From the Washington Consensus to the New International Financial Architecture

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1. Introduction

It is my great pleasure to join this distinguished panel of experts and to deliver the Japanese view on private capital flow issues.

I feel somewhat relaxed and freer since I resigned from the position of Vice Minister of Finance for International Affairs about a month ago. At least now I don't have to worry about what I say about the yen/US dollar rate for the wire people who used to follow me all over the world. I would like to remind you that what I say today does not necessarily reflect the official views of the Japanese Government, although I still retain the position of Special Adviser to the Minister of Finance.

2. The Nature of the Crisis

Since the crisis erupted in Asia in 1997, I have consistently insisted that it was not an 'Asian' crisis, but a crisis of global capitalism. I think it is fair to say now that many have accepted this proposition and agree that the crises of 1997 and 1998 should be analysed as a continuation of the 'global' crisis that broke out in Mexico and Argentina in 1994 and 1995. Unlike the Mexican crisis of 1982, where external factors, such as a steep rise in the US interest rate and the sudden appreciation of the US dollar, played a major role in triggering the crisis, there were no apparent external causes of the 1994–95 crisis. International conditions, including the US market, were stable, and economic reforms in both Mexico and Argentina were well received by the international community. Some economists, notably Rudiger Dornbusch, argued that overvalued currencies were the direct cause, as in the case of the Asian crisis of 1997. Indeed, throughout the crisis from 1994 to 1998, overvaluation of real effective exchange rates was a factor that triggered the panic. Also, the short-term debts of Mexico and Argentina in 1994 exceeded the level of foreign reserves. In particular, Mexico's 1995 short-term official debt denominated in US dollars (tesobonos) of around $28 billion, which was scheduled to be paid within several months, far exceeded the level of foreign reserves, which at that time was only $6 billion. A similar situation existed between private short-term debts and the level of foreign reserves in Thailand, Indonesia, and South Korea in mid 1997. In Asian countries, it was private, short-term debts – not official debts such as tesobonos – which had accumulated.

Despite some signs of growing vulnerability, these crises from Mexico to South Korea were not predicted by market participants and analysts until certain events – political uncertainty, or bankruptcies of big corporations – triggered panic. Risk premia in loans remained low, and rating agencies, such as Standard & Poor's

and Moody's, maintained their relatively high rating of sovereign bonds until the onset of the crises. Many analysts and financiers, particularly at the outset of the crises, argued that the lack of proper disclosure and high-level transparency hampered the appropriate assessment of risks. However, objective evidence and data seem to indicate that the pertinent information, such as real effective exchange rates, short-term foreign debts in the private sector, current account balances, and balance sheets of banking sectors, was largely available. The problem was that this information was not appropriately incorporated into the risk assessment of the markets. Particularly when considering factors in the behaviour of non-bank financial intermediaries, such as hedge funds and pension funds, one is inclined to believe that the herd mentality has been more prevalent than rational and detailed calculation of emerging market risks. Moreover, so-called rational calculations *à la* LTCM turned out to be misleading in that their models assumed a stable equilibrium.

Thus, looking more objectively at the details of these crises, one is led to believe that they are testaments to the inherent instability of liberalised international capital markets where sudden reversals of market confidence cause periodic panics of differing magnitudes and durations. Also, it is interesting to note that both the Mexican and South Korean crises occurred immediately after these countries joined the OECD and began to conform to the code of capital liberalisation of the organisation. Indeed, after the substantial liberalisation of the capital accounts of five Asian countries – South Korea, Indonesia, Malaysia, Thailand, and the Philippines – around 1993, approximately US$220 billion in private capital flowed into the region during the 3-year period from 1994 to 1996. The reversal of flows in 1997 due to the sudden shift in confidence amounted to roughly US$100 billion. No country or region can tolerate a sudden shift in market sentiment from euphoria to panic that causes a huge reversal of private capital flows.

