

The International Financial System

THE “FINANCIAL REVOLUTION” of the 1970s was a major development in the postwar international economy.¹ Removal of capital controls by leading economies and the consequent freedom of capital movement resulted in increased integration of national capital markets and creation of a global financial system. Emergence of an international financial market has greatly facilitated efficient use of the world’s scarce capital resources and has enabled capital-poor LDCs to borrow funds for economic development. On the other hand, international capital flows have increased the instability of the international economy. The international financial system itself is inherently unstable and subject to serious crises. Despite its importance, the nature and the extent of the global integration of financial matters are poorly understood outside the economics and financial communities.

PARTIAL GLOBALIZATION OF INTERNATIONAL FINANCE

International finance is the one area to which the term “economic globalization” clearly applies. Globalization of finance has become a crucial and distinctive feature of the world economy. The international movement of capital has integrated economies around the world. The daily turnover in currency exchanges increased from \$15 billion in 1973 to \$1.2 trillion in 1995; the equity and bond markets also grew and became more global. The ability to move billions of dollars from one economy to another at the push of a button has transformed international finance and increased its impact on both international and domestic economies. However, it is important to place these developments, like other aspects of economic globalization, in proper perspective.

Despite the impressive numbers that describe the international financial system, in relative terms the volume of financial flows at the beginning of the twenty-first century is still not equal to the interna-

¹ This chapter draws from Chapter 5 of Gilpin, *The Challenge of Global Capitalism* (Princeton: Princeton University Press, 2000).

trional flow of capital at the end of the nineteenth century. Prior to World War I, for example, the British invested approximately one-half of their savings abroad. Between 1880 and 1913, British capital exports averaged 5 percent of GNP and at their peak reached almost 10 percent of GNP. In contrast, although the world marveled at Japanese capital export in the 1980s and early 1990s, Japan actually exported only the equivalent of 2 to 3 percent of its GNP. We should also remember that pre-World War I British investments were largely in railroads, port facilities, and other infrastructure that provided physical foundations for the highly interdependent international economy developing at that time. Without substantial British overseas investment in the United States and other "lands of recent settlement," these countries would not have developed at the rate they did achieve. Today, a substantial portion of international capital flows are short-term (six months or so) and highly speculative, and there is controversy concerning the extent to which they actually contribute to world economic development.

Although internationalization of finance has become an important feature of the global economy, the international financial system continues to be largely nationally based and consists of closely interconnected, discrete national financial systems. Some countries, such as Japan and China, even retain controls on capital flows. Moreover, in the prosaic language of economics, finance is still characterized by a powerful "home bias" effect. Investors tend to invest in their home economies rather than to maintain internationally based investment portfolios. In the 1990s, for example, 94 percent of the stocks in the American stock market and 98 percent of the stocks in the Japanese stock market were domestically owned, and Japanese financial markets were closely regulated by the powerful Ministry of Finance. However, one should note that the "home bias" tendency may be lessening even though the world is still characterized by national financial markets.

An important study by Martin Feldstein and Charles Horioka found that increased freedom of capital movement has not integrated international finance as much as many believe.² If the world were really integrated in financial matters, then national savings rates and investment rates would no longer be closely correlated, and interest rates around the world would be more nearly equal. If capital were fully mobile, investment in a particular country would depend on the

investment opportunities in that economy and would not be highly correlated with the savings rate in that nation. The fact is, however, that savings and investment are closely correlated; high-saving countries, such as Japan, tend to be high-investing countries, and vice versa for low-saving countries. The United States is a major exception to this generalization in that domestic investment significantly exceeds national savings and is dependent on foreign borrowing. Moreover, in a perfectly integrated international financial system, the cost of capital, discounting the risk factor, would be approximately equal everywhere; instead, significant national differences in capital costs remain characteristic of the world economy.

Despite these caveats, the globalization of finance is a reality, and it does have profound consequences for the international economy. The absolute size, the high velocity, and the global scope of financial movements have been very important in the postwar period. In particular, the increased importance of speculative, short-term investments by financiers such as George Soros, by "hedge funds" in emerging markets, and by international banks have significantly increased the vulnerability of the international financial system and the world economy more generally; speculative funds amount to hundreds of billions of dollars. Many economists and public officials believe that these short-term, speculative flows increasingly threaten the stability of the global economy and should therefore be regulated.

