally imbue the economics zeitgeist of the time. In all this, the pronouncements of the official Washington community (the IMF and the Treasury in particular) play an important anchoring role. Since market participants have no capacity to generate judgements on the long-term developmental effect of government policies, they have to rely on what they are told.

Assume for a moment that my argument is valid, and that the IMF (as well as other Washington institutions) shape the conventional wisdom on sound economic policy, and that this

conventional wisdom in turn is a determinant of whether markets bestow confidence on specific economies. Then, when the IMF acts as if markets' judgement of economic policy is independent of its own, it ends up entrenching its own vision of economic policy in the name of restoring market confidence. Just as governments often hide behind the IMF in explaining that they have no choice but to cut fiscal expenditures and raise interest rates (and do a myriad other things on top), the IMF can hide behind markets and argue that "market confidence" requires it all.

But of course this is all circular. Indeed, the interdependence between market confidence and IMF policy preferences can lead in the limit to self-fulfilling equilibria of a different sort. If market confidence comes only after sound policies are followed and sound policies are defined as policies that trigger confidence, financial markets and the IMF can in principle converge on any arbitrary set of policies. No developing country could then possibly embark on alternative policies, even when the empirical basis for the policy recommendations was weak or non-existent. Any country that tried to do so would be stamped "renegade" and would face the risk of withdrawal of investments by foreigners and locals.

The point is that official views coming out of Washington do a lot to shape markets' evaluations of what constitutes sound economic policy and are thereby important in turning market confidence on and off. To be sure, there are limits to that role. In the short run, the IMF can do very little to stop a stampede out of an emerging-market economy that is suffering a confidence crisis. But it is not appropriate for the IMF to use the confidence factor as an excuse for experimental surgery on national economies. By articulating a clear view about the immediate macroeconomic and financial needs of economies like South Korea or Brazil, and drawing a sharp distinction between these immediate requirements and structural reforms that are

of peripheral concern and which may or may not be desirable in the medium- to long-run, the IMF can guide markets' evaluations of whether these countries are doing the "right" things. By acknowledging more openly the limits of our knowledge about economic development policy as well as the possibility that national economic strategies can legitimately differ, it can warn financial markets against putting too much faith on fads.

What kind of an international architecture?

The Asian financial crisis has demonstrated that a functioning world economy needs an institutional infrastructure. Markets that work well are always underpinned by institutions that provide at least three functions: they regulate market behavior, stabilize aggregate demand, and redistribute the risk and rewards of market outcomes. World markets are no different. In particular, a truly global financial market requires an equally global set of institutions that provide regulatory, lender-of-last resort, and safety-net functions.

The G7 approach to the international financial architecture is inspired by much the same thinking. The objective of the new architecture is to close the gap between the scope of institutions--heretofore mostly national--and the scope of markets--increasingly international.

So far so good. However, the manner in which the G7 propose to achieve this is curious in one significant respect. As a matter of logic, the most immediate way of closing the gap between the reach of institutions and that of markets is to enhance the international regulatory apparatus while slowing down the international integration of financial markets. Instead, the G7 work program entails the establishment of a set of international codes and standards while enhancing the international mobility of capital. Capital-account liberalization, albeit in an

"orderly and progressive" manner, remains a key element of the architecture. In other words, rather than bringing the target closer, the G7 push it farther away.

The G7 agenda aims to build a set of institutions that will take the boom and bust cycles out of capital flows and minimize the adverse effects on the poor, but otherwise maximize capital mobility. Among all the proposed codes, standards, and enumerations of best practice, one looks in vain for an effort to help developing countries manage, and restrict if need be, capital flows. A crude but not altogether inaccurate statement of the objective is that it consists of making the world safe for free capital flows.

