Introduction

When Mexico was hit by a dramatic currency crisis in December 1994, the immediate international policy response was to try and halt the possible spreading of Mexico's crisis to other emerging market economies. Looking to the future, policymakers and academics also engaged in designing strategies that would help prevent similar crises from occurring in other developing and transition countries – at least, to the extent that these other countries had sound economic policies.

With regard to the first effort, making sure that the Mexican crisis would not infect other emerging economies, the remedy applied was highly successful – though with heavy social costs for the Mexican people. The second effort, however, has proven to be much less successful. The remedies *adopted* to prevent future crises – which, obviously, is not the same as the remedies *suggested* – have simply not worked. Indeed, within two years after the Mexican crisis, Thailand was struck by a serious currency crisis. And this time it turned out to be much harder to prevent the crisis from spreading to other emerging economies. Not only did it infect many East Asian countries that were originally considered good credit risks, but it also affected major emerging economies elsewhere such as Russia and Brazil. Moreover, the crisis that had started in East Asia turned out to be much more persistent and profound than originally expected or hoped, with recessionary and speculative features becoming present in almost every country of the world – including the richer nations.

So the need for an in-depth diagnosis of (a) why things went wrong, (b) whether the current management of the crisis is adequate, and (c) how future currency crises can be prevented more effectively, has become a very pressing one. In particular, the regulators and supervisors of private capital flows are now being challenged to assess whether they are doing a proper job and how they might improve it. This challenge is posed to national as well as international regulators and supervisors because in this new era of global finance, no country can insulate itself from world markets. Indeed, both national and international policymakers are puzzling over how they can best deal with the problems and uncertainties they are now facing.

This book addresses, above all, these regulatory and supervisory challenges. It includes the analyses of and the views on the current crisis (and its remedies) by a number of highly experienced experts in the field of global finance – academics as well as policymakers, working in national as well as international institutions, in emerging as well as advanced economies.

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I Diagnosis and Cure

At the time of this writing (October 1998), it has become commonplace to describe the current crisis as a global financial storm raging in various regions and sectors – primarily financial but also industrial – of the world economy. Even though this storm is more or less under control, it still threatens to erupt in 'unstable' and economically important parts of the world such as Brazil. A financial crisis in Brazil would certainly cause further havoc in Latin America and elsewhere, including the United States. So rather than leaning back quietly and taking a dispassionate look at the problem, analysts and policymakers are faced with a crisis which continues to linger on. Moreover, because of its *global* character, it cannot simply be relegated to those who are trying to resolve it in the affected emerging economies. Coming to grips with the crisis requires, first of all, a proper diagnosis.

This is more easily said than done, as this book – once again – illustrates. There are so many possible explanations for the current financial turmoil that the experts, as usual, do not agree on one indisputable diagnosis. Instead, they suggest a variety of explanations *and* remedies. These run from blaming the Asian countries for "crony" capitalism to arguing that the international lenders were at fault with their irresponsible over-lending and subsequent panicky, herd-like withdrawal when investors' sentiment changed. Other explanations, which can also be found in this book, include the well-known argument that guarantees by domestic as well as international institutions have created moral hazard for the lenders, or that the Asian crisis has once more demonstrated the inappropriateness of fixed (pegged) exchange rate regimes.

Depending on the type of diagnosis made, a similar range of remedies is suggested. In the order of the above mentioned explanations for the emergence of the crisis, these include that: (i) the Asian countries and other emerging economies should establish the same standards of liberalisation, transparency and regulation as the rich nations have; (ii) international capital flows ought to be controlled better, and, in addition, an international lender of last resort is needed; (iii) lenders should no longer be given guarantees that they will be bailed out when crisis strikes; and (iv) all emerging countries should adopt a freely floating exchange rate regime.

Evidently, more explanations and remedies are being suggested, both in this book and in other fora. For example, many argue that the Asian saga proves that liberalisation of inadequately regulated domestic financial systems is a recipe for disaster. In a similar vein, it is also said that liberalisation policies were a mixed blessing for emerging economies. They improved the investment climate in these economies but, at the same time, also made them extremely vulnerable to external shocks. Looking at the foreign debt

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problem confronting these economies right now, it is also stressed by many that a swift elimination of the debt overhang is urgently needed.

In this book, the *diagnosis* of the crisis mainly comes out in its first two sections, which deal with the global implications of currency crises in emerging market economies and the policies pursued thus far by the international financial institutions. In these two sections, the focus is on the macroeconomic aspects of the current crisis, whereas in the latter two sections the focus is on regulatory and supervisory issues.

In the first section of this book, Yung Chul Park meticulously analyses both the internal and external factors behind Korea's financial turmoil and concludes that both domestic borrowers – with their disregard for prudence and risk management – and foreign lenders – with their short-term profit and herd mentality – are to blame for bringing about this crisis. In the next paper, Charles Wyplosz observes that a few well-known causes lie at the root of the currency and financial market crises of the last two decades, and that these causes have been at work in the Asian crisis as well. He mentions six of such "old lessons" not yet learned, and presents three "new lessons".