3. Washington Consensus

In April 1990, John Williamson defined what he called the 'Washington consensus' in relation to conditionalities attached to Latin American countries at the time of the debt crisis of the 1980s. The consensus has served since then as guiding principles among G7 countries and international financial institutions in managing the global economy of the 1990s. Williamson identified and discussed the consensus on 10 policy instruments, but here, it suffices to say that the basis for the consensus essentially boils down to free markets and sound money. Latin American countries in the 1980s and earlier experienced hyperinflation a number of times, and it was absolutely necessary for policy authorities to control inflation. As a theory of hyperinflation, monetarism seemed to be the most relevant macroeconomic framework. Thus, it was only natural that monetarist thinking occupied centre stage for policy discussions in the 1980s in Latin American countries. The IMF's financial programming, which is quite monetarist in its theoretical orientation and is the cornerstone of the IMF's thinking, originated from the Western Hemisphere Department as early as the 1960s, but it was no coincidence that this department dealt with the American continent, and mostly Latin American countries.

Another development which served as a vehicle for the proliferation of monetarist thinking was the unification of Europe and the unification of European currencies in particular. The convergence of inflation rates and interest rates among countries was the key to the unification of currencies. Thus, anti-inflationary policies through the reduction of fiscal deficits and through sound monetary policies became one of 10 core elements in European unification policies. The key country in this unification process, namely Germany, was a country, like many Latin American countries, with a legacy of hyperinflation.

So far so good. However, if monetarism is enshrined as a universal theory of macroeconomic policy management rather than as a framework to cope with hyperinflation or potential hyperinflation, the problem could arise again. A director of the International Monetary Fund visiting my office a few years ago jokingly told me about an experiment he conducted at the Fund. He crossed out the name of the country from one of the consultation papers and circulated the document among experts in his department asking them to guess the name of the country which happened to be a relatively small, developing country in Asia. No-one was able to guess the name of the country from the paper, which was full of Washington jargon such as money supply, domestic credit, budget deficits and debt-service ratios.

The blind application of universal models, be they neoclassical or monetarist, to emerging economies seems to have been the predominant practice by international institutions or other public and private creditors. To some extent, emerging economies themselves accepted such unilateral imposition of dogmatic formulas, fearing a negative reaction from the market if they rejected such prescriptions. In this sense, the Washington consensus was not only the consensus in Washington, but represented the official position of G7 and other IMF and World Bank member countries, creditors as well as debtors, and market participants. This perfect co-ordination, on the other hand, generated mutually reinforcing, excessively optimistic and then pessimistic expectations about the country in question.

The Asian crisis seems to be a good example of this Washington-generated excessive optimism-turned-into-panic. Asia, particularly South-East Asia, in some sense, was an area well suited for global *laissez-faire*-type financial and commercial transactions. South-East Asia had been resonating with Washington-led globalisation with their own traditional structure of global commercialism. Between the 8th and 18th centuries, Asia was the centre of world commercial activities among Islamic, Indian, and Chinese merchants and later with Venetian, Dutch, and English merchants. Thus, the human networks for global transactions, both financial and commercial, were there, and overseas Chinese and Indians speedily adapted to newly emerging global markets. However, after the Asian crisis, we came to recognise that this resonance of Asian tradition with the Washington consensus had some serious problems.

To the extent that markets believed the pay-offs for implementing the Washington consensus in Asia were high, Asia euphoria continued and resulted in huge inflows of capital from 1993 to 1996.

One major aspect of the combination of Asian commercialism and financial and telecommunication globalism was that it tended to skim over the surface of economic structures and weaken manufacturing bases. Projects tended to be concentrated in the services and real estate industries, such as the construction of financial centres, rather than in basic infrastructure or manufacturing. Thus, education and on-the-job training of workers and organisational improvements in corporations tended to lag behind. Thus, as has been pointed out by many, including Paul Krugman, labour productivity and efficiency gains were not noticeable even in export industries which were affected by the appreciation of the real effective exchange rate. One-time gains in competitiveness due to low wages quickly dissipated, and skyrocketing costs for business offices also resulted in loss in relative competitiveness.

Thus, it is fair to say that the Asian crisis was not necessarily generated by the unilateral imposition of the Washington consensus by institutions in Washington, but was a result of worldwide euphoria about the market mechanism, including that of Asian countries, which created the bubble and eventually bursting of the bubble in this region.

