THE NEW CHALLENGE: REGULATING GLOBAL FINANCE

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Living in "Interesting Times"

Beginning in Thailand in July 1997, the storms of financial instability and economic collapse have spread to much of Asia and from there to Russia and Brazil. China's growth is slowing as a result of falling external demand and this may bring about a domestic financial crisis and a devaluation, which would strike another body blow to other East Asian economies striving desperately to recover. There is anxiety that Japan may not be able to reform and revitalize its own diseased financial sector fast enough to provide a much needed boost to the rest of East Asia and the world economy in general. Amidst all this turmoil, proposals are being aired that would bring in major reforms of the existing institutional framework, such as the setting up of an Asian Monetary Fund to service Asia.

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These issues are being hotly debated today by leading economists and other policy makers. The purpose of this article is to summarize the main conclusions, the extent of disputes where they exist and the ways in which the global economy is likely to evolve or be changed as a result of present problems. Most of the papers referred to are available at the Asian Crisis Home page (**www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.html**) compiled by Professor Nouriel Roubini of New York University. Elsewhere explicit references are given.

The way in which the Asian crises erupted and then spread to the rest of the world economy has come as something of a surprise to most people. Japan's growth had indeed been faltering since 1991, and weakening Japanese demand was indeed a major contributor to East Asia's problems. Russia has been in deep crisis from the early nineties; but it remains a negligible component of the world economy. The rest of Europe, Asia and North America had shown relatively strong growth for most of the decade. The countries worst affected in Asia, Thailand, the Republic of Korea, Malaysia and Indonesia, had been among the fastest growing and most successful economies over the previous two to three decades. In this respect, the crises in East Asia are very different from most other crises which tend to afflict countries with well recognized weaknesses, balance of payments problems and so on.

Indeed there were some lightweight politicians and columnists in the US who even believed that the "Asian Crisis" would not only not affect Europe and North America, but also cut the upstart East Asians down to size and demonstrate the superiority of "Western " business practices. These voices have subsided as the consequences of the East Asia's slump have begun to be felt in North America through falling exports and a succession of layoffs in the dynamic export oriented industries. The economic setbacks in Asia, Russia and Latin America have now metamorphosed into a truly global problem, which President Clinton and many economics gurus have identified as the most serious crisis of the second half of this century.

Just as the rapid growth of economic activity in East Asia, including China, had revitalized economic activity in America and Europe, now the collapse of production in Korea, Malaysia, Indonesia and Thailand, though not yet in China, has had adverse consequences in the heartlands of industrial capitalism. These effects could not simply be explained by the mere volume of exports and imports in relation to GDP. The fact is that trade with East Asia and Japan was concentrated in key industries and involved states such as California and Washington which provide economic impetus to the rest of the economy by virtue of the high technology, leading edge industries located in these states.

Strange as it may seem, there are still significant numbers of politicians in the USA who do not seem to realize, that in the present globalized economy, continued prosperity at home depends on continually growing prosperity in the rest of the world, together with financial stability in big emerging markets. The world watched with bemused wonder as the political establishment in Washington DC went on tearing itself apart on the issue of impeaching the President, more-or-less ignoring the rapidly developing crises outside. All the while, Russia went into technical default on its foreign loans, and Brazil slipped into financial crisis, threatening to drag down other major Latin American economies. This is the contemporary equivalent of Nero fiddling while Rome burned.

Rising anxiety over the global events, however, were reflected in sustained falls in stock prices, the largest seen since the crash of 1987. The danger of a global financial melt-down which would drag all countries into a global depression, was well realized by the US Administration (i.e. the White House) and the Treasury officials appointed by the President. The governors of the Federal Reserve system, under its chairman Greenspan, were in full concurrence. Greenspan had earlier voiced concern with his widely quoted statement about the "irrational exuberance" of US stock markets. With rising urgency, all of these people tried to awaken the US Congress to the critical nature of the situation.