Financial crises are a recurrent feature of the international economy. Even prior to the 1997 East Asian crisis, the postwar international economy had experienced several serious crises; three were especially important. The first resulted from the debt problems of many less developed countries in the late 1970s and early 1980s; a number of LDCs in Latin America and elsewhere had borrowed heavily from commercial banks in the mid-1970s and were thus highly vulnerable to the global recession of the late 1970s. The second was the 1992–1993 collapse of the European Rate Mechanism that forced Great Britain to withdraw from the effort to create a common European currency and resulted in fragmentation of the movement toward monetary unity. The third crisis was the collapse of the Mexican peso in 1994–1995, which threatened to precipitate a general financial crisis throughout Latin America; only the quick intervention of the Clinton Administration averted such a crisis.

These earlier crises were concentrated in particular regions, did not threaten the larger international economy, and were managed relatively easily, at least when compared to the East Asian financial crisis of 1997. That crisis was vastly different. The end-of-the-century crisis

² Martin Feldstein and C. Horioka, "Domestic Savings and International Capital Flows," *Economic Journal* 90 (1980): 311–19.

quences were truly devastating for that region, and the crisis eventually spilled over into the larger global economy. It is reasonable to say that the crisis resulted, at least in part, from globalization and transformations in modern finance; huge short-term investments in the region by international banks and financiers made these countries highly vulnerable to sudden swings in investor preferences. Nevertheless, as I have argued elsewhere, the risky policies undertaken by governments in the region must assume much of the blame.¹ The severity of the crisis led many to believe that international financial movements must be made subject to some regulatory mechanism.

NATURE OF FINANCIAL CRISES

Recurrent financial crises cause one to question the rationality of markets and to ask how rational actors can become caught up over and over again in investment booms or manias that almost invariably result in financial panics and crises. Or, to put the matter another way, if economic actors are rational, as economists assume them to be, how can one account for the frequent utter irrationality of financial markets? As Charles Kindleberger has written, over the past several centuries the world economy has been subject to a series of financial "manias, panics, and crashes" (to use the title of his book) that have shaken international capitalism.² Some economists have even argued that economic and institutional changes have made serious financial crises impossible, and that if crises were to occur, they would be caused by unique historical circumstances and would certainly not be caused by the inherent workings of the capitalist system. Given such attitudes in the profession, it is not surprising that few economists anticipated the East Asian or global financial turmoil.

The generally dismissive attitude of professional economists to the dangerous and destabilizing consequences of international financial crises has been challenged by Hyman Minsky, a maverick economist hardly at the forefront of the discipline. In a series of articles spanning a number of years, Minsky set forth what he called "the financial instability" theory of financial crises.³ According to his theory, finan-

¹ Gilpin, *The Challenge of Global Capitalism*, Chapter 5.

² Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Basic Books, 1979).

³ This discussion of Minsky's theory of financial crises is based on Kindleberger's *Manias, Panics, and Crashes: A History of Financial Crises*. Minsky's writings on the subject can be found in Hyman P. Minsky, *Can "It" Happen Again?: Essays on Instability and Finance* (Armonk, NY: M. E. Sharpe, 1982).

cial crises are an inherent and inevitable feature of the capitalist system, and they follow a discernible and predictable course. The events leading up to a financial crisis begin with what he calls a "displacement," or an external shock to the economy; this external shock, which must be large and pervasive, can take such different forms as the start of a war, a bumper or a failed crop, or innovation and diffusion of an important new technology. If large and pervasive enough, the external/exogenous shock increases the profit opportunities in at least one important economic sector while simultaneously reducing economic opportunities in other areas. In response to a shift in profit opportunities, a number of businesses with adequate financial resources or lines of credit rush into the new area and abandon existing areas. If the new opportunities turn out to be sufficiently profitable, an investment boom or mania begins.