However, it may be a different matter to argue that crisis management by G7 countries and international institutions after July 1997 in Asia was, at least initially, seriously flawed. The world establishment still believed in the neoclassical paradigm with a monetarist orientation, and that may have caused fiscal and monetary policy prescriptions that were too tight at the outset and allowed international institutions to impose unrealistic structural reforms which were politically and socially difficult to implement in the short run. Since I was personally involved in the process and agreed, although reluctantly, in the end to what was recommended, I am in no position to criticise others for what happened.

However, it is quite clear now that the Washington consensus needs to be replaced by a new paradigm which has been called a new international architecture. A first step toward the new architecture was taken at the Köln Summit, but it remains to be seen whether it will develop into a new paradigm for the new century or degenerate into 'minor interior decorating'.

4. Toward a New Financial Architecture

Let me now review the key points in the Report of the G7 Finance Ministers on the International Financial Architecture which was published in Köln on 19 June in this context of shifting from the Washington consensus to a new paradigm for the 21st century. Indeed, the new paradigm is still very abstract and lacks implementation details. Since, as it is often said, 'the devil is in the detail', it is possible that national and international bureaucrats at the Fund and elsewhere may substantially water down the content of this report in the implementation process. However, if that were the case, another major crisis would probably erupt to accelerate the transition in the direction suggested by this report. In any event, let me now discuss the details of the Report.

On the creditors' side, the Finance Ministers' Report says that the G7 will 'encourage private firms to strengthen their own risk management practices' and that

'national authorities should ensure banking institutions in their countries implement adequate risk management practices in accordance with' the Basel Committee's recommendations in its paper on Highly Leveraged Institutions published early this year. At the same time, the Report notes that the newly established Financial Stability Forum will study a number of issues related to HLIs, including instability possibly caused by HLIs in relatively small financial markets. Enhancing supervision in offshore centres is also encouraged in the Report.

Furthermore, in order to ensure that 'private creditors know that they will bear the consequences of their investment decisions', the Report identifies the principles that govern debtor/creditor relationships and the tools that may be used to promote appropriate private-sector involvement in the resolution of crises, including an effective use of the 'lending into arrears' policy of the IMF. Legal and technical questions involved in implementing these specific approaches will be considered by the IMF by the time of the Annual Meetings in September this year.

On the emerging economies' side, the Report proposes concrete measures in four different areas: exchange rate regimes, capital flows, financial systems, and debt management.

First, on exchange rate regimes, the G7 notes that 'the choice of exchange rate regime is critical for emerging economies to achieve economic development'. It says, 'We agree that the most appropriate regime for any given economy may differ, depending on particular economic circumstances'. For instance, 'some emerging economies have sought to achieve exchange rate stability by adopting peg regimes against a single currency or a basket of currencies, often in the same region, of countries with which they have the closest trade and investment links'.

Adopting an appropriate regime is important since it allows overseas investors to properly judge the exchange risks they are taking. For the regime to reflect changing exchange risks, it must be continuously reviewed, so that it can be finetuned as 'economic circumstances vary over time'. In this context, the IMF should play a more active role 'to enhance the attention it gives to exchange rate sustainability in the context of its surveillance activities'. If a country intervenes heavily to defend an unsustainable exchange rate level, large-scale official financing should not be provided.

A simple hypothesis, the so-called 'two corner approach' has sometimes been suggested in international circles, including by officials. This school of thought assumes that only a completely free-floating regime or a currency board is viable. The Report does not share this view. Although it says that 'countries choosing fixed rates must be willing…to subordinate other policy goals to that of fixing the exchange rate' and that 'arrangements institutionalising that policy can be useful to sustain a credible commitment to fixed rates', the common understanding among the G7 countries is that the 'arrangements' referred to here are not limited to a currency board, but include various measures.

On capital flows, the Report recommends that 'capital account liberalisation should be carried out in a careful and well-sequenced manner, accompanied by a sound and well-regulated financial sector and by a consistent macroeconomic policy

framework'. It goes on to explain the G7 consensus on controls on capital flows. It says: 'The use of controls on capital inflows may be justified for a transitional period as countries strengthen the institutional and regulatory environment in their domestic financial systems…More comprehensive controls on inflows have been employed by some countries as a means to shield themselves from market pressures. Such steps may carry costs and should not in any case be used as a substitute for reform…controls on capital outflows can carry even greater long-term costs…although they may be necessary in certain exceptional circumstances'.