Assume for a moment that maximizing freedom of capital mobility is a worthwhile objective. Can it be achieved safely with the institutional tinkering that is on the G7 agenda? Possibly, but it is important to realize that there are severe risks. For one thing, our ability to anticipate the regulatory codes and standards needed to ward off the next crisis (as opposed to the previous one) is necessarily limited. One indication of this is that each crisis spawns a new generation of economic models that purport to explain it. Regulators are likely to remain behind the curve too. For example, the IMF's Special Data Dissemination Standard (SDDS) was a response to one of the perceived lessons of the Mexican peso crisis: timely data on central bank reserves can stabilize markets by enhancing transparency. But the SDDS proved quite ineffective at the time of the Asian crisis. The standards had not adequately anticipated the need to keep track of off-balance sheet liabilities of central banks (such as forward commitments) and of short-term private debt stocks. These shortcomings are now being fixed, but who knows what the next crisis will teach us.

Another example comes from the Basle capital adequacy standards. These standards prescribe a higher risk-weight on long-term loans than on short-term loans where lending to non-

OECD countries is concerned--100% versus 20%. The effect is to make longer-term loans significantly more expensive for banks, by requiring them to hold higher capital when they make loans of longer maturity. The original logic was that short-term loans are an accepted method of managing liquidity (when placed with other banks) and carry lower transfer and/or credit risk. In the aftermath of the Asian crisis, we have a better appreciation of the fact that what is safe for an individual bank may not be safe for the system as a whole. High levels of short-term debt increase the chance of self-fulfilling runs and financial crisis.[13] Consequently, it is possible that this particular feature of the capital adequacy standards has made things worse during the 1990s by stimulating short-term lending to emerging-market economies.

Moreover, differences in economic and institutional circumstances mean that regulatory regimes that work in one setting may not work in others. The difficulties with implementation in countries with weak bureaucratic and judicial systems and poor levels of human capital are obvious, and need not be elaborated. Equally serious are structural differences that may hamper the effective operation of regulatory systems imported wholesale from abroad. Rojas-Suarez and Weisbrod (1996) provide an illustration from Latin America. They examine bank capital standards and conclude that the region's high levels of concentration of wealth and thin equity markets make it very unlikely that such standards can be effectively enforced. The main difficulty is that these conditions enable bank owners to dilute their real capital stake by making loans to themselves, either directly or by borrowing from each other. An implication is that capital standards work less well in Latin America than, say, liquidity requirements expressed in terms of foreign-currency assets. But of course what is true for Argentina may not be true of India.

[13] See Rodrik and Velasco (1999) for evidence that short-term debt-to-reserves ratios are a robust predictor of financial crises.

The proposition that regulators are always one step behind financial markets is not particularly controversial. U.S. regulators periodically complain about weak loan standards,[14] even though the U.S. has probably the most sophisticated regulatory regime in the world. Interestingly, it is the opponents of capital controls that highlight the issue of regulatory inadequacy the most when they argue that capital controls could never be made to work because investors would find ways of evading the controls. If that were true, one would be left with no hope that adequate prudential supervision could be extended to international financial markets. If financial intermediaries could easily evade transactions taxes, deposit requirements, or ceilings on foreign liabilities, they could surely do the same with capital-adequacy standards and reporting requirements. The truth is possibly somewhere in between: financial regulation, prudential supervision, and capital-account controls can all be made to work, but only imperfectly.

Regulatory failure is a bigger issue in the international setting than in the domestic one for two reasons. First, domestic regulatory systems in the advanced industrial countries are the product of a natural and gradual evolution over time. Consequently, there is a greater presumption that they are functional in an adaptive sense. More importantly, the costs of domestic regulatory failure are much lower because domestic regulation is backed by a central bank that performs a lender-of-last-resort function. When a mid-size bank fails, say, in Texas, what prevents that from turning into a crisis for the U.S. economy is not bank regulation, corporate governance, or bankruptcy procedures, but the fact that the Fed stands ready to provide the liquidity to forestall bank runs in California, New England, and elsewhere.

---

[14] See for example "Banks Warned on Letting Loan Standards Slide," Financial Times, February 19, 1998, p. 5.