Rapid and substantial expansion of credit is a key aspect of an investment boom; this greatly expands the total money supply. Even though, as Minsky points out, bank credit is notoriously unstable, an investment boom is fueled as well by personal and business funds used to finance the speculative boom and thereby add further to the money supply and expansionary activity. In time, the urge to speculate drives up the price of the sought-after goods or financial assets. The price rise in turn creates new profit opportunities and draws more investors into the market. This self-reinforcing or cumulative process causes both profits and investments to rise rapidly. During this "euphoria" stage, to use Minsky's apt word, speculation on price increases becomes yet another important factor driving up the market. More and more investors, lusting after the rewards of rising prices and profits, forsake normal considerations of rational investment behavior and invest in what by its very nature is a highly risky market. This irrational development is the "mania" or "bubble" phase of the boom. As the mania phase accelerates, prices and the velocity of speculative monies increase.

At some point along this path of speculation, a few insiders, believing that the market has reached its peak, begin to convert their inflated assets into money or "quality" investments. As more and more speculators realize that the "game" is about over and begin to sell their assets, the race to get out of risky overvalued assets quickens and eventually turns into a stampede toward quality and safety. The specific event or market signal that triggers the rout and eventually causes a financial panic may be a bank failure, a corporate bankruptcy, or any number of untoward events. As investors rush out of the market, prices fall, bankruptcies increase, and the speculative

economic eventually bursts, causing prices to collapse. Panic follows as investors desperately try to save what they can. Banks frequently cease lending, and this causes a "credit crunch"; a recession or even a depression may follow. Eventually, the panic ceases through one means or another, the economy recovers, and the market returns to an equilibrium, having paid an enormous price.

Economists, with a few notable exceptions, reject Minsky's model of financial crises because they believe no general model of financial crises can be formulated, as every crisis is either unique or of a very particular type for which a specific model is required. They consider every financial crisis to be a historical accident not amenable to general theorizing. A further criticism is that Minsky's model of financial crises assumes that such crises are generated by uncertainty, speculation, and instability—and economists assume rationality and brush away such awkward aspects of economic behavior. Nobel Laureate Milton Friedman, for example, has even proclaimed that because economic actors are at all times rational, speculation cannot occur in a market economy. In fact, he argues that what most of us call "speculation" is the effort of investors to protect themselves from the irrational actions of governments. Minsky, on the other hand, considered irrationality ("euphoria") and financial crises inherent features of modern capitalism. In Kindleberger's formulation, even if one were to assume the rationality of the individual investor, the historical record demonstrates over and over that even markets themselves sometimes behave in irrational ways and that "mob psychology" provides the best explanation of financial manias. Although individuals may be rational, financial speculation is a herd phenomenon in which the seemingly rational actions of many individuals lead to irrational outcomes.

Although Kindleberger is reluctant to declare that financial crises are an inherent feature of domestic capitalism, he asserts that they are inherent in international capitalism. He argues that Minsky's model is applicable to the realm of international finance, where one finds those essential features of an international financial crisis that were set forth by Minsky. Risky speculation, monetary (credit) expansion, a rise in the price of desired assets, a sudden and unexpectedly sharp fall in the price of the assets, and a rush into money or quality investments are endemic in the international pursuit of high profits by international investors. The East Asian financial crisis and subsequent global financial turmoil did indeed closely follow Minsky's model. Speculative investment in emerging markets by international banks and highly leveraged hedge funds fueled the mania and the investment

bubble, until the collapse of the Thai baht on July 2, 1997, signaled the end of the East Asian "miracle." Somewhat over a year later, in mid-August 1998, devaluation of the Russian ruble and other bad news from Russia triggered global financial turmoil.

THE EAST ASIAN FINANCIAL CRISIS

In the summer of 1997, East Asian economies suffered a devastating blow. Economies that only four years earlier had been hailed by the World Bank as exemplars of "pragmatic orthodoxy" and as "remarkably successful in creating and sustaining macroeconomic stability" experienced the worst economic collapse of any countries since the 1930s and were declared victims of their own irresponsible ways! Beginning in Thailand in early July, the crisis spread rapidly up the East Asian coast and engulfed every nation in Southeast and East Asia. It had previously been unthinkable, given modern economic knowledge, that a financial crisis of this magnitude could occur. In fact, no one had predicted the crisis. In retrospect, however, a crisis of some sort appears to have been inevitable, given all the things that could and did go wrong in the months preceding it. In the language of social science, the East Asian financial crisis was overdetermined. If one cause had not plunged the East Asian economies into crisis, there were half a dozen others that might have done so.

