

Discussion

1. General Discussion¹

There was broad discussion on the general topic: New Financial Architecture or ‘Minor Interior Decorating’? The debate was dominated by four issues for policy reform:

- measures to help prevent currency and financial crises;
- crisis management and measures to reduce the severity of crises;
- the reform of international institutions; and
- the adequacy of reform undertaken so far.

On the first point, there was general agreement that there are benefits from improved financial transparency and regulation of financial systems. These may develop either in the countries from which capital originates or in recipient countries. Either way, recipient countries face the added responsibility of developing legal and administrative frameworks for dealing with bankruptcy.

The role of foreign exchange reserves in defending fixed exchange rates was also discussed. Some believed that recent currency crises had firmly validated the policy of maintaining ample stocks of reserves as a deterrent to runs on a currency. Others pointed out that reserves have a social cost because the return on them is likely to be less than the opportunity cost of holding them.

There was also some debate about the ability of capital adequacy standards to prevent currency and financial crises. Although standards tend to improve the health of those financial institutions to which they are applied, if they are too onerous, they may also cause the growth of alternative financial institutions which are beyond the purview of regulators and which may therefore become an alternative source of financial fragility.

Capital controls were also discussed. Some participants felt that they are so distortionary as to be obviously undesirable. Furthermore, they contended, capital controls are susceptible to evasion and they buckle under pressure. Others took issue with these arguments, pointing to the case of Chile, where capital controls appear to have increased the average maturity of foreign-currency-denominated debt. Since a heavy weighting of short-term foreign-currency-denominated debt in external liabilities is a robust leading indicator of currency crises, some participants inferred from Chile’s experience that well-designed capital controls may contribute to domestic financial stability.

In discussion of crisis management, there was debate about the relationship between private and public sectors. The relations between the state and foreign

1. Discussion in this session proceeded without the benefit of Michael Mussa’s paper which arrived after the session finished.

investors were likened by one participant to the relations between competing creditors in a situation of corporate financial distress: when trying to restrain capital flight, the state is effectively contesting a foreign investor's right to withdraw capital, much as one private creditor to a firm might contest another's right to withdraw funds and wind up the firm.

Other participants saw the situation differently. They argued that capital flight is essentially a competition among foreign investors over an exhaustible stock of liquid tradeable assets. The government's role in these circumstances is to mediate the competing private claims of foreign creditors in such a way as to limit the economic dislocation imposed on fundamentally sound domestic enterprises. By limiting capital flight – perhaps via a standstill or by imposition of direct capital controls – it achieves this objective.

The general analogy with financial distress and bankruptcy informed subsequent debate about the international financial architecture, with participants noting the lack of an international equivalent to national bankruptcy laws and procedures. At the national level, such laws and procedures provide an economically efficient way in which corporate-ownership issues can be resolved when normal commercial arrangements have broken down. The lack of an international equivalent to these mechanisms means that alternative, economically less efficient, mechanisms have to be invoked when there are international financial crises. Some suggestions, such as standstills, are imperfect attempts to reproduce the mechanisms of domestic bankruptcy laws at an international level.

Participants also considered the relationship between the IMF's lending facilities and the problem of moral hazard. One advantage of the IMF's promise of liquidity support to member countries is that it eases the burden national governments face in having to hold high levels of liquidity as insurance against sudden capital flight. Furthermore, the promise of assistance encourages the governments of developing economies, and foreign investors in those economies, to take actions which improve economic growth, but which would otherwise be too risky. One participant noted that moral hazard problems only arise when the extent of promised assistance is so great as to encourage governments and foreign investors to become too complacent in their assessment of risks.

Participants were divided on the question of whether the moral hazard problem would overshadow the benefits of providing greater resources to the IMF for supporting countries in distress. One suggestion was that any redesigned IMF should lend sparingly to individually distressed countries and conserve its resources for financial crises which threaten to extend beyond national borders. Others pointed out that this principle had characterised the Fund's operations in east Asia: actual IMF disbursements to the troubled east Asian economies had indeed been small relative to their needs.

The welfare implications of various mechanisms for resolving crises were also noted. One problem with workouts which assign priority to international lenders is that they often, and quite arbitrarily, subordinate the interests of domestic taxpayers

to those of foreign investors. This was quite clearly true of the bailouts of Mexico and parts of east Asia, where domestic residents bore a disproportionate share of the burden of restoring stability in the aftermath of crises.