The chances of a similar lender-of last-resort being established internationally are virtually nil. The G7 envisages an enhanced IMF facility to provide short-term credits to countries in difficulty, but the only connection to a standard lender of last resort is that the new facility will lend at a penalty rate. Neither of the other two requirements--lending freely and against good collateral--is a realistic possibility. In particular, the IMF will require that countries partaking of the new facility pursue what the G7 call "strong IMF-approved policies"[15]--i.e. the type of high-level conditionality that I have discussed previously. What precludes a true international lender of last resort is the simple fact of national sovereignty. For reasons that are well explained by Eichengreen (1999, 93-102), no country, least of all the United States, is willing and likely to endow an international agency with the ability to issue unlimited credit.[16] And in a world where the daily volume of foreign currency trading is $1.5 trillion, an international facility with limited funds is a standing duck for George Soros and other hedge funds.

Should capital-account liberalization be an objective?

One problem of treating capital flows as the maximand while using "institutional reform" as the policy instrument is that, as I have just discussed, the instrument is unlikely to be very effective on its own. Another is that it is not clear why capital mobility should be an objective. Policy discussions too often evolve into statements of the form "globalization requires x, y, and

---

[15] Declaration of G7 Finance Ministers and Central Bank Governors, October 30, 1998.

[16] For a useful discussion of how far the LLR concept can be stretched internationally, see Fischer (1999). See also Ahluwalia (1999) for a realistic appraisal.

z," betraying a confusion between ends and means.[17] Capital flows, just like trade flows, are a vehicle for prosperity, not a policy objective in their own right. The link between capital flows and national development efforts is a relationship that has to be scrutinized, not presumed.

The appeal of capital mobility is obvious. In the absence of market imperfections, freedom to trade enhances efficiency, and that is as true of trade in paper assets as it is of trade in widgets. But most people, including Alan Greenspan, Michel Camdessus, and George Soros, would now agree that the "if" that qualifies the previous sentence is a big if in the case of international financial markets. Financial markets suffer from informational asymmetries, agency problems, self-fulfilling expectations, bubbles (rational and otherwise), and myopia to an extent that makes their economic analysis inherently a second-best one. No amount of institutional tinkering is likely to make a significant difference to that basic fact of life.

The question of whether developing nations should be pushed to open their capital accounts (in an "orderly and progressive" manner as the G7 recommend, whatever those terms may mean) can ultimately be resolved only on the basis of empirical evidence. I know of plenty of evidence that financial liberalization is followed by financial crash, but know of practically no evidence that suggests that capital-account liberalization is followed by higher rates of economic growth. Since this has been an issue of some contention in the public debate, one assumes that any existing positive evidence on this score would have long been brandished prominently as an exhibit in support of the defense. In the absence of evidence of this sort, canonizing capital mobility risks being perceived as a mercantilist effort to drum up business for the financial elite of the U.S. and Europe (Bhagwati 1998).

---

[17] Here is an example from Camdessus (1999): "Globalization makes it essential that every country ensure that its policies are sound and forces every country to guard against the policy of changes, sometimes quite abrupt, in its external environment."

Among all the arguments in favor of international capital mobility perhaps the most appealing one is that such mobility serves a useful disciplining function on government policy. Governments that have to be responsive to investors cannot squander their society's resources as easily. As Larry Summers (1998) puts it, "market discipline is the best means the world has found to ensure that capital is well used."

The idea is attractive, but once again one has to question its empirical relevance. When foreign creditors suffer from the syndromes noted above, a government intent on irresponsible spending finds it easier to finance its expenditures when it can borrow from abroad. Moreover, for such a government even domestic borrowing becomes politically less costly because, in a world of free capital mobility, there is no crowding out of private investors (the latter can borrow from abroad). In both instances, international financial markets allow reckless spending that might not have taken place in their absence. Conversely, the discipline that markets exert in the aftermath of crises can be excessive and arbitrary, as discussed previously. As Willett (1998) points out, the appropriate characterization of market discipline is that it comes too late, and that when it comes it is typically too much.