The East Asian economic crisis made more credible to many people the charge that economic globalization has significantly increased international economic instability and has been harmful to domestic societies. It is certainly undeniable that the economic plight of East Asia attests to the ability of international financial markets to wreak havoc on domestic economies. However, imprudent domestic economic policies were as important as global economic forces in making these economies highly vulnerable to sudden shifts in international financial flows. Many of the allegedly negative effects of economic globalization are actually due either to poor economic management by governments or to developments that have nothing whatsoever to do with economic globalization. The victims in these situations have generally been small economies. The United States has run a trade/payments deficit for approximately three decades without unleashing any dire consequences! While large states with large markets and resources may be able to defy economic forces for a long time, such a privilege is rarely accorded to small states, especially small states with such reckless policies as borrowing "short" and lending "long"; that

... finance long-term development and risky projects with short maturity funds.

It is extraordinary that there is no mechanism to regulate international finance. Even though the world economy experienced three major financial crises in the 1990s—the 1992–1993 crisis of the ERM, the 1994–1995 Mexican/Latin American crisis, and, beginning in 1997, the East Asian crisis—efforts to create effective regulations governing international capital flows and financial matters have not made much progress. A number of scholars, including Paul Kindleberger, Susan Strange, and James Tobin note that the international financial system is the weakest link in the chain of the international economy and that international finance should be regulated effectively. Financial markets, these scholars have argued, are too subject to irrational manias and crises and cannot police themselves. In such a situation, it is quite unfair to blame the East Asian crisis solely on the forces of economic globalization and on “wicked” Western speculators like George Soros.

Although destabilized financial markets will eventually return to an equilibrium, the crises can impose an unacceptably heavy cost on innocent bystanders and on the larger world economy. For this reason, scholars such as Kindleberger, Strange, and Tobin advocated establishment of international regulations or a formal regime to govern financial markets. For example, Tobin and others have proposed an international tax to discourage financial speculation, especially in short-term investments. Others, such as George Soros, go farther and argue that creation of an international central bank and true “lender of last resort” should be at the heart of a mechanism to govern international finance; that is, an authority should be created to function internationally as central banks do domestically. Then, when a government finds itself in trouble, the international bank could step in to rescue it. It is not necessary to say that the prospects of establishing such an international central bank are quite remote, at least under the political conditions of the early twenty-first century!

In the late summer of 1998, the East Asian economic crisis spilled over into the global economy, setting the stage for what President Clinton declared the worst economic crisis in fifty years. The Russian government’s devaluation of the ruble against the German mark by about 40 percent in late August triggered the globalization of the crisis. The Clinton Administration, for political reasons, had bet heavily on “saving” Russia and had pressured the IMF to loan Russia tens of billions of dollars, many of which were subsequently squandered and funneled to private Russian accounts in foreign banks. Investors and governments around the world panicked as they wit-

nessed a major nuclear power reneging on its agreements and facing economic/political chaos. Worried that other countries would also default, investors searching for safe havens in the early fall of 1998 began to withdraw funds from LDCs. Declining corporate profits and investor panic led to a precipitous fall of the American and other stock markets (October 31, 1998). The threat that the Long-Term Management Fund would collapse greatly deepened the crisis. These events in turn set off a serious credit crunch that further slowed global economic growth. Late that fall, some estimated that approximately one-third of the world economy was in recession; the United States alone was still experiencing economic growth. With the depression in East Asia and recession in much of the rest of the world, commodity prices fell considerably, and this caused economic distress in many commodity-exporting sectors, including American agriculture.