It has sometimes been suggested by the press and others that Japan is advocating more controls on capital flows while other G7 countries are arguing for free capital movements. This is simply not true. If one carefully reads Finance Minister Miyazawa's speech of last December, it is clear that Japan's position from the outset was that maintaining market-friendly controls that would prevent turbulent capital inflows should be justified when a country wants to keep capital inflows at a manageable level according to the stage of development of its financial sector, and that there might be some cases that would justify the reintroduction of controls on capital outflows as an exception, for example, in order to avoid a bailout by IMF loans. As the Report shows, this stance is shared by all G7 countries.

As for financial systems, the Report calls for close co-ordination between the IMF and the World Bank when they give advice to emerging economies in the area of financial sector reform. It also welcomes commitments by the emerging economies of Asia and Latin America to take necessary steps towards the implementation of the Basel Core Principles for effective banking supervision.

In addition, the G7 thinks that best practices in debt management should be promoted, so that countries avoid too much reliance on short-term borrowing, particularly in foreign currencies. I expect that these principles will be discussed by the IMF Board in the near future.

It is now clear that the IMF was unable to meet the challenges posed by this 21st century-style crisis in several Asian countries. The biggest mistake was that the IMF prescribed for the countries 'medication' that had been effective for the old-style current account crises.

I have on several occasions discussed in detail what was inappropriate in the IMF programs for Thailand, South Korea, and Indonesia. I shall therefore not repeat my arguments today. Should you be interested, some of my speeches and the Minister's speeches can be found on the Ministry of Finance homepage on the Internet.

Of course, I firmly believe that the IMF should be at the heart of the international financial system. This is not to say, however, that the IMF can stay as it is now. In this connection, the G7 Report says: 'building upon the experience of IMF-supported programs in the financial crisis, the IMF should explore ways to further improve IMF surveillance and programs so that they better reflect the changes in the world economy, in particular potentially abrupt large-scale cross-border capital movements'.

The decision-making procedures of the IMF must be improved, too, so that Board members are better briefed by IMF staff and more closely consulted, as appropriate. The Report notes this point as well.

Incidentally, there are two new proposals in the Report concerning the governing structure of the IMF. First, it is proposed that the Interim Committee be given permanent standing and renamed the International Financial and Monetary Committee. Second, it is suggested that an informal mechanism for dialogue among systemically important countries be established within the framework of the Bretton Woods institutional system. I expect that the G7 and other countries will jointly consider these proposals with a view to reaching an agreement in the near future.

The operation of the IMF will also be improved by increased transparency, especially through enhanced disclosure of its Board documents and better internal and external evaluation efforts. The G7 Report supports this point, too.

5. Conclusion

Indeed, what was accomplished in Köln was a first step, probably a modest first step. However, we need to recognise the importance of the fact that the G7 countries, including the United States, have agreed on the text of the Report. Needless to say, the G7 and non-G7 countries have to continue to work hard among themselves and at the IMF and World Bank Boards, so that our proposals can be implemented as quickly and as fully as possible.

Let me conclude by saying a few words about Japan’s contribution to this important endeavour. I do not mean to sound self-congratulatory or boastful, but I think that Japan has led the discussions on the Architecture for the past two years or so. Many of Japan’s proposals and arguments have been supported, criticised, and mulled over, and now eventually have found their way into the G7 Report. Of course, it is a team effort with other G7 and non-G7 countries, and not a zero-sum game where only the first advocate is rewarded. Nevertheless, I simply would like to emphasise that Japan will continue to strive to make these kind of intellectual contributions to resolve pressing issues in the world economy. I am sure you will see more of such contributions in the years to come.

Reference

Report of the G7 Finance Ministers to the Köln Economic Summit (1999), 'Strengthening the International Financial Architecture', Köln, 18–20 June. Available at <URL:http//www.mof.go.jp/english/if/if003.htm>.