Governments do need discipline of course. However, in modern societies this discipline is provided by democratic institutions--opposition parties, independent courts, parliamentary debate, a free press and other civil liberties. Governments that mess up their economies are punished at the polls. The broad cross-national evidence suggests that democratic nations tend to be pretty good at maintaining conservative fiscal and monetary policies. Most significant cases of fiscal profligacy occur under authoritarian regimes rather than democratic ones. It was military dictatorships that got Latin America into its debt crisis, and democracies that cleaned up the mess. In Asia, democratic countries such as India and Sri Lanka have exemplary

macroeconomic records by Latin American or African standards. Africa's only two long-running democracies (Mauritius and Botswana) have done an excellent job of managing booms and busts in the prices of their main exports (sugar and diamonds). Among the transition economies, the most successful stabilizations have occurred in the most democratic countries. One finds a strong negative association between the Freedom House index of democracy and the average inflation rate in a sample of more than 100 countries, after controlling for per-capita income.[18]

Hence it is not obvious what defect of democratic decision-making external market discipline can solve, or why such discipline should be viewed as superior to internal checks and balances. In fact, external market discipline can be perceived as subverting democracy, and to that extent make national economic governance messier. What goes under the name "market discipline" is not a neutral political force. It empowers financial markets—both domestic and foreign—over other constituencies in society. Hence it can be seen as serving the needs of particular social groups at the expense of others. The international-capital-mobility-as-discipline position embodies a view of politics that is at best partial, and at worst harmful to democracy.

Finally, the pursuit of the capital-account liberalization agenda has the effect of crowding out policy makers' agenda and diverting their energies from national development efforts. A finance minister that is spending all his/her time mollifying investor sentiment and marketing the economy to foreign bankers is one that is spending no time on traditional developmental concerns: reducing poverty, mobilizing resources, and setting investment priorities. In the end, it is global markets that dictate policy, not domestic priorities.

[18] The period covered is 1975-1990, and the democracy index used is an average for the 1970s (to minimize reverse causality). The (heteroskedasticity-corrected) t-statistic on the democracy index is -2.40.

Concluding remarks

A more balanced agenda for the international financial architecture, one that is more in line with developing country interests, would have the following features. First, it would strive for a more appropriate mix between strengthening the institutional infrastructure through codes and standards, on the one hand, and discouraging short-term capital flows, on the other. At present too much thinking and effort is invested in the former, and too little in the latter. Second, it would recognize the limits of our knowledge about what constitutes sound economic policy as well as the need for allowing diversity in national development efforts. It would not overreach by attempting to restructure emerging-market economies in pursuit of making the world safe for capital flows. Last but not least, the G7 would make a genuine effort to discuss issues of international economic governance with the developing countries. The current model is one in which the G7 work out all the details, and then conduct outreach to educate developing countries. The outcome of such a process will not only lack widespread legitimacy, it will also suffer from oversights arising from inadequate understanding of the developing countries circumstances.

Back to Sweden in 1992. How did the Swedes deal with their financial crisis? To begin with, they enacted a general guarantee for the entire banking system to stem panic (providing blanket protection to all but the shareholders). This was followed by a recapitalization of the banking sector. They also followed an expansionary monetary policy and let interest rates slide. The budget deficit was allowed to increase. Real GDP began to recover in 1994 after three years of decline.

Imagine now that Sweden had been a run-of-the-mill developing country and that the IMF had been called in. What would the Fund have recommended? Presumably bank closures,

higher interest rates, and fiscal tightening to restore market confidence. And no doubt many structural reforms as well. It wouldn't have escaped the Fund's attention that the Swedish public sector plays a significant role in the economic life of the country: taxes are high, public employment is large, and government spending is close to half of GDP. What better candidate for structural reform than a dismantling of the Swedish welfare state?

Would the IMF have made its assistance conditional on significant reforms in labor markets and in the social insurance system? Probably yes. Would Sweden have been better off today as a result? We do not know. Would it have been a good idea for the IMF to extend its conditionality in this manner? Almost certainly not.

