

Problems and Challenges of International Capital Flows

Paul A Volcker

Many months have passed since Ian Macfarlane approached me about the idea of a conference on international monetary reform in Sydney. It was a good idea then – and I think it is now. But except for the locale, it is hardly unique.

I do not know how many conferences the Asian financial crisis has spawned. I do know it has been a time of full employment for economists with any pretension to competence in the area – and even for those who don't. I also know that, for the moment at least, the sense of crisis has died down.

It is also my sense that there is little or no connection between those two observations.

The conferences have provided, as nearly as I can detect, little by way of consensus on the really critical issues – the issues of truly systemic importance. Given that lack of intellectual conviction, and the limitations of time, little has been done to achieve concrete reforms.

The sense of receding financial crisis is more analogous to the passage of a forest fire than to successful fire precautions: the flames die down and the embers cool, but there remains a lot of devastation and the prospect of a long period of regrowth.

What will be critically important in the end is whether that regrowth will be healthy and sustained. It will at any rate, be quite a challenge, to return to anything like the growth paths that prevailed in most of Asia before the crisis. The specific arithmetic varies among countries. But it is obvious that countries that had been enjoying growth trends of six or seven or eight per cent a year are now producing far below their potential, even if some of them have now turned the corner from deep recession.

Maybe restoration of the earlier rate of growth is too tough, too unrealistic, a test. A strong argument can be made that the extraordinary growth rates in Thailand, in Indonesia, in Malaysia and elsewhere had to taper off to a more sustainable pattern. But whatever the precise number, the issue with which we are all grappling is whether the emerging nations of Asia, of Latin America, and of Eastern Europe can in fact restore a strong and sustainable growth path in the context of open international markets for money and capital.

That, it seems to me, is the basic issue before this conference. It is quite obviously a terribly important issue, an issue bearing upon all our thinking about the benefits of an open globalised economy.

The papers before this conference help put it in proper perspective. The current crisis is not the first, nor will it be the last, in international finance. But there are factors vastly complicating the situation.

We all know how modern technology – the information society and all – has broken down natural barriers to the free movement of money. It can flow faster and faster in larger amounts, with the number of participants rising exponentially. But it is not just technology that rules the economic world. Within a single decade following the fall of the USSR, the ideology of open markets for money has swept the emerging world, with all the bright promise of enhancing efficiency and growth.

Is that all more chimera than reality? Or, more appropriately, what do nations, individually and collectively, need to do to better assure that the vision will become reality? I'd like to think we could reach really solid conclusions in the next 36 hours. I realise the precedents are against that. But I am an ardent fisherman – an avocation in which hope springs eternal, and which occasionally is rewarded by success!

In fact, a fisherman often needs to be satisfied and rewarded by the experience rather than by the size of his catch, and the papers before us have already helped our thinking. Perhaps my own view of the source of the difficulties is a bit idiosyncratic. I can only plead the fact that I was directly engaged in these matters from both public and private perspectives for about 40 years, and that provides a certain perspective. And just possibly, the fact that I am, at this advanced state of life, somewhat removed from the operational fray, permits me to be more pointed.

Of one thing, I feel quite confident. The points about which the greatest degree of consensus has emerged – the reforms that have received the most emphasis in official circles – provide little basis for expecting future crises can be avoided or even greatly ameliorated.

These reforms take as their point of departure that the Asian crisis, and presumably the earlier Latin American crises, primarily grew out of deficiencies in the emerging countries – and most particularly institutional deficiencies. The emphasis has been placed on stronger national banking regulation, better auditing standards, American-style accounting practices, transparency in all things (including, I should note, central bank disclosures and decision-making). Now those happen to be things with which I have been concerned my entire professional life. I don't want to minimise their importance. Intelligent supervision and regulation, more accurate information, more widely available, and disciplined professional behaviour, free of corruption and cronyism should, in principle, improve the efficiency of markets. There will be broader participation, possibly enhanced savings, and improved allocation of capital – all of which is worthwhile and desirable.

What I question is whether it is at all an adequate response to the seemingly repetitive, and perhaps increasingly severe, pattern of international financial crises.

I remind you of the plain fact that US-style supervision and regulation did not prevent a massive savings and loan crisis in the United States, nor a substantial threat to some of our major commercial banks at the start of this decade. In well-developed and traditionally prudent Scandinavia, entire banking systems collapsed, saved only by direct government intervention. I well remember the collective failure of the large Texas banks (mostly supervised by the Federal Reserve) in the mid 1980s only a few years after they were considered among the very strongest of all American banks.

How many occasions can you cite, I might ask, when auditors of banks, applying GAAP standards, have given timely advance warning of the potential failure of a major financial institution? Perhaps there are such instances, but they haven't come to my attention.

The hard fact of the matter is banking supervision is at best a difficult and uncertain process. Inevitably, it lags the actual development of markets and institutions responding to the drive and impetus of imaginative risk-takers. The fact those risk-takers now operate with all the paraphernalia of the electronic age, reinforcing highly sophisticated financial engineering blessed by Nobel Prize winners, only makes it more difficult.