In the second section of the book, Jack Boorman (from the IMF) gives his view on what went wrong in Asia. Echoing Park's observation that, in part, the borrowers are to blame, Boorman stresses that the primary reason lies in the weaknesses in the financial and corporate sectors of the Asian countries, and in the inadequate regulation of capital movements. At the same time, Boorman notes that most of the Asian countries now in trouble *were* pursuing sound macroeconomic policies – so they were not completely at fault. In the next paper, Ariel Buira (former Deputy Governor of Mexico's Central Bank) deals with the other part of the blame – the lenders' irresponsible behaviour. He observes that the current IMF approach is ill-suited for handling crises of confidence. In his view, such crises are due as much to market misperceptions and overreactions to the news of the day, as to policy shortcomings.

Regarding the *remedies*, Park reviews a number of policy measures that have been suggested to help prevent a crisis and, if a crisis is inevitable, to contribute to its more effective management. Being aware that most of these measures are not likely to be realised anytime soon, he seriously questions the advanced countries' advocacy of a "pell-mell" opening of the financial markets of emerging economies. Until these countries are more protected from the recurrence of financial crises, they should be allowed to "throw some sand in the wheels of international finance," Park states.

Wyplosz says that the traditional IMF recipe should only be applied to countries with wrong fundamentals. Otherwise, restrictive macroeconomic policies complicate matters rather than resolve them. He suggests methods to reduce the incidence of crises and ways to alleviate their effects, including

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an IMF-sanctioned moratorium. In Wyplosz' view, a moratorium would work as an incentive against irresponsible (over)lending and give a country in crisis the much needed temporary relief from the weight of its external debt.

In Boorman's view, crisis prevention should include the now standard trio of (i) better information to market participants, (ii) more transparency in economic policies, and (iii) the strengthening of domestic financial systems. He adds 'orderly' capital account liberalisation as a fourth item to the list, recognising that full-fledged liberalisation is no longer a dogma. With regard to crisis management, Boorman shares the view that the private sector should be more involved in resolving the crisis by, among other things, taking losses. He also believes that IMF-sanctioned debt standstills could contribute to a more effective crisis resolution.

According to Buira, an alternative approach to dealing with financial turmoil in developing countries is needed. Other than current IMF practice, it should aim at preventing a speculative attack from developing into a full-fledged crisis. This could be achieved by the timely provision of sufficient financial support to sustain confidence coupled, if appropriate, with a policy reform package. He suggests that the IMF is in a good position to play this role. It should be enabled to provide member countries – at least if they show to have sound economic fundamentals – with a readily available stand-by credit to be drawn on in the event of a significant speculative attack on the currency. As others, Buira also stresses the need for measures that would force creditors to take certain losses (e.g. through a bankruptcy-type procedure or the imposition of certain limitations on capital transfers).

The analyses and views of Park, Wyplosz, Boorman and Buira are enriched and evaluated in the comments and reports of floor discussions that are included in the first two sections of the book. They reflect the thinking and the insider's knowledge of a group of high-level experts who participated in a two-day conference held at the Dutch Central Bank. One observation which comes out clearly from these discussions is that the many different perspectives add up to a highly useful set of policy recommendations. In some cases these are mutually exclusive, but more often they seem to be complementary.

The reflections by H. Johannes Witteveen in the Preface to this book points to another observation worth emphasising. Most of the discussions on the diagnosis of and the prescription for financial crisis (particularly those discussions that influence policy) are taking place within rather narrowly defined terms of the debate. Witteveen, who was the IMF's Managing Director from 1973 to 1978, is one of the few high-level experts who is publicly presenting a broader view. In his Preface – and in his interventions in the floor discussions included in this book – he stresses, for instance, the need for studying ways to control the *creation* of international liquidity as

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well as the *movement* of enormous capital flows around the world. In his contribution to another Fondad publication (see *The Policy Challenges of Global Financial Integration*, Fondad, 1998), Witteveen also includes ecological and ethical concerns in his analysis of economic globalisation. A broader view on both the origins of and the remedies for the crisis is unfortunately missing in most of the mainstream debate.

II Regulatory and Supervisory Challenges

In the aftermath of the Mexican crisis, various institutions and groups have begun working on the regulatory and supervisory challenges posed by financial turbulence in emerging markets. The Basle Committee on Banking Supervision, in particular, made substantial progress in establishing "Core Principles of Effective Banking Supervision" (BIS, April 1997). The G-10 report on "Financial Stability in Emerging Market Economies", also released in April 1997, is another example of this continuous effort. However, as the ongoing crises in Southeast Asia and elsewhere demonstrate, more research and policy debate is needed.

