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Between 1990 and 1996, capital inflows to emerging market countries rose from $60 billion to $194 billion. Mexico’s problems in 1995 changed the form of these capital transfers. Equity owners learned from their losses. After 1995, portfolio investment declined, but direct investment increased. Banks were bailed out, so they continued to lend. Bank loans rose with direct investment.

No one carefully monitored these flows. When problems developed in Asia last year, neither the International Monetary Fund (IMF) nor the private lenders knew the magnitude of some of these countries debts within a large range. Firms borrowed directly and through their subsidiaries. Often the total was not shown on any balance sheet. The provision of the IMF Articles of Agreement requiring surveillance, and the decision to strengthen surveillance following the 1995 Mexican problem, proved to be of little use.

Though important, the IMF’s failure to monitor seems small beside the elementary mistakes of private lenders. The lenders ignored three principles of prudent behavior that history has shown repeatedly to be a major reason for financial failure.

First, Asian banks and other Asian borrowers used short-term renewable credits from foreign banks to finance long-term loans. Of course all banks do this to some extent. But the extent matters a great deal. When the foreign loans were not renewed, the Asian banks and corporations faced large defaults.

Second, Asian banks and corporations borrowed in foreign currencies—yen, marks, and dollars—and loaned in local currency. They accepted the exchange risk without hedging. The reasoning is appalling—interest rates were lower abroad. None realized that the difference in interest rates, after allowing for difference in inflation, included the risk of currency depreciation. I suspect that this risk is now apparent.

Foreign lenders shared this myopia. They didn’t show concern about making short-term dollar or yen loans to borrowers that financed long-term domestic assets. U.S. and other bankers added
a third elementary error. Many, perhaps most, did not ask to see consolidated balance sheets; they did not monitor the total assets and liabilities of the borrowers.

The banks' behavior is evidence of the pervasive problem of moral hazard. The banks expected to be bailed out as they had been after Mexico in 1995 and Latin America in the 1980s. They acted imprudently, without regard for elementary banking principles.

What has been the result? Equity investors, debt holders, and owners of claims denominated in foreign currency have taken large losses. By early 1998, stock markets in Indonesia, Malaysia and Thailand had lost about 75% of their value on December 31, 1996.\(^1\) In the Philippines and South Korea the loss was 65%. Holders with claims in Indonesian rupiah lost 70% of their value. The Thai baht, South Korean won, and Malaysian ringgit fell 40 to 50%.

What of the U.S., Japanese and European banks? Their loans are in dollars, yen, and other hard currencies. They want repayment in full. The IMF and the principal governments lend money to the Asian governments so they can pay the interest on their bank loans or repay the principal. It helps the Asian banks to avoid default, but the money goes to the foreign bankers. Instead of taking losses like the holders of currency, stocks and bonds, the banks collect with relatively small losses. And in exchange for extending repayment, the banks collect fees for renegotiating the loans. They demand government guarantees of the loans they made to banks, financial institutions and private corporations.

This policy is the fourth mistake. I believe it is the greatest mistake of all, because it invites a larger financial crisis in the future. The Mexican bailout required $40 billion. This time the IMF and the developed country governments have promised $117 billion to South Korea ($57 billion), Indonesia ($43 billion) and Thailand ($17 billion).

Capitalism without failure is like religion without sin. It doesn’t work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior. Prudence is the missing element in the Mexican and Asian problems. In its absence, bankers and other lenders have taken excessive risks. They don’t concern themselves to learn about how many loans the borrowers have outstanding, how much the borrower has borrowed short to lend long, how much currency risk has been assumed. The lenders don’t care much, because they collect with little or no loss whatever happens.

\(^1\) Based on "Emerging Market Indicators," the Economist, January 17, 1998, p. 98.
The IMF's programs are one source of moral hazard. Moral hazard arises where there is a
difference between the social risk -- the risk borne by the troubled country -- and the private risk
borne by bankers. Moral hazard is one reason we have a crisis-generating system. A common
argument in its defense is that Mexico repaid its loans to the U.S. government and the IMF. That
argument misses the point. If banks and financial institutions had taken losses in Mexico, they
would have exercised elementary judgment and prudence about risks in Asia.

Some bankers and Treasury officials defend more money for the IMF by citing loans to
Mexico as a success for U.S. Treasury - IMF intervention. This is an extraordinary claim. It
looks only to the repayment of the loan, achieved mainly by borrowing abroad. It ignores the
effect on the Mexican economy.

Consider the record. The U.S. Treasury and the Federal Reserve have been "helping"
Mexico since the 1930s. The IMF has been at it since the 1970s. Successive Mexican
governments have learned that if they face a crisis, one or both of these friends will lend them
money to make the immediate crisis appear less onerous. Investors have learned that they get
bailed out, so they continue to invest. I believe that goes far toward explaining why Mexican
policy has been erratic and undisciplined at times. The Bank of Mexico and the government take
excessive risk and incur large losses for Mexican taxpayers.