The fragility of the financial system was brought home very sharply by the collapse of a prestigious hedge fund, Long Term Capital Management (LTCM). Founded by two Nobel laureates in economics, LTCM was one of Wall Street's darlings, a successful finance house, mythologized as having a superior understanding of financial market dynamics, which enabled them to make extraordinary profits by assuming daring risks. Somehow their model failed since benefit both the recipients and the lenders. Many countries have benefited enormously from external funds in the form of loans, portfolio investments and foreign direct investment. As a result of industrial expansion in East Asia over the last three decades, tens of millions of people have been lifted out poverty into relative prosperity. But the recent setbacks have pushed many millions back into poverty, and it may take many more years to restore them to their original levels of prosperity.

It must be stated, however, that the present situation in Korea and Thailand, even with the devastation of the economic crises, is still better than that of countries like Sri Lanka which have yet to even seriously embark on the path of modern industrialization. The social capability of Korea consisting of the skill levels of workers, managers, engineers and entrepreneurs and the business-promoting institutions already built up, are at a level comparable to that of Britain in the immediate pre-Second World War period. Though Germany was reduced to destitution immediately after the War, within a few years after stable macro-economic conditions were restored, its economy was booming, because its social capability was not destroyed. Though Thailand is in a much less favourable situation than Korea, its industrial capabilities are still much more than Sri Lanka's.

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To recognize the regular pattern of investment booms followed by slumps, is not however to accept it as inevitable or justifiable. The point of scientific analysis is not merely to interpret the patterns of the world, but to change them in a way that is people-friendly, at least not damaging to the livelihoods of the most vulnerable sectors of society. This indeed, seems to be the over-riding concern of most policy makers, if one is to judge by their stated positions.

Assigning "blame" and finding remedies

There is a lively ongoing debate on how the developing crises in Asia were handled by the IMF and affected country governments. There is no dispute at all about the disastrous social effects of the crises and the need to avoid them where possible. Even laissez-faire ideologues understand that the damaging effects of recessions triggered by financial instabilities undermine the legitimacy of capitalism. In addition to the domestic reforms advocated for countries stricken by crisis, there is now serious discussion, at the highest levels, about the pressing need to reform and regulate global financial flows and the IMF itself. The World Bank appears to have aligned itself with the angels, by pressing forward the interests of stricken countries against the manic logic of global finance, to judge by the statements of Wolfenson and Stiglitz.

It is certainly true that many of the investments made in Asia were misguided, especially those made in highly speculative property development. Many of these could only have been the product of an extensive "crony" system linking bankers, politicians and developers. Furthermore, it was madness to fund long-term investments with short-term debt taken out in international markets. Not only is there a mismatch of maturities, which violates a cardinal principle of finance, but there is a mismatch of denominations: hard-currency debt was linked to payoff in domestic currency, thereby introducing exchange rate risk into the investment returns. Of course, lenders and borrowers believed that the exchange rate that was pegged to the dollar would hold. In retrospect, the dollar peg itself is seen as too rigid an arrangement.

Additionally in Korea, major companies were excessively leveraged with very high debt to equity ratios. Corsetti et al (1998) have shown that a number of them were bankrupt before the currency crisis hit in late 1997. At the same time, the foreign banks that continued to make questionable loans without looking too deeply into the associated risks are surely as much to blame. Much more detail on the specifics of the East Asian crises are given in the above article, which is published in two parts in the Asia Crisis Homepage. Wade and Veneroso have argued that excessive leverage in Asia is well suited to the different savings patterns of the region. This issue is discussed further on in this article.

No one is arguing against the reforms proposed after the onset of crises. The banks with solvency problems must be closed and the rest must be rescued by the temporary infusion of state funds, supplemented by IMF and other foreign loans. The crony systems must be dismantled and full transparency introduced into financial transactions. All these are necessary to restore confidence in domestic and international markets. Stiglitz has also stressed the importance of setting up the effective regulation of financial institutions before the full liberalization of financial markets. In his article "Road to Recovery" (Asiaweek, July 17, 1998) Stiglitz argues that countries that put the liberalization cart before the regulation horse are more likely to experience a financial crisis, on the basis of World Bank research.