American officials had become concerned in the early fall that the financial crisis would continue to spread and had focused much of their attention on Brazil. Brazil possessed many of the characteristics of a developing economy in serious trouble, including a huge budget deficit and sizable international debt. The country’s uncertain fiscal situation was accompanied by a heavy capital outflow and put severe pressure on the Brazilian real. The Clinton Administration feared that financial collapse in Brazil, a major importer of American products, would seriously damage the American economy and accelerate turmoil throughout the world. As the troubles of the global economy continued to unfold, the Administration took action. In a well-publicized speech in mid-September to the New York Council on Foreign Relations, the President proposed that all the major economic powers stimulate their own economies in order to restore global economic growth; he also proposed that the major economic powers should meet at the time of the next IMF/World Bank meeting in October and should then develop a longer-term solution to the problem of global financial instability.

These Clinton initiatives were given a cool reception. Every central bank ignored the suggestion that interest rates be cut in order to stimulate global growth. Nevertheless, on October 15, the Federal Reserve, motivated primarily by concerns about the American economy, did cut interest rates; it did so twice more before the end of November. These important moves restored investor confidence and succeeded in reinvigorating the American economy. The other major economic powers had agreed, although without enthusiasm, to Clinton’s proposal that they meet, and that meeting took place during the annual joint meeting of the IMF and World Bank (WB) that was held in Washington in late October.

At the IMF-WB meetings, President Clinton set forth proposals for a "new international financial architecture" to contain the spreading economic crisis and prevent future crises. The Administration also hoped to forestall efforts by other governments (mainly Western Europe and Japan) to impose new restrictions on international capital flows. The President's proposals were considered at the October 30 meeting of the major economic powers, and several important decisions were reached. The G-7, assuming that if investors were fully aware of risky situations, they would not repeat the mistakes made in Mexico (1994-1995) and in East Asia, agreed that much greater transparency of financial conditions in every country was crucial to prevention of future financial crises. In addition, the G-7 called for much tighter international standards for accounting and for bank regulation.

The most important G-7 decision was to accept Clinton's proposal that the IMF should establish a \$90 billion contingency fund to provide countries with emergency financial assistance; the fund would help only those countries already carrying out economic reforms and those whose economic "fundamentals" were basically sound. Before a crisis actually occurred, this would enable the IMF to intervene in order to shore up the country's financial defenses of its currency by providing adequate liquidity and thereby preventing financial panic. When it made this proposal, the Clinton Administration had Brazil in mind, as Brazil required a huge infusion of foreign capital to keep its economy afloat. Following a bruising but ultimately successful battle in the Congress over replenishment of IMF funds, much of which had previously been squandered in Russia, in November the IMF offered Brazil a large assistance package of over \$40 billion and attached a precondition that the Brazilian economy be significantly overhauled. In early 1999, having failed to improve its economic performance, Brazil suffered a major economic crisis.

As important as the G-7 decisions had been, they failed to quell the intense controversy over reform and regulation of the international financial system. By early 2000, a number of proposals had been formulated to deal with destabilizing international financial flows; current proposals range from creation of a worldwide central bank to imposition of an international tax on financial transfers across national boundaries (called the "Tobin tax").* Some experts believe that

* An excellent discussion of international financial reform is Barry J. Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asian Agenda* (Washington, D.C.: Institute for International Economics, 1999). Also, Council on Foreign Relations, *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture*, Report of an Independent Task Force (New York: Council on Foreign Relations, 1999).

self-imposed national restrictions on both financial inflows and outflows are necessary. A number of governments such as Japan, China, Malaysia, and Chile have, in fact, instituted controls on financial flows. The European Union, too, has begun consideration of some regional regulations on capital flows.

CONTROVERSY OVER REGULATION OF INTERNATIONAL FINANCE

With the global financial turmoil of the late 1990s, the economics profession and many governments became concerned about and deeply divided over international finance and regulation of international capital/investment flows. Many American economists believed, and certainly the Clinton Administration did, that international financial flows perform a crucially important role, and that such flows should be free from government regulation. Most economists also believe that the financial system should ensure that capital moves from economies with surplus savings to those where investment opportunities exceed local savings—that capital should be free to move toward those places and activities where it will be used most effectively and will thereby increase efficient utilization of the world's scarce capital resources. The prevailing opinion in the United States is that markets rather than governments or international organizations should govern the international financial system. At least since the time of the Reagan Administration, the United States government has strongly believed that American financial interests benefit greatly from freedom of capital movements, and it has made a concerted effort to open foreign economies to those investments. The Clinton Administration, led first by Treasury Secretary Robert Rubin and Deputy Secretary Lawrence Summers, and later by Summers as Treasury Secretary, enthusiastically carried this effort forward.

