

BUILDING AN INTERNATIONAL FINANCIAL ARCHITECTURE FOR THE 21ST CENTURY

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Building a successful global financial architecture for the next century will involve a great many challenges—for example, establishing the role of the euro and expanding the World Trade Organization. I want to focus on just one of those challenges: creating a safe and sustainable system for the flow of capital from the developed to developing countries. This is not an easy problem. The most rose-tinted consideration of the record of investing in developing countries would admit that it has a checkered past. Ever since the South Sea Bubble there have been recurrent episodes where investors' initial enthusiasm turned to panic—and boom turned to bust.

The postwar history of global capital flows can be summarized as several decades of little or no international capital flows, followed by a wave of petrodollar lending that halted in Mexico City in 1982, followed after a pause by the flood of capital to emerging economies in the 1990s—a flood which we now see turned into reverse.

So the problem of how to establish the means for safe and sustainable capital flows to the less developed countries is not one to which the world was alerted with the collapse of the Thai baht—or the Mexican peso. But we face this challenge today at a time when it has taken on unprecedented desirability and importance for the world's aging population.

The developed countries are now crossing the threshold into an era of increasing rates of retirement and a much lower rate of growth in the labor force. Negative population growth is already a fact in some European countries and the investment of retirement saving is becoming a critical concern. When all of the world's population growth over the next 25 years—and the lion's share of its growth in productivity—will take place in the developing countries we are heading into

a period when there will be exceptional global benefits to the transfer of capital, expertise, and know-how from the developed world to the developing world.

We have lately had a taste of the potential this offers. When history books are written 200 years from now about the last two decades of the 20th century, I am convinced that the end of the Cold War will be the second story. The first story will be about the appearance of emerging markets—about the fact that developing countries where more than three billion people live have moved toward the market and seen rapid growth in incomes. For the first time in human history, living standards for huge populations have quadrupled or more in a single generation.

If the degree of convergence between developing and developed countries in recent years stands out in 20th century economic history, it is hard to believe that it is not related to the very substantial increases in economic integration that have occurred—and increases in foreign investment, trade finance, and portfolio investment are an important aspect of that integration.

Ongoing Reform of the International Financial Architecture

Building a more effective international financial architecture that can ensure that capital flows are sustainable as well as strong is of profound importance around the world. It matters for economic growth in the developing world and, as we saw in the 1980s in a very powerful way, it matters for the stability of our own financial system.

This has been a priority for the United States and the other industrial countries since President Clinton's call for reform at the Naples Summit. And there have been some significant results, including:

- The norm of transparency has come to be more widely accepted with the development and continued refinement of the IMF international data dissemination standards and international agreement, for example, on the need for better information on the true state of central banks' balance sheets.
- Emerging countries have been brought into a broad-based initiative to raise the quality of banking supervision and regulation in emerging economies, with the development of the Basel core principles for effective banking supervision and similar international standards for securities firms and others.
- The Bretton Woods system has been recapitalized with an increase in IMF quotas and the creation of the New Arrangements to Borrow. And these institutions have made important innova-

tions, with moves to become more transparent and accountable, with premium rate lending on large IMF loans, and with a new recognition at the World Bank of the importance of issues such as good governance, social safety nets, and the prevention of corruption.

These are important developments, but we have seen too many financial crises in recent years to let matters rest there. In October 1998, President Clinton joined the meeting of finance ministers and central bank governors of key industrial and emerging nations held during the IMF and World Bank meetings in Washington. The reports presented there will carry work forward on transparency, financial stability, and crisis resolution.

Major Questions Going Forward

Economists and historians will debate what caused the crises in Asia and Russia for many years to come. But it is fair to say that the debate has focused on four key problems: (1) weak domestic financial systems; (2) imprudent borrowing and lending; (3) inconsistent macroeconomic and exchange rate policies; and (4) in face of difficulties, problems of confidence and lack of liquidity in markets. Each of these factors points to areas that the international community will need to address going forward.

How to Build Sound Domestic Financial Systems in Emerging Economies

Empty office buildings in Houston, record levels of nonperforming loans in Japan, and the need for nationalization of most banks in sober Scandinavia remind us that no one has figured out how to regulate financial systems soundly or is well positioned to offer definitive answers.

That said, if there is a common element in the emerging market financial crises we have seen, it is a large amount of short-term borrowing inefficiently intermediated into low-return investments because financial systems functioned poorly. This, in turn, was the precursor to major confidence problems later on.

Among other things, making these systems work better will involve:

- Pressing for greater opening of domestic financial markets to foreign providers of financial services—and the experience and greater diversification that they afford. Hungary was a pioneer in moving to encourage foreign entry to its market in 1989 and has since reaped the benefits to build probably the deepest,

most diversified financial system in Central Europe. Argentina's experience since 1995 holds similar lessons.