It is also a fact that tough financial supervision is politically popular only in the aftermath of crisis, when it is least needed to restrain animal spirits. When markets seem to be working well and large profits are being generated, as in South-East Asia not so long ago, all the practical and political pressures are the other way – typically supported by substantial academic opinion emphasising the merits of free markets and the arbitrariness of regulators and regulations.

Most significantly, the market is adept at finding ways around tough (and inevitably arbitrary!) regulations. If banking regulations are confining, then other ways will be found to do business. We need no more recent and dramatic example than that of the now notorious LTCM – an institution operating with great secrecy and without supervision right within the United States – the threatened collapse of which purportedly would have torn apart the world's largest and most fluid and efficient capital market.

A generation ago, the rapid growth, and officially tolerated lack of regulation, of American savings and loans was a market and political response to the 'tough and arbitrary' regulation of banks. Today it is competition from investment banks and hedge funds. In Thailand just a couple of years ago, it was more highly regulated finance companies that were the weakest link. And so it goes.

By all means, let's work on improving financial supervision and regulations. But let's recognise that it is unrealistic to assume that that is adequate to deal with the truly systemic problem before us.

Well, what about controls? Here is another area of emerging consensus.

The general agreement is all the more surprising in the light of common opinion a few years ago. It was at the Hong Kong annual meeting only two years ago that the IMF came close to promulgating a new Article elevating open money and capital markets to the same status as freedom of current account transactions from controls. Now, there seems to be a general willingness to accept at least limited restraints on short-term capital inflows as a self-protective measure, so long as those controls are applied in as non-discriminatory and as market-oriented a manner as feasible.

I happen to be among those thinking that approach is sensible. In fact, it can work in tandem with prudential measures, for instance by controlling foreign exposures of banks or by 'taxing' short-term capital inflows by means of special reserve requirements. But surely there are questions of the lasting effectiveness of that

approach. The empirical evidence is ambiguous. My sense is that approach, like improved banking supervision, falls into the category of ‘interior decoration’ rather than grand ‘architecture’.

Well, what are the important systemic issues, issues upon which little consensus has emerged? As I reviewed the papers prepared for this conference, I was happily surprised to find they concentrated very largely on precisely these issues, and in particular questions of exchange rates. The authors have quite properly been modest in arriving at firm conclusions. But if we are able to make progress in framing the issues in the next two days, that alone will be worth the price of admission.

There are several characteristics of these recent crises that, in my opinion, have received too little emphasis.

The first is that they hit disproportionately hard on emerging economies that have inherently small banking and financial systems. The aggregate size of banks in Argentina or Thailand or Indonesia falls in the range of a single regional bank in the United States. As a consequence, it doesn’t take more than rather marginal shifts of funds in the massive and fluid international financial markets to overwhelm the absorptive capacity of those banks and their countries. In fact, a handful of individual private institutions can have a large impact on small emerging markets.

As the funds flow in, the prospect of healthy expansion becoming a bubble is all too real. Sooner or later, something triggers an outflow, lenders run for the door, a financial crisis results, and too often the financial crisis turns into a first-class economic debacle.

The difficulty of maintaining a pegged exchange rate in the circumstances is widely recognised. But experience also strongly indicates floating exchange rates provide no effective protection. Volatility is both extreme and inconsistent with smooth and orderly economic adjustment. In fact, few if any, economically small and internationally exposed nations find freely floating exchange rates a feasible system.

For all the commentary about the role of overvalued exchange rates in triggering or aggravating crises, the evidence before this conference is striking. It suggests that, measured by usual approaches, the pre-crisis misalignments were typically not particularly large – in fact, I would judge well within the inherent range of uncertainty in their calculation. (Ironically, the calculated overvaluations are well within the range of fluctuations we have come to take for granted among large countries.) Moreover, the crisis, particularly in the Asian manifestation, hit at countries that had no very obvious macroeconomic disequilibrium; good performance in that respect didn’t provide much protection. Indeed, there is the irony that the perception of good performance will induce the capital inflow that, given the disproportions in size, threatens to disequilibrate the economy.

What does all this mean for the role of the IMF for its conditionality, and for other official support?

We certainly do not lack for a variety of experience. We have had massive, near pure ‘bailout’ packages – that is, only straightforward macroeconomic conditionality,

à la Mexico 1995, and the provision of enough resources to meet the potential demands of short-term lenders. We have had late and limited assistance *à la* Thailand in 1997, shortly followed in Indonesia by a nominally very large assistance program accompanied by heavily intrusive conditionality. Korea initially followed in the pattern of those programs in providing for no organised negotiations with private lenders. However, that approach was soon reversed, partly at the initiative of commercial banks themselves, and bank ‘standstills’ were negotiated in Korea and subsequently in Brazil, somewhat along the precedents in the 1980s Latin American crisis.