However, the East Asian financial crisis caused some American economists and many governments concern about the frequently devastating impact of international financial movements. A number of prominent economists in the United States and elsewhere challenged the value of unrestricted international capital flows, arguing that although it has been amply demonstrated that international trade benefits the global economy, the benefits of free capital movements have not been adequately demonstrated. On the other hand, the costs to the international economy of frequent financial crises have become painfully obvious. Indeed, as Kindleberger has shown, international financial history does record constantly recurring speculative manias, panics, and crises. Therefore, many have concluded that international

market forces, but that some rules or mechanisms to regulate international capital movements should be devised.

Unfortunately, economists disagree over the cost and desirability of international financial flows. Although they agree on the virtues of trade liberalization, no comparable agreement exists with respect to capital flows and whether or not they should be regulated. It is worth noting, for example, that six of America's most distinguished economists—Jagdish Bhagwati, Stanley Fischer, Milton Friedman, Paul Krugman, Jeffrey Sachs, and Joseph Stiglitz—have disagreed with one another vehemently, and not always in a friendly spirit, regarding analysis of the East Asian financial crisis and the policies that should be pursued to prevent future crises. While some believe that governance of the international financial system should be left entirely up to the market, other economists and the IMF favor freedom of capital movements along with greater IMF surveillance over both domestic and international financial matters. A number of countries, including Japan, Germany, and France, believe that greater international controls are required over monetary and financial matters.

Reliance on the Market

Those economists who believe that a completely open and unregulated international financial system is the only realistic way to deal with the problems resulting from international financial flows also believe that any other approach necessarily raises the problem of "moral hazard." Moral hazard would be a problem, because if lenders and borrowers were to believe that the IMF or another official agency would rescue them from their folly, they would be encouraged to engage in reckless behavior; indeed, this had happened in the East Asia financial crisis. On the other hand, an unregulated financial market would itself punish investors and borrowers who failed to pursue prudent economic behavior. If international investors realized that no one would rescue them if they got into trouble, they would become more cautious with their investments.

Milton Friedman, Walter Wriston, George Schultz, and William Simon, all of whom wanted reliance on the market, believed that the IMF was ineffective and obsolete and should be abolished. Friedman considers the IMF's role in the world economy to exemplify bureaucratic self-aggrandizement. The IMF, Friedman points out, had originally been created to supervise the system of fixed exchange rates that was ended by President Nixon in 1971. The IMF then found a new function as an economic consulting agency for countries in trouble, offering money in exchange for promises of reforms. In Friedman's

opinion, this interventionism by the IMF encouraged countries to continue to pursue unwise and unsustainable economic policies (moral hazard). Russia's failure to take the hard decisions required to salvage its devastated economy, he believes, was a classic example of IMF encouragement of irresponsible behavior.

For Friedman and fellow conservatives, the IMF's response to the Mexican crisis of 1994–1995 represented a quantum jump in the IMF's counterproductive interventionism. Mexico was bailed out by an aid package of \$50 billion put together by the IMF, the United States, and other countries. Friedman has asserted that the IMF money actually ended up in the hands of such foreign entities as American banks that had foolishly lent money to Mexico, and that Mexico itself was left in recession and saddled with higher prices. However, the Mexican crisis had a longer term and even more serious consequence because it fueled the East Asian crisis by encouraging investors to again make risky investments. Drawn by high returns and assured that the IMF would bail them out if the exchange rate broke down and governments defaulted, investors poured money into the emerging markets of East Asia. In effect, the IMF and its provision of insurance against currency risk subsidized private banks and investors, a clear example of inducing moral hazard; that is, encouraging undesirable and/or counterproductive behaviors. This chain of reasoning led Friedman and others to conclude that the solution to financial instability must be through elimination of IMF-induced moral hazard.