The papers included in the third and fourth sections of this book respond to that need. In the third section, Susan Phillips, of the US Federal Reserve System, focuses on four themes of sound international supervision: (i) the specific risk profile of individual institutions; (ii) sound accounting and disclosure systems; (iii) adequate capital standards; and (iv) international coordination. William White, in turn, discusses in his paper how international financial stability can be promoted and what role the Bank for International Settlements (BIS) is playing in this respect. Reviewing the work of the various committees meeting at the BIS in Basle, he focuses on specific measures already agreed upon and, given the extraordinary pace of change in modern financial markets, new measures that need to be developed. The papers by Phillips and White are complemented by commentaries and floor discussions.

In the fourth section, experts from Asia, Eastern Europe and Latin America assess a number of specific issues that confront regulators and supervisors in these respective regions. Amaret Sila-On, from Thailand, reports on the financial reform in his country and concludes with a note on the future prospects for financial restructuring and development in Thailand. György Szapáry, from Hungary, discusses a number of bank regulation and supervision issues faced by his country and other transition economies. He also touches upon some crucial issues concerning exchange rate and monetary policy in transition economies. Christian Larraín, from Chile, deals extensively with the challenges of banking supervision in developing

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economies. He first describes, from an insider's perspective, a large number of supervisory weaknesses in developing economies, then makes policy recommendations for strengthening supervision in these economies, and finally suggests what positions developing countries should take in international forums with respect to issues such as capital adequacy, operation of financial conglomerates, and consolidated supervision. Larraín distinguishes between first and second-generation reforms. The former are primarily applied in recently privatised financial systems that are unsophisticated and where supervision is extremely precarious. The latter are to be implemented in more developed and consolidated banking systems.

III A New Architecture for the International Monetary System?

The current global financial turmoil has spurred a rethinking of the functioning of the international monetary and financial system. Not only has the crisis turned out to be much more profound and long-lasting, but also more contagious and systemic (affecting the functioning of the system as a whole) than originally foreseen. Therefore, in the course of 1998, a growing number of proposals for remedying the flaws in the world financial system have appeared. They range from a mere refinement and enhancement in efficiency of current practices to encompassing proposals of how the world's financial architecture should be renewed.

As said, the steps already taken by policymakers to improve both the prevention and management of currency crises have yet had little effect. This is a major reason why the call for reform of the system has now, as in previous post-war periods of financial crisis, become popular again.

Calls for reform of the so-called Bretton Woods system (agreed upon at the end of the Second World War) have gained momentum in two particular periods. The first one was at the end of the 1960s and early 1970s, when there was a serious crisis of confidence of the key currency of the system, the US dollar. Even though in 1974, after many years of painful negotiations between experts of rich and poor nations, a sensible plan for reform was adopted, the plan was nonetheless shelved. The main reason for this was that, with the oil crisis of 1973, the US dollâr had regained strength as the world's currency.

The second period was the early 1980s, when the foreign debt problem of Latin America and other parts of the world evolved into an international debt crisis which threatened the survival of the Western banking system. The plea for reform was then voiced almost exclusively by experts from the developing world. They felt that the international monetary "non-system" and the sudden steep rise of interest rates in the United States (as a result of a change in monetary policy) were as much at fault for the emergence of the debt crisis, as was the "mis-management" by the developing countries concerned. Obviously, this time, there was no reform plan, let alone negotiations.

Now, the situation looks, again, more like the period in the beginning of the 1970s. Now, as then, academics and policymakers (or former policymakers) in the major nations are elaborating proposals as to how the system should be changed. Now, as then, these proposals are beginning to be taken seriously by the people who are in "command" of the system. And now, as then, deep doubts remain with most of those who are managing the system as to whether such a reform is really needed.

Age Bakker, in his epilogue to this book, seems to fall in the latter category. Although he recognises that more needs to be done to address today's financial turmoil, he believes that a stronger emphasis should be placed on putting present ideas and policy recommendations into practice, rather than on a complete overhaul of the current architecture of the global financial system.

In a couple of years it will become clear as to whether Bakker's view and that of his colleagues have prevailed and if all the nice plans for reform are shelved – as was the case before. So far, the post-war monetary system has demonstrated an amazing resistence to attempts at reform. With the current belief among policymakers that more should be left to the free play of markets, this resistence seems only to have grown stronger. Moreover, the ongoing trend of economic (and cultural) globalisation does not seem to go along well with the old idea of steering the economy. Who would be at the helm? The IMF? The World Bank? These two "Bretton Woods sisters" together? A new multilateral institution for global economic governance?

Reflecting back on the conference from which this book results and previous Fondad conferences (see, for example, *Can Currency Crises Be Prevented or Better Managed? Lessons from Mexico*, Fondad, 1996), I think that both the efforts at reform *and* the efforts at better management of the current system are valid. In fact, these efforts are not mutually exclusive. The one can be done while the other, in the meantime, should by all means be continued. In this book, the analyses and policy proposals are inspired both by attempts at reform as well as better management – though with a bias towards the latter.

I hope that the wealth of facts and ideas presented in the following pages will stimulate and enrich the thinking of the reformers as well as the crisis-managers. The creative thinking of both groups is needed in order to improve the functioning of the global financial system.

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