The foreigners don't deserve all of the blame, by far, but they contribute. The results
have been disastrous for the Mexican economy and its people. Despite enormous growth in the
world economy in the past 20 years, Mexican real income in dollars was the same in 1996 as in
1974. (See Chart 1). The Mexican people have been on a bumpy road, but they have gone
nowhere. In the same period, Mexican debt in constant dollars increased from $40 to $160
billion. (See Chart 2). Much of this is the price Mexico paid for U.S. and IMF assistance.
Without the IMF and the U.S. Treasury, Mexico would learn to run better policies, would have
less debt and, I believe, would have made more progress.

Many people ask, at this point, why the large financial transfers to Mexico, Korea, Thailand and
Indonesia don't alleviate the burden on the country. The answer is straightforward. Very little of
the money goes to the country in crisis. The money goes principally to the banks -- the lenders --
to pay interest and principal on foreign loans. What the country gets is a debt to the IMF and the
U.S. and other governments.

Charts 1 & 2 here
Frequently, the argument is made that moral hazard is not a problem because no government chooses to subject its economy and its people to the losses experienced in Latin America in the 1980s, Mexico in 1995, or in Asia now. I believe this is true but irrelevant. The issue does not arise in that way.

A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. Mexico, Korea and others have faced precisely this choice. The government may choose to guarantee the loans by issuing dollar denominated securities, such as the Mexican tesobonos, or by promising to accept responsibility for private debts denominated in dollars, as in Korea. When the government offers the guarantee, it believes the default risk is manageable or bearable, just as the U.S. government believed that the risk in the savings and loan system was manageable. It is not necessary for the government to plan a debacle; the debacle is one possibility. The probability may be small at the time the crucial decision is taken. A finance minister faced with this choice will almost always prefer to avoid the crisis now, at the risk of a future larger crisis, than to accept the crisis now when many critics are ready to claim that the crisis is avoidable. And sometimes they can be right. The opportunity to take a (possibly small) risk of a later, larger, crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the chances of a finance minister having to make the choice I described.

IMF and U.S. Treasury lending to Asian countries continue this dangerous system. The risk of a bigger, future crisis increases. Too much of the world has become "too big and too indebted to fail." Neither the IMF, nor the development banks, nor the U.S. and Japanese governments can pay for all the errors, mistakes, and imprudent actions they help to create.

“Too big to fail” was a flawed idea when applied to U.S. savings and loans and to Swedish, Japanese, Latin American and other banks. It is no less flawed when applied to U.S., Japanese and European banks and financial institutions that have lent in Asia.

Secretary Rubin was right when he said in September: “What we don’t want to have is a situation where people can do unwise things and not pay a price.” But that is the system that Secretary Rubin and the IMF have created and sustained.

The cost of continuing this system is that we will face larger crises in the future. Currently, we have Russia teetering on the edge of crisis with China possibly to follow. After almost a decade of IMF intervention, Russia lacks most of the legal foundation that makes
capitalism the superior economic system that it is. The rule of law, a stable financial network, a transparent accounting system, and private property rights, and contracts enforced by law, are not just adjuncts of capitalism. They are the prerequisites for successful operation of a market economy. Capitalism will not flourish in Russia until these and other foundations are in place. In Russia, as in Korea, Thailand, Indonesia, and Malaysia, the large international banks lend mainly because they assure themselves, and each other, that the IMF, and major governments will bail them out using the money provided by the taxpayers in the developed countries.

Many arguments are used to justify these policies. Some are misleading. Some are based on misunderstanding. Some are simply wrong.

One common argument, repeated many times, is that South Korea is a large country, the world’s eleventh largest economy. It sounds impressive and, indeed, growth of the Korean economy since 1953 is a remarkable achievement. But the inference is that a financial collapse in South Korea would be a world-shaking event. In fact, Korea has a GDP about equal to the GDP of Los Angeles County. It may be the eleventh largest economy, but it is about 5% of the U.S. economy.

One of the most serious misunderstandings concerns the role of a lender of last resort. Historically the function of a lender of last resort is to prevent unnecessary financial failures during periods of panic. It functioned at its best in Great Britain after 1866, at its worst in the U.S. during the great depression.

The role of a lender of last resort is not to bail out failed banks. Its job is to assure that solvent financial institutions do not fail because of lack of liquidity. The Asian central banks have the power to stem a domestic, liquidity crisis. The remaining problem is the need for foreign exchange to repay foreign currency loans.