REFERENCES

Ahluwalia, Montek Singh, "The IMF and the World Bank: Are Overlapping Roles a Problem?" Studies on International Monetary and Financial Issues, Group of 24, Colombo, Sri Lanka, March 1999.

Bäckström, Urban, "What Lessons Can Be Learned from Recent Financial Crises? The Swedish Experience," in The Federal Reserve Bank of Kansas City, Maintaining Financial Stability in a Global Economy, 1997, 129-140.

Bhagwati, Jagdish, "The Capital Myth," Foreign Affairs, May/June 1998.

Camdessus, Michael, "Latin America in a Globalized Economy: The Chilean Response," speech delivered to a Round Table organized by the Government of Chile, Paris, March 14, 1999.

Chang, Roberto, and Andrés Velasco, "The Asian Liquidity Crisis in Perspective," New York University, 1999.

Eatwell, John, "International Capital Liberalization: The Impact on World Development," Estudios de Economia, vol. 24, no. 2, December 1997, 219-261.

Eichengreen, Barry, Toward a New International Financial Architecture: A Practical Post-Asia Agenda, Institute for International Economics, Washington, DC, 1999.

Feldstein, Martin, "Refocusing the IMF," Foreign Affairs, March/April 1998.

Fischer, Stanley, "In Defense of the IMF: Specialized Tools for a Specialized Task," Foreign Affairs, July/August 1998.

Fischer, Stanley, "On the Need for an International Lender of Last Resort," paper delivered at the American Economic Association meetings, New York, January 3, 1999.

Furman, Jason and Joseph E. Stiglitz, "Economic Crises: Evidence and Insights from East Asia." *Brookings Papers on Economic Activity* (1998:2): 1-135.

Ito, Takatoshi, and Anne Krueger, eds., Financial Deregulation and Integration in East Asia, Chicago and London, The University of Chicago Press for the NBER, 1996.

Kaminsky, Graciela, and Carmen Reinhart, "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems, "International Finance Discussion Paper 544, Board of Governors of the Federal Reserve System, 1998.

Krugman, Paul, "The Confidence Game," The New Republic, October 5, 1998.

MacLean, Brian K., "The Rise and Fall of the 'Crony Capitalism' Hypothesis: Causes and Consequences, " Department of Economics, Laurentian University, Ontario, March 1999.

McKinnon, Ronald, and Huw Pill, "Credible Liberalizations and International Capital Flows: The 'Overborrowing Syndrome'," in Takatoshi Ito and Anne Krueger, eds., Financial Deregulation and Integration in East Asia, Chicago and London, The University of Chicago Press for the NBER, 1996.

Morris, Stephen, and Hyun Song Shin, "Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks," American Economic Review, June 1998, 587-597.

Radelet, Steven, and Jeffrey Sachs, “The East Asian Financial Crisis: Diagnosis, Remedies, Prospects,” paper prepared for the Brookings Panel, Washington D.C., March 26-27, 1998.

Rodrik, Dani, "Promises, Promises: Credible Policy Reform via Signaling," Economic Journal, 1989.

Rodrik, Dani, The New Global Economy and Developing Countries: Making Openness Work, Overseas Development Council, Washington, DC, 1999.

Rodrik, Dani, and Andres Velasco, "Short-Term Capital Flows," paper prepared for ABCDE, World Bank, Washington, April 1999.

Rojas-Suarez, Liliana, and Steven R. Weisbrod, "Towards an Effective Regulatory and Supervisory Framework for Latin America," Inter-American Development bank, Washington, DC, September 1996.

Stiglitz, Joseph E., " More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus," the 1998 WIDER Annual Lecture, Helsinki, Finland, January 7, 1998.

Summers, Lawrence H., "Building an International Financial Architecture for the 21st Century," remarks to the Cato Institute, Washington, DC, 1998.

UNCTAD, Trade and Development Report, 1998, New York, 1998.

Willett, Thomas D., "International Financial Markets as Sources of Crises or Discipline: The Too Much, Too Late Hypothesis," Claremont McKenna College, 1998.