DOES THE INTERNATIONAL MONETARY FUND HAVE A ROLE IN ASIA?

THE IMF
NOT PERFECT,
BUT ESSENTIAL

VIEWPOINTS

Robert D. Hormats

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Robert D. Hormats, of Goldman, Sachs, and Co., Lawrence B. Lindsey, of the American Enterprise Institute, and Barry Bosworth, of Brookings, discussed the role of the IMF in the Asian financial crisis at a National Issues Forum at

The International Monetary Fund has three important roles in international financial crises. The first is to help countries to fashion programs to restore currency and market stability. The second, under certain circumstances at least, is as a lender of last resort. The third is as a rallier of others in support of actions necessary to end the crisis. The IMF is far from perfect in determining the conditions required for countries to get out of difficulties. But it is far better at doing so than any single government—and even if it weren't, no single government would want that job, for very good political reasons.

To those who want the IMF to stay

out of the business of managing international financial crises and "let the market do it," my response is "Yes, the market *can* do it—but at what pain, what social discontent and political instability, and what contagion worldwide?" It simply is not worth the high cost and high global, systemic risk.

Having said that I think the IMF does have a role, let me add that I also think that it can surely improve its performance in that role.

Changes in the international environment have made it much harder for the IMF to perform its traditional role. The infiow of capital into individual countries has soared. The ratio of private capital to the resources that the IMF has at hand is now enormous. Up against the huge short-term money fiows and the potential they carry of exodus, the IMF's ability to supply capital has diminished considerably.

There are three reasons for the market greater fiows. One is technology, the ability to move large amounts of money across borders very quickly. A second is demography. Baby boomers are saving vast amounts of money for retirement, and their pension saving has led to a greater institutionalization of funds. And the third reason for the increased capital fiows is the growth of hedge funds. When these funds see problems, they exit quickly, greatly increasing the volatility of capital. Naturally, all these developments necessarily herald change in the IMF's role.

Whatever one thinks about the origin of the Asian financial crisis, two important aspects of the crisis were the mispricing of risk—the excessive optimism behind all that money going into Asia—and the excessive confidence that the exchange rates were stable or guaranteed to a degree by governments. That myth, of course, was punctured by the collapse of the Thai baht.

Another important aspect of the crisis was that the increase in fiows into the banking systems in Asia was not accompanied by an increase in the ability to judge credit risk—to judge where the money ought to go. The lack of expertise in judging credit risk led to large structural imbalances in commercial real estate and in certain cases in industry.

Now, what do all these developments suggest with regard to changes in the role of the IMF? I would point out three ways. First, the IMF should be insisting on improved disclosure—not just government accounting, but disclosure of private-sector borrowing, especially private overseas borrowing—corporate and private banking combined. The goal should be to encourage countries to move from what I call "insider capitalism" to "accountability capitalism." Markets are going to insist on greater accountability. If they don't get it, they're going to misprice risk, either on the upside or the downside. Much progress has been made since the 1995 Mexican crisis, but more is required.

Second, the IMF should insist on a more active dialogue with the broad private sector—banks, mutual funds, all the people who are moving money around. Such a dialogue would help to identify risk and to share perceptions about the market.

And third, the IMF should increase its general supervisory role. It should insist that individual countries improve supervision and regulation of their own domestic banking systems. Domestic banking deficiencies caused many of the problems in Asia and exacerbated others. The improvement in banking guidelines should be undertaken through the Bank for International Settlement. The BIS has already come up with capital adequacy requirements for banks of the industrialized G-10 countries. It should also subject emerging countries to guidelines that apply to bank overseas exposure, particularly short-term exposure relative to long-term exposure.

Several points in closing. The structural issues that the IMF and the BIS

ought to deal with are not the traditional IMF macroeconomic issues, but rather changes in corporate governance, investment regimes, and trade and banking regimes. But is it appropriate for the IMF to be involved in such domestic issues? Certainly the IMF should make clear why it is urging changes in these areas to avoid appearing arbitrary. It should also demonstrate why such changes are necessary to promote financial and currency stability. Without strong domestic support, any reforms engineered by the IMF will not last. There is a great potential for backlash, for countries backing away from reforms.

Finally, there is a need for democratic accountability. It is extremely important now for the industrialized countries to conduct a much more open dialogue about the role of the IMF and why it is important. Not long ago it was not difficult for a U.S. presidential administration to get Congress to approve spending for the IMF. It was a matter of sending the experts to testify before a few committees to explain why the IMF was needed. Most members of Congress would just go along with the administration. It wasn't a visceral issue then. Now it is—because the IMF raises questions about globalization, about why we should be helping countries that do not make the domestic changes we want or enact the policies that we prefer.

We need an active dialogue in our own country about why it's in our own interest to provide support for the IMF, the World Bank, and other such institutions. We also need to conduct the same dialogue in emerging countries. It's extremely important to gather substantial public support for programs the IMF is insisting that other countries undertake, particularly in democratic countries.

In short, the IMF can play, has played, and is playing an important world financial role. Certainly, in the current financial environment, changes are needed. The role of the IMF is already being evaluated, as it should be—in Congress, in the administration, and in the IMF itself. If the IMF is going to do the job it's supposed to do in this dramatically changed international financial environment, improvements are essential. But the centrality of the IMF's mission and the vital role it plays in the international monetary system argue for strong U.S. support.

Lawrence B. Lindsey

THE IMF

No Room for an International Agency in a

The international system set up after World War II was appropriate for that era. But now it is time to move from an international ("between nations") world to a global one. The problem today is that we have an economic system where conflict between creditor A and debtor B immediately becomes an international conflict. It shouldn't.