In sum, no consistent pattern has emerged. Surely, it can be argued that that is practical and appropriate: every situation has its unique characteristics that require particular remedies. But surely the results haven’t been so gratifying as to provide confidence in such *ad hoc* approaches. Moreover, can any international institution, no matter how intelligently run and how well intentioned, successfully devise in emergency circumstances approaches sensitive to the economic, social and financial facts of every situation? And is there any willingness to concede that degree of authority and initiative to an international authority?

My instinct suggests we should be satisfied with broad ‘macro’ conditionality, and official liquidity support should be limited. Structural change may well be needed. But that typically takes time. Incentives to change logically fall more within the province of the World Bank and the regional institutions.

All of this raises a key structural question. To what extent should lenders be expected to face delays and potential losses in the event of financial crisis? The logic seems clear. Lenders bear some share of the responsibility of volatile capital flows. They are rewarded for the risks. They should be prepared to bear more fully and predictably in the pain. That has, in fact, been true fairly regularly for international bank lenders – a relatively small and cohesive group with continuing relationships at stake. It has been less true for other creditors which have proliferated in recent years. Those lenders are less cohesive and identifiable and certainly less responsive to entirely voluntary approaches.

Whatever the logic, there is not today an international equivalent of a bankruptcy court. Moreover, the point is made that imposing new risks on international lenders will tend to reduce the availability of capital to emerging countries just when they need it most. Of course, some cautionary impact on short-term lenders may be welcome, but a lack of consensus is not surprising. In any event, this strikes me as an area that shouldn’t be left in limbo. This and other conferences can make a contribution.

Finally, and most importantly, I hope we can make some progress on one item that is clearly on our agenda. I was a bit concerned that the preliminary program indicated there would be a ‘short paper’ on exchange rates. I am gratified that the issue dominates more than one paper!

To my mind, it is here that we get beyond interior decoration to true architecture, implying a coherent design and some lasting quality. The exchange rate system

surely lies at the heart of any international monetary arrangement. And it is a subject upon which, it seems to me, there has been little fresh thinking in the face of the rather obvious fact that the exchange rate system is gravely flawed – flawed as much or more among the major currencies as among the emerging nations.

The general attitude seems to be that every country should do what it finds most suitable to its particular circumstances – fix, float, or do something in between. But generalising that approach runs into a logical difficulty. An exchange rate by its nature is multi-sided. It can't logically be a matter of free choice for everyone.

One illustration of that point is the dilemma – an insoluble dilemma – for the emerging countries of Asia. Their trade is strongly diversified among Japan, the United States and Europe. What is a coherent exchange rate policy for Asia when the exchange rates among their major trading partners are themselves highly volatile? Individually, the three 'elephants', with large, diversified and relatively self-sufficient economies, may find it possible to live reasonably comfortably with their reciprocal exchange rates fluctuating violently. But what of their small and externally dependent partners whose established trading patterns are thrown askew by factors entirely outside their influence.

To some substantial extent, the radical appreciation of the dollar relative to the yen in the late 1990s surely impaired the perception of the competitiveness of countries tied loosely to the dollar, raising doubts about their currencies. But that is only an extreme example of a systemic problem. It is an important reason why a fixed exchange rate is not a desirable or practical approach for most Asian countries. They simply have no satisfactory currency to which to peg.

At the same time, freely floating exchange rates for small open economies are simply too volatile to be practical. So neither of the two so-called corner solutions set out as the logical textbook alternatives are really useful.

It's a highly unsatisfactory situation. Nonetheless, there is a great reluctance to deal with it. That reluctance seems to me to reflect, in large part, strong vested interests.

Part of that vested interest is intellectual. The academic community has a large commitment to the theorising that floating exchange rates are a means of providing almost automatic and relatively painless external adjustment. They are, in that line of reasoning, a means of reconciling domestic policy autonomy with open markets.

Financial institutions and professional speculators have long since learned that exchange rate volatility can offer large profit opportunities. Their sense is that 'insiders' like themselves, able to recognise and 'ride' – even promote – herd instincts, will on balance make money. The available statistics seem to bear that out. The losers, mainly non-financial businesses, are relatively silent in the face of other, seemingly more immediate, problems.

At the same time, the authorities of major countries are leery of accepting responsibility for maintaining stability. What seems to concern them is a high degree of uncertainty they can even be successful in that purpose.

For all of that resistance to change, it can't be satisfactory to leave the situation as it is.

The present degree of volatility can not fit any conception of an effective exchange rate system. It certainly bears no resemblance to the textbook description of gradual and smooth adjustment, nor to the theorising about identifying comparative advantage.

Most directly, in terms of this conference, exchange rate arrangements among the major countries gravely complicate the ability of emerging economies to deal with capital flow.

My suspicion is that, in time, independent currencies for many smaller countries that wish to participate fully in globalised capital markets will disappear, in substance if not in form. But that is also a proposal for two or three currency blocs, not necessarily an optimum organisation of the world financial system.

One thing is sure, the conference faces critically important – and still unresolved – issues. The way these issues are ultimately dealt with will bear directly on the prospects of much of the world for growth and stability – for, in fact, making good on the promise of the world of global finance.