Stiglitz, now the chief economist at the World Bank, does not emphasize the point that he is arguing against the ideological policies foisted on many developing countries over the last decade or two by the World Bank and IMF. In the above cited article, he goes on to state. "More generally, there is little evidence that full capital-account liberalization contributes much to investment and growth. What is clear is that short-term capital flows increase volatility which is bad for growth......Policies need to be designed which will both inhibit the flow of volatile short-term capital and, at the same time, encourage long-term capital, especially foreign direct investment" .

The IMF's failure and the idea of an Asian Monetary Fund

One of the casualties of the present crisis is the IMF itself, or at least its policy-making bodies. First, they are held responsible for urging premature financial liberalization on Asian countries, which contributed very significantly to the crises. Second, once the crises erupted, they imposed pre-fab policies, such as high interest rates, which instead of alleviating the impending contraction of demand, actually deepened the slumps (see Krugman's article "How Washington worsened Asia's crash", October 5, 1998 published in the New Republic and also posted on the Asia Crisis Homepage). The argument is that the IMF took measures developed in the context of typical Latin American crises and mechanically applied them to the Asian countries without regard to the very different conditions prevailing there.

Latin crises have been characterized by large public sector fiscal deficits, excessive demand and strong inflationary tendencies. In this context, IMF-style austerity measures involving high interest rates, reduced government spending and devaluations designed to reduce domestic absorption, can at least be defended on the basis of conventional theory. "But the East Asian economies were in rough macro-economic balance" protests Stiglitz (op.cit.) "as evidenced by their low and in some cases, falling inflation rates". The IMF demanded contractionary measures which led to a severe slump. The argument that the IMF deepened the crisis has been stated more forcefully by Wade and Veneroso (Economist, November 7, 1998), Krugman and Radelet and Sachs (in the articles already cited).

Wade and Veneroso, in the article cited above, have argued that the time has come to set up a separate Asian Monetary Fund (AMF) to handle Asian economies. They state that an AMF was proposed by Japan in August 1997 to deal with the Asian crises, with the support of China, Taiwan, Hong Kong and Singapore. But "The United States Treasury pulled out all the stops to kill the proposal, and it died". Now the idea is being raised in the region again. It is going to be hard to resist the idea this time around, given the general awareness of the IMF failures. Most people seem to think that competition from an AMF is just what the IMF needs. After all, the IMF has always preached the value of healthy competition.

Wade and Veneroso also argue that East Asia has strengths that have been downplayed in the West. "Asia is the world's great savings-surplus region. Its governments' foreign exchange reserves of almost $800 billion dwarf those of all other regions". Virtually all of those reserves are parked in US Treasury bills and to a lesser extent in Europe. "The private sectors of Japan, Taiwan, and Singapore are also large net lenders to the West. How ironic that a region with such massive savings surplus and net foreign assets should be plunged into crisis by the flight of capital belonging to institutions that reside for the most part in the United States, a massive net debtor with a savings deficit".

The most severely affected countries in Asia, Korea, Thailand, Malaysia and Indonesia, have a gross external debt of $400 billion, of which about $ 100 billion have long-term maturities and are therefore not in need of refinancing. Even if the entirety of the remainder is to be refinanced, which is an unlikely extreme, at $ 300 billion, it is a small part of the aggregate net-creditor position of the region. Clearly this is an absurd situation. Currently Asian reserves in the US and Europe earn 5% while Asian borrowers pay 10% or more. The setting up of an Asian Monetary Fund would mobilize Asian funds to easily resolve the debt crisis of Asia. Further, the AMF could lend to Asia at 6% thereby saving an enormous amount in excess interest payments now accruing to the West.

It is easy to see why this idea would be opposed by IMF-Treasury-Wall Street interests. But given the failure of the IMF, it is going to be hard to resist the setting up of the AMF to take control of Asia's finance. If the AMF is set up, the present US centred system of finance could give rise to a multi-centred system, especially if the new Euro system takes off well.

Regulating global finance

While transparency and accelerated reforms within countries are indeed necessary to overcome the domestic weaknesses of emerging market economies, a great deal of attention has also been focused on how the "international financial architecture" can be reformed to minimize the occurrence of financial panics. There is widespread recognition that the instability endemic to global finance is a major obstacle to further development of the global economy. As I argued in the SSA paper, global financial markets have spun out of the control of national governments or any international authority.