- Following up on the agreement of the Basel principles, with effective surveillance of national authorities' progress toward implementing these principles and building more effective systems. In improving surveillance and regulation, it may be that market-based approaches such as subordinated debt requirements need to be given consideration as potential supplements to traditional regulatory approaches.
- Curtailment of domestic moral hazard in emerging economies, which in turn means the creation of more effective domestic deposit insurance systems, better domestic bankruptcy laws, and a much greater emphasis on arms-length transactions. Inflows in search of fairly valued economic opportunities are one thing. Inflows in search of government guarantees, or undertaken in the belief that they are immune from the standard risks, are quite another.

It is easier to say how emerging markets should improve their financial systems than it is for their governments to bring about change or to figure out how the surveillance of the IMF and other institutions can best be used to motivate change. These issues will require considerable thought going forward.

Reducing Imprudent Borrowing and Lending

Domestic financial systems can and must be improved. But the root cause of crises is not so much the weakness of financial systems as it is the inflow of capital that is excessive relative to the maturity of the system in which it must be absorbed. This raises a variety of more macroeconomic questions about the flow of international capital.

Countries need to calibrate their efforts to seek capital to the capacity of their domestic financial systems. It bears emphasis that where foreign capital has contributed in a measurable way to the onset of these crises it has not been a matter of countries swamped by unrequited foreign inflows—but of countries positively digging a path to their own door:

- We saw this in Mexico, with the increasing resort to issuing dollar-denominated Tesobonos in the lead-up to the crisis in 1994;
- We saw it in Thailand, in the tax breaks on off-shore foreign borrowing which helped encourage Thai banks to take on excessive foreign debt;
- We saw it in Korea, where discriminatory controls kept long-term capital out and ushered short-term capital in;

- We saw it in Russia, with the government's increasing efforts to attract foreign investors to the domestic market for GKO.

While excessive efforts to attract hot money can clearly end in disaster, it would be a mistake to infer that restrictions on securitization, illiquidity, or the resistance of financial innovation necessarily promote stability. Those with a tendency to blame problems on hot money and short-term speculation need to confront the observation that the largest financial sector crisis we have seen in the 1990s—that of Japan—has occurred in a system that has historically been most closed and “long-termist” in its approach. And they need to reckon with the fact that the most reliable source of major financial disturbances in the modern era has been the market for real estate—one of the most illiquid and long-term assets around.

There are a variety of difficult issues that arise in relation to the proper pacing of capital account liberalization and effective prudential management. And there is no question that stronger prudential management will involve measures that will have the effect of preventing flows that might otherwise have occurred.

But we should all be able to agree on the danger of approaches to joining the global financial system that involve denying a country's own citizens the capacity to convert their own currency and invest abroad. Such measures represent substantial intrusions on freedom. They make unsustainable policy errors more tempting. They repel new capital inflows. And, in the age of the Internet, they are unlikely to be successful in the long run.

Of course it is important to recognize, in situations where more money is borrowed than can be well used, that every credit has both a lender and a borrower. And certainly recent experience has been chastening to developers of risk management systems everywhere. In this context I have wondered lately what advice a sophisticated value-at-risk analysis would offer based on past correlations about the need to anticipate two major league baseball players hitting more than 65 home runs in a single season.

As we consider the building of more effective international supervision systems and the continued evolution of risk-weighting within the Basel system of capital standards, it will be important to think about how these tools can best be attuned to systemic stability. But, at a time when international integration is so important, it will be critical not to take steps that will dramatically raise the obstacles to international lending relative to similar-risk domestic investments.

Properly pacing capital inflows with the development of a country's financial system is important for stability. But the best outcomes will

come with rapid strengthening of financial systems and substantial capital inflows over time. And, with the right kinds of prudential regulation and risk management, the volumes of capital we have seen in recent years can be sustainable. After all, as Alan Taylor (1996) has shown, the flow of capital to developing countries as a share of both borrowers' and lenders' GDP was substantially greater a century ago than it is today.

The Right Kind of Exchange Rate Regimes

The kind of economists that migrate to the Cato Institute are united on many tenets of economic theory and practice yet divided on the management of money in its international aspect. Some are with Milton Friedman in treating exchange rates as a price—and a price that should be flexible for the same reasons that others are. For others, money and its exchange is a promise—one that should be fixed and that should not be broken or devalued.

The choice between these two poses enormous difficulties. But we can all agree that where it is a promise, the promise should be maintained—and that treating it as a promise, then breaking it, is probably the worst of all options. There is no single answer to exchange rate dilemmas. Indeed, the core proposition of monetary economics is a trilemma: that capital mobility, an independent monetary policy, and the maintenance of a fixed exchange-rate objective are mutually incompatible. I suspect this means that as capital market integration increases, countries will be forced increasingly to more pure floating or more purely fixed regimes.

To be sure, the grass is always greener elsewhere. Some fixed rates have built up pressure like a dam—and wreaked devastation on the economic landscape on breaking. Yet the present enthusiasm in Mexico for the notion of dollarization underlines that floating rates are fine, except for where they float to.