The market-oriented position rests on the assumption that investors are rational and will not invest in risky ventures if they know that they will not be bailed out. Therefore, elimination of moral hazard also eliminates the problem of serious international financial crises. Although this conclusion may be correct, no such approach has ever been tried, and there is no empirical evidence to support such a daring policy experiment. Indeed, available evidence leads this writer to conclude that investors are *not* consistently rational, that they *do* get caught up in what Minsky called "euphorias," and that, when the speculative bubble bursts, many innocent people get hurt. This causes most governments to be unwilling to risk leaving financial matters entirely "up to the market;" indeed, many governments have even installed mechanisms at the domestic level to protect their citizens from financial instability.

Strengthening the IMF

Others believe that the solution to the problem of international financial instability can be found in strengthening the regulatory role of the IMF. Proponents of this position, especially the Clinton Ad-

...of capital move-
ments should be a primary purpose of the IMF. While agreeing with the market approach about the beneficial nature of unrestricted international capital flows, they believe that a greater supervisory role by the IMF and other reforms are necessary. Indeed, the IMF has already taken a number of important initiatives to create a regime for international finance. Most importantly, the IMF charter has been amended to give it greater jurisdiction over financial matters. As IMF's first deputy managing director Stanley Fischer has stated, the amendment is intended "to enable the Fund to promote the orderly liberalization of capital movements." He has also noted, however, that achievement of this goal requires continuous and reliable information on the financial conditions in potentially risky economies, development of an effective surveillance system to monitor such economies, and greater authority for the IMF to act as the "lender of last resort."⁷

The following paragraphs discuss some of the major proposed reforms to strengthen the role of the IMF in preventing financial crises.

Greater Transparency and Improved Information-Gathering. The 1994-1995 Mexican crisis was made worse by the poor information about Mexican financial conditions supplied by the Mexican Government to the IMF and investors. For example, the size of both Mexico's financial reserves and its external debt were kept secret. In 1996, lessons learned from this experience did lead to increased IMF data gathering and dissemination. Nevertheless, some experts have asserted that even the improved system of data gathering proved inadequate when it did not forestall the 1997 East Asian financial crisis. Although more reliable information on the financial conditions of developing economies could be an important safeguard against reckless investing, governments do wish to keep financial data secret in order to increase their leverage with foreign investors, and this raises a major hurdle. The predicament is made worse because governments also wish to keep their financial condition secret in order to strengthen their relative position in the intensifying competition for capital imports. The 1997 East Asian crisis, however, did strengthen the belief that greater openness about the financial conditions in many countries is required.

Codes of Conduct and Better Surveillance. The IMF has placed much greater emphasis on developing codes of conduct regarding "good

⁷ The purpose of the "lender of last resort" is to pump money into an economy whose banking system is suffering from a "liquidity problem." The term "liquidity problem" is explained below in note 9.

practice" in financial affairs in order to increase discipline at the international level. Among other changes, this effort requires upgrading of the Basle Accord (1988) regulating international bank practices.⁸ In addition, improved surveillance and monitoring of specific economies for such potential dangers as high budget deficits and high rates of inflation may suggest potential financial troubles. However, even if a country is warned of impending problems, it may not act to forestall them, and the IMF remains powerless to force such action. Nor would it be proper for the IMF to warn investors about potential problems in a particular country.

Lender of Last Resort. In a world of increasing capital flows and growing numbers of borrowers, it is inevitable that individual countries will occasionally experience serious financial troubles and require international assistance in the form of a large infusion of money to prevent a liquidity or even an insolvency problem.⁹ Many believe that the IMF should perform the role of lender of last resort; however, the IMF is seriously limited in this capacity because, unlike a true central bank, the IMF cannot create money; also, its cumbersome governing mechanism prevents it from acting quickly in a crisis. In addition, assumption of the lender-of-last-resort role raises the problem that the larger the IMF's resources, the greater the risk that it will encourage moral hazard.