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Just as laissez-faire capitalism has been replaced by regulated capitalism in all major industrial nations, *we now seem to be on the threshold of moving from essentially laissez-faire to regulated global financial flows*. The proposals being made to regulate global finance, essentially address the non-linear and positive feedback effects that introduce instability into the operation of financial markets. As Krugman has pointed out, these markets operate in the way the major financial players think they operate, because they make their decisions in accordance with their beliefs. In other words, financial dynamics are "expectations driven" to a large extent, much more than the dynamics of the underlying industrial system. Thus if the markets estimate that a country is likely to default on its loans, they withdraw funds and bring about the anticipated state of affairs.

In discussions with colleagues, students and other well-informed people, the realization has dawned on me that there are two major conceptual obstacles to communicating the causes and remedies for crises. The first of these is the common tendency to look for monocausal explanations: "is the crisis a result of weaknesses in the domestic economy, or is it the fault of the global capital markets?" The idea that it is the result of both operating together seems somehow hard to grasp. As a result, it is necessary to invoke metaphors, such as unstable boats capsizing in stormy seas, or poorly designed houses collapsing during an earthquake, to explain the conjunction of causes.

Dornbusch (The International Economy, Nov/Dec 1998) has invoked the example of the high rise buildings that collapsed in Mexico's massive earthquake: it was found that the concrete had too much sand and not enough cement, as a result of some shady deals between the builders and the supervising authorities. In this situation, though steps can be taken to ensure that future high rises are constructed more robustly, not much can be done about earthquakes, except to avoid regions in which they are more likely to occur. In line with his illustrative metaphor, Dornbusch stresses the internal reforms necessary to avoid future crises. But most other analysts argue that redesigning the international financial architecture is at least as important as pushing through domestic reforms. We need to attack both causes at the same time, to ensure the best *outcome. Neither domestic cronyism nor the anarchy of the present financial system can be allowed to inflict so much damage at such heavy social cost.*

funds flow in, thereby feeding the bubble. After the collapse, funds drain away and the country or region is starved of finance and goes into a slump. Stiglitz and Krugman argue that few economies could have withstood a reversal of capital flows on the scale that actually took place in the afflicted East Asian economies. The volatility of the capital markets exacerbated the problems that undoubtedly existed, and made eventual recovery much more difficult and prolonged. This position has been even more strongly argued by Sachs, Wade and Veneroso.

To combat excessive volatility in global financial markets, James Tobin of Yale had earlier proposed that some "sand" should be thrown into the "machinery of global finance", by taxing short term flows. Now, that call has been taken up by many others, including Stiglitz of the World Bank. While agreeing that "countries will benefit most from globalization when they have transparent, robust and well-regulated financial markets", Stiglitz states that new *policies need to be designed which will inhibit the flow of volatile, short-term capital, while assisting long-term foreign direct investment, which is inherently stabilizing.*

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George Soros, the celebrated financier, who made his billions by exploiting imperfections in the international capital markets, is no laissez-faire ideologue: he has called very strongly for the regulation of financial flows. Soros moreover, identifies the principal reason why unregulated flows generates instability: the existence of positive feedback mechanisms in market processes, where price is influenced by expectations. Soros calls this "reflexivity". Positive feedback blows up a positive trend into expectations-driven euphoria; this is how asset price bubbles are formed. It similarly constricts negative movements into a collapse. In short, positive feedback amplifies positive and negative trends and thereby generates instability. This phenomenon is more common in economics than in electronic circuits.

Linear thinking seems ingrained in most peoples approach to problems, despite the complexity observed in the real world. The difficulty of appreciating the practical consequences of non-linearity, is the other conceptual stumbling block, referred to in the second paragraph in this section. Most people's conception of economic behaviour seem based on exclusively linear models. Thus if an input X gives rise to a stable output Y, then 2X is expected to generate 2Y. But if non-linearity exists, 2X might give rise to 3Y and, worse, it might take the entire system beyond some critical threshold into an unstable region. Positive feedback and non-linearity are distinct processes, though the former often leads to the latter. I have discussed this issue in more detail in the previous SSA article, and will not say any more here.