In light of the difficulties we have seen in recent years, the question facing the supporters of freely floating rates will be how to find a way for governments to establish a disciplined and transparent policy framework without a fixed exchange rate that provides a clear signal—particularly in a post-crisis environment. And the question for those who see no alternative in these settings must be how to reconcile that need for stability with the fact that all the work done by years of exchange rate commitments to markets can be undone by four days trading in exchange markets.

Although there is no single answer, I suspect that the European experiment with economic and monetary union will influence views and choices that are made in the future. What is important going

forward will be the recognition that the contagion caused by discontinuities gives the international community an even larger stake in the right choices being made—and that the approach that the international community takes will be very important to their success.

The Right Systems for Crisis Response

It is important always to remember that far and away the best response to a financial crisis is to prevent it. We should not hold out too much hope that any mechanism for crisis response will ever offer anything approaching complete palliation of the adjustment costs of investors deciding that at current prices they wish to move 10 percent of GDP out of a country tomorrow.

Crisis response mechanisms have an *ex post* aspect, in that we want to respond well to crises, and an *ex ante* aspect because the decisions people make will be influenced by the fact that they exist.

In this context there is perhaps a useful analogy to be made between the dilemmas involved in responding to financial crises of countries and those involved in responding to the difficulties of individual institutions:

- On the one hand, the danger of bank runs, multiple equilibria, and self-fulfilling prophecies provides a case for providing liquidity where credit shortages are not fully justified by the fundamentals. That is why the Federal Reserve was established. And that is why deposit insurance of some kind is a feature of almost every national financial system.
- On the other, market discipline is the best means the world has found to ensure that capital is well used. And the inevitable byproduct of the confidence instilled by the availability of emergency capital—indeed, in a sense the goal of mechanisms such as deposit insurance—will be some blunting of investor discipline, and some greater preparedness to leave money invested when prudence might otherwise have dictated taking it out.

In a sense, moral hazard is the mirror image of contagion. When the availability of a supply of capital raises confidence and investment, it can either be called confidence that reduces contagion, or it can be called moral hazard.

Closely related to this is the notion that it is essential to distinguish problems of liquidity from problems of insolvency. When liquidity elements are dominant, it is the irony of financial crises that while the problem may have been caused by too much lending, the solution may lie in more lending taking place. Of course, where the solvency

element is dominant, more lending is wrong and the challenge is to allocate burdens among creditors and write down debts accordingly.

In academic models the distinction between liquidity and solvency crises is clear. In the real world, the distinction is difficult to draw even in hindsight—and even more difficult to draw in advance. It is not surprising, therefore, that the actual response to financial crises often involves a combination of subordination of old claims and their extension or reduction, and the provision of new finance.

How best this process should be managed in the future and how these elements should be combined is a central issue in thinking about how the IMF should function and what its scale should be. Even with the recent increase, it is striking to recall that if IMF quotas represented the same share of GDP today as when it was founded they would be five and a half times larger than they are.

Two recent developments have strengthened the IMF's capacity for responding to financial crisis problems: the Supplementary Reserve Facility providing that when large quantities of finance are provided to respond to pressure from capital inflows, a premium will be charged; and the recent agreement that in certain very specific circumstances the IMF could lend into arrears. And presently discussions are under way about the possibility of providing contingent finance to countries to help contain contagion.

Suggestions that the IMF should precommit to provide finance to countries that conform to various standards of macroeconomic conduct and financial prudence have lately attracted considerable attention. Among the many questions they raise are a problem akin to those raised by narrow banking proposals—about the credibility of promises not to support important institutions or countries outside the system—and important concerns about moral hazard.

In the real world it is perhaps inevitable that ex post conditionality will fill the gap between the promise not to reward imprudence and the realities of contagion. But in imposing conditions ex post there is the challenge of providing confidence to markets while at the same time providing a spur to necessary reforms. This will involve a difficult balance, both in the setting of conditions and the timing of disbursements.

Conclusion

I have stressed the international financial architecture, which is obviously very important for the way the global economy functions. But no one should lose sight of the fact that the most important determinant of every country's fortunes is the policy choices of its

people and its government. We can seek to create the best structure and best environment possible, and the international community can make a contribution when problems come. But none of this is a substitute for strong, determined action of countries to maintain stability and to address instability when it comes.

I have touched on a number of the economic issues involved in thinking about the financial system of the future. But it may be that the most profound issue is a political one. Just as much greater integration in Europe has led to pressures for more pan-European decisionmaking, it is inevitable that at the global level tensions between integration and sovereignty will arise. But if recent events are a testament to the challenges that such tensions present, they are no less a confirmation of the critical importance of their being overcome.

Reference

Taylor, A.M. (1996) "International Capital Mobility in History: The Saving-Investment Relationship." NBER Working Paper 5743. Cambridge, Mass.