Bob Hormats and I agree that the Asian crisis is largely a banking crisis. But unlike Bob, I don't think this is anything new. It's the way systems work. Banking crises and economic cycles are driven by fear and greed. Someone discovers Bangkok is a great place to open a factory. Labor there is cheap. So people start opening factories there. More people come in. Then we discover that real estate prices are rising because everyone's opening factories. Soon we discover we need office buildings there—for all the lawyers. So commercial real estate prices rise. Then money moves in because commercial real estate prices are rising. Hey! Not only is Bangkok a good place to build a factory, it's a good place to invest in commercial real estate. This is not a story that should be unfamiliar to any American, particularly any American bank regulator. Whether it's Texas in 1986 or New England in 1989, the story is the same.

If the Asian crisis is a banking crisis, what sets it apart from earlier banking crises is that we did not have in place the institutions necessary to handle the downturn cycle of a banking crisis. There was no way to deal with debt that went into default. Until this past January, it was illegal for foreigners to have a major equity stake in a Korean business. Nor was there a real bankruptcy statute in any of these countries. But even if there had been, one of the key elements of bankruptcy is that the lender takes equity possession of the property once the borrower can no longer pay. Well, if you can't own the property, you can't have a bankruptcy. So one of the important differences between this banking crisis and earlier ones is that the fundamental institutions of capitalism that move the real assets—commercial real estate, factories, whatever—from bankrupt hands to strong financial hands that can run them were simply not in place.

I don't mean to say that the two are quite comparable, but I would urge you to remember Texas in 1986. Virtually all the major banks in the state went bust. Eight are now owned by foreigners, or what Texans would consider foreigners—North Carolinians and New Yorkers. The bankruptcy process was devastating. Thousands of very wealthy Texans went bankrupt. But the bankruptcies are part of the process, a way to keep productive

assets in operation, to move them from weak to strong financial hands.

Now to return to internationalism vs. globalism. The world I want to see in the 21st century is one where a citizen of any country can take an equity stake in an investment in any other county, *any* other country, it doesn't matter which. Similarly, I believe in a world where any citizen in any country can lend money to a company in any other county, and if the borrower can't pay it back, there exists some arrangement by which it can be worked out without becoming an international crisis. That's the 21st century we should all be working for.

The IMF is not designed for that kind of world. My world is a world of small crises, individual bankruptcies, individual purchases of one company by another, changing hands of small assets, not national crises. The IMF is structured and will always be structured as an international, not a global, institution. It is composed of member states. Member states are shareholders. Member states nominate the board of directors. And member states will act like member states always do. They will act on an international—between national governments—basis and not a global basis. Is the IMF bad? No. Some of my best friends work at the IMF. They are talented, competent people. But the world we need for the 21st century is a global, not an international, economy. ■

Barry Bosworth

WHEN THE IMF CAN'T & THE MARKET WON'T

SOME PRACTICAL STEPS FOR DEVELOPING COUNTRIES TO HELP

In a world of mobile financial capital, the threat of financial crises will always be with us. As international investors diversify their wealth across national boundaries, the distinction between domestic and foreign investors will become meaningless. The investors, though, will use diversification and indexed funds rather than going to the trouble of learning about the countries in which they invest. They will also react strongly to news. They will "take their money and run"—from one country to another. As a result, the threat of a run against a country's currency will remain substantial.

Domestically, most countries try to control the risks of bank runs through a system in which the central bank operates as a lender of last resort, in combination with a system of prudential supervision and regulation. The IMF cannot be placed in the position of providing unprecedented resources to countries threatened by a run on their currency when it has no way of overseeing their financial institutions and ensuring that their banks have prudent policies for managing risks. Such open-ended commitments are neither credible nor desirable.

But leaving things to the market seems equally untenable. It is reasonable to stand aside from a market crisis when the only parties at risk are willing participants, but that is true neither of bank runs nor of currency crises, whose costs are large both for others within the affected country and for trading partners. We can't just say, "We won't do it." The international community has to address the problem, no matter how difficult it may be.

But the developing countries should not wait for the solution to come from the IMF. They should also reassess their own policy options. They have been urged by the international community to open their financial markets as a means of making great efficiency gains. But the international community has shown insufficient concern for the need for developing countries to create strong domestic financial systems before moving to full capital mobility. The highly touted efficiency gains made in Asia in past years, after all, have been virtually wiped out by the current crisis.

In part, financial openness in developing countries may require a greater emphasis on markets as opposed to banks. Though banks are often regarded as being better at providing financial intermediation services in the initial stages of a country's development, well-functioning markets provide a more

effective risk-sharing mechanism. The existence of markets also means that a bank run will not immediately translate into a currency crisis simply because there are so few domestic options. A strong financial system, however, cannot be built overnight.

As an interim policy, developing countries could hold larger reserves to protect themselves against a currency run, though large reserve holdings eliminate much of the advantage of capital flows to recipient countries. Developing countries could also control some of the risks of a currency crisis by following the lead of Chile in monitoring and regulating the net currency exposure of its financial institutions and with measures that discourage short-term borrowing from abroad. While it has no significant restrictions on capital outflows, Chile is careful to limit the composition of the inflows. It has enforced a one-year holding period on foreign portfolio capital and direct investment and a 30 percent reserve requirement against short-term bank liabilities to foreigners. These controls have effectively limited Chile's foreign exposure without discouraging longer-term capital inflows. Chile has also used a tight fiscal policy to reconcile its need for restraint on domestic demand with a desire to avoid the high interest rates that would attract foreign capital. ■