The history of numerous asset price bubbles, from the Tulip Mania of 17th century Holland to 20th century stock market and property bubbles, show very clearly how pervasive is the phenomenon. In the scramble to garner extra gains during the period of euphoria, excess

Policies are now being proposed to eliminate incentives to short-term flows, or even to directly curb these flows through taxes, such as in Chile. Also being discussed are policies to make lenders and borrowers pay the full costs of the risks incurred. Thus if banks make risky loans, they would be compelled to collateralize more of their own capital. Restrictions on exposure to real estate lending and foreign loans would be imposed and monitored by regulatory bodies. Stiglitz argues that governmental action is necessary, because "we cannot count on free markets to lead to the best outcomes.. ." Just as firms that impose costs on society through pollution are taxed or regulated, banks that impose risks on the entire society through risky financial practices, should be made to meet the full costs of these risks.

Almost un-noticed, another major change seems to be taking place: the collapse of "free-market fundamentalism" as the ruling ideology. It is rarer today to find people arguing that unfettered markets will bring about the best possible outcomes. Despite opposition from Wall Street, the US Treasury and even the IMF, the chances are that some form of regulation of global finance will be initiated. This will involve the setting up of a new global financial architecture, including perhaps a new Asian Monetary Fund. The cleaning up of Japan's own diseased financial system will have to move forward. The passing over to public ownership of the powerful LTCB is only a first step. All of these steps are not of course easy processes; many political battles lie ahead. But, it is very likely they will move forward, because too many influential people are afraid of the consequences of delaying and avoiding reform: a major world crisis which will usher in a global depression.

The consensus of the present is expressed most succinctly by Stiglitz. "Today, we stand on the edge of a new world economy. But we do not have international institutions to play the role that the nation-states did in promoting and regulating trade and finance, competition and bankruptcy, corporate governance and accounting practices, taxation, and standards within their borders. Navigating these uncharted shoals will be a great challenge........In approaching the challenges of globalization, we must eschew ideology and over-simplified models....I believe that there are reforms to the international economic architecture that can bring the advantages of globalization, including global capital markets, while mitigating their risks".

Lessons for Sri Lanka

There is a great deal that Sri Lanka can learn from the experience of growth and crisis in East Asia. As yet we are in no danger of a financial crisis on the scale of Thailand or Korea, because we are nowhere near to being that attractive to international capital. However, if and when we get into an episode of rapid economic growth, the chances are that similar weaknesses in the financial system will develop in Sri Lanka as well. That is because the social relationships that underlie dubious finance, cronyism and corruption are common to all societies, depending on level of economic development.

Perhaps we could even take some advantage of our relative backwardness to establish transparency and social accountability before embarking on a period of rapid expansion? These issues will be widely discussed in the coming years and actually implemented in many Asian countries, especially those stricken by crises. I am assuming that the present global crisis will not intensify, before these reforms are put into place, which is far from certain. But if we do get the breathing space, it will be an ideal time to push through modernization and reform, when the rest of the world is also pre-occupied with it.

I would also argue that this is not just a concern for economists and business people. Everyone has a stake in ensuring rapid and crisis-free growth. It is very clear that the crises in Korea, Thailand and Indonesia have hit the least advantaged sections of society hardest. Industrial unions and civil society activists have important roles to play. In advanced and developing countries such independent groups are seriously taking up the task of holding up business companies to modern social standards. Such standards extend from environmental concerns to working conditions, civil rights, consumer protection and health issues. There is no reason why the struggle for the expansion of this basically democratic agenda, should not extend to promoting the transparency of business and finance activity. But social activists must first study the sometimes perverse logic of business and finance and overcome visceral antipathies to commercial activity.

Finally, we cannot be sanguine about the quality of advice given us by the IMF, the World Bank and their representatives, on macro-policy relating to exchange rates, monetary policy and regulation. Recent events have shown that political judgements are involved in most such issues. The mistakes made by highly trained professionals in all these institutions, have made bad situations catastrophic in Thailand, Indonesia and Korea. It seems clear that many economic decisions are based on ideology rather than science. The least we can do is to introduce more transparency into the processes by which decisions are made and make sure that key officials are held to high standards of public accountability. ■

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