Strengthening the IMF in order to promote freedom of capital movements and prevent financial crises has been an important objective of the United States. American commitment to promarket ideology, powerful financial interests to which the U.S. Treasury is highly responsive, and a general belief that America has a strong comparative advantage in financial services have been reflected in U.S. efforts to keep economies open to international finance. However, the controversy in 1998 over America's \$18 billion contribution to the IMF illustrates that the Clinton Administration's effort (backed by export

⁸ "Basle" refers to the International Bank for Settlements in Basle, Switzerland, which sets standards for international banks. The Basle Accord of 15 July 1988 established international harmonization of regulations regarding the capital adequacy or reserve requirements of international banks. The agreement was the result of an American initiative in response to American banking interests. American proponents of the agreement believed that foreign banks had an unfair advantage because of their relatively low reserves requirements. Despite strong opposition from other countries, American pressure for the accord eventually won.

⁹ A "liquidity" crisis exists when an otherwise sound economy has a temporary cash-flow problem. An "insolvency" crisis exists when an economy has severe economic problems and cannot repay its debts without making major economic reforms.

interests) to strengthen the IMF's role in preventing financial crises had many opponents; that Congressional and public controversy raised serious questions about the ability of the United States to lead in fashioning a "new international financial architecture."

Regulation of International Finance

A number of economists and governments favor some controls over international capital movements. Agreement that short-term capital flows should be regulated appears strong. James Tobin and other American economists, for example, have proposed a tax on short-term capital flows, and Paul Krugman has argued that countries in financial difficulty should consider capital controls. The French, German, and Japanese governments have raised the possibility of other measures to tame large swings in global financial markets and in currency values. They have also proposed that the European Union, Japan, and the United States should manage exchange rates and keep them within specific bands or target zones in order to stabilize the global economy. However, the United States has strongly objected to delegating decisions over interest rates and other aspects of its own economy to any international authority; it prefers to rely on the market.

The differences between the United States and its principal economic partners over currency and financial matters were the subject of the annual meeting of the G-7 finance ministers and central bankers in February 1999, where creation of a mechanism to regulate international finance was the principal issue discussed. On one side of the debate were the German, French, and Japanese governments favoring increased controls; many European and Japanese officials wanted to control hedge funds in particular. On the other side were the United States and U.S. and other central bankers who strongly opposed an international authority and preferred to leave matters to national governments and central bankers. The differences between the United States and the other economic powers partially reflect ideological positions on market functioning, but they also reflect the relative competitiveness of American financial institutions as well as their political strength within the United States. Eventually, agreement was reached that a "financial stability forum" composed of national currency regulators meeting twice a year to consult and consider ways to improve the quality of financial information would be created. The difficulties experienced by the G-7 in efforts to agree on reforms of international financial affairs do not augur well for the future stability of the global economy.

The underlying motive of the West Europeans and the Japanese in their advocacy of greater controls over international finance is, at least in part, political. The West Europeans would very much like to diminish the American role in international monetary and financial matters in order to minimize the potential negative impact of American policies on Europe. The European Union would like to restrict the independence of American macroeconomic policy. Japan has encouraged greater use of the yen in international transactions and would like to distance the Asia-Pacific region from the international use of the dollar.

CONCLUSION

Freeing capital and integrating financial markets around the world have had several important consequences for the global economy. Freedom of capital movements has complicated and, some believe, reduced macroeconomic policy autonomy and the ability of individual governments to control their own economies.¹⁰ International financial flows have also become an important determinant, and many economists believe they are *the* most important determinant of exchange rates (at least in the short term) and a cause of erratic movements in currency values. Movement toward a single, globally integrated market for corporation ownership has resulted from increased financial flows, and this has greatly facilitated corporate mergers and takeovers across national boundaries and the integration of the world economy by multinational firms. Altogether, the reemergence of international finance has increased interdependence of trade, monetary, and other aspects of the international economy. The need to mesh these formerly separate domains of international economic affairs has complicated the task of managing the world economy.

¹⁰ A dramatic example of how international financial flows have constrained domestic economic policy was the disastrous attempt of the French socialist government of François Mitterrand in the early 1980s to stimulate the laggard French economy. Capital flight forced the French government to rein in its expansionary economic policies. This instructive episode is analyzed from quite different perspectives by Michael Loriaux, *France After Hegemony: International Change and Financial Reform* (Ithaca: Cornell University Press, 1991); and Paulette Kutzer, *Business and Banking: Political Change and Economic Integration in Western Europe* (Ithaca: Cornell University Press, 1991).