The IMF offers two services. It lends foreign currency on condition of reform, called conditional lending, and it acts as a consultant to troubled countries. Unlike most consultants, it pays the borrower to take its advice by offering favorable terms for its loans. With interest rates in Korea above 20%, the IMF lends at less than 5%.

Asian problems do not require large international loans from the IMF and the developed countries. These loans are more likely to delay than to promote reform. The IMF may threaten to withhold payments, but its history shows that the threat is empty. The IMF has a stake in “successful recovery.” Client governments understand that. They know that the IMF does not
want a failure. They call its bluff, delay reforms, but they get the loan payments. Despite many attempts and much research, the IMF has not been able to demonstrate that countries meet the conditions they promise to fulfill. Some do; some don’t, but some would have done more to reform without the loans.

Many critics of the IMF oppose the policies of fiscal stringency and control of inflation. I do not share these criticisms in all cases. In countries with inflationary policies, control of spending is essential.

That is not the problem in Asia. The present predicament was not caused by imprudent spending policies, excessive demand and high inflation. Much of the problem arose because one of the principal markets for Asian products, Japan, has grown slowly and because China increased its share of the Japanese market after devaluing in 1994.

I applaud the IMF for urging structural reforms to increase competition and reduce local cartels supported by government. These actions will help to sustain growth and improve efficiency, but there should be no mistake. Their effectiveness is long-term. Banking and other structural reforms work in periods of time measured in years, even decades. And I believe such reforms would come faster in this crisis without conditional loans.

The IMF errs when it urges Asian countries to reduce demand. What is needed is expanded demand, produced not by inflationary policies in each of the countries, but by increased demand from Japan.

The key to the Asian problem is to end mistaken Japanese policies and reform the Japanese economy. Japan’s problems are internal. It should restructure its financial system, open its banking system to competition, and end its deflation by increasing money growth. It has the power to do this without international loans. An expansive policy would benefit both Japan and Asia.

The solution to the Asian problem will not come by treating Thailand, Korea, and Indonesia as individual problems. The problem must be treated as a whole. Japan is the key.

The United States Treasury has been giving Japan bad advice for several years. Repeatedly, the message has been to reduce tax rates permanently and maintain the exchange rate for the yen in its recent range, about 125 to 135 yen per dollar. A permanent tax cut was supposed to do what previous fiscal efforts had failed to do -- generate sustained expansion of the Japanese economy.
No one should doubt that Japanese expansion is desirable. The Treasury is right about that. The Japanese government has watched the economy stagnate much too long. A policy change is long overdue.

The problem is that few would, and none should, believe that Japan can reduce tax rates permanently. Japan has run big budget deficits for the past five years and accumulated a large debt that must be serviced at considerably higher interest rates in the future. And Japan must soon start to finance large prospective deficits for old age pensions and health care. There is no way to finance these current and future liabilities that will not involve higher future tax rates. They may not understand that in the U.S. Treasury, but the ordinary Japanese citizen has been told the truth about this problem for years. That truth is embedded in the Fiscal Reform Act, requiring scheduled deficit reduction. Japanese citizens have every reason to believe that future tax rates will rise. Under these conditions, there is no prospect that people will believe that a tax cut is permanent.

The U.S. Treasury is wrong, also, when it tells the Japanese to maintain the value of the yen. It is true that the yen has depreciated from its peak, 80 yen to the dollar, in the past two years. It is just as true that the yen has appreciated against the dollar in most of the years since 1971. When the U.S. grew more slowly than Japan, or had more inflation, the dollar depreciated, and the yen rose.

The fluctuating rate system should work both ways. Strong economies appreciate; weak economies depreciate. A 20% or 25% appreciation of the yen against the dollar would bring the yen/dollar exchange rate back to the upper end of the band that it has been in since 1988. The yen would strengthen later in an expanding Japanese economy.

What is the alternative? If temporary tax cuts are saved, not spent, and permanent tax cuts are impossible, Japan’s choice is between devaluation and renewed deflation. The deflationary solution runs grave risks. Asset prices would continue to fall. Land prices are back to the level of the early 1980s. Investors anticipating further asset price declines would have every reason to hold cash and wait for better prices. The fragile banking system would face larger losses as asset prices fell.
Monetary expansion and devaluation is a much better solution. An announcement by the Bank of Japan and the government that the aim of policy is to prevent deflation and restore growth by providing enough money to raise asset prices would change beliefs and anticipations. Rising asset prices, including land and property prices, would revive markets for these assets once the public became convinced that the policy would be sustained.

The volume of "bad loans" at Japanese banks is not a fixed sum. Rising asset prices would change some loans from bad to good, thereby improving the position of the banking system. Faster money growth would add to the banks' ability to make new loans, encouraging business expansion.

This program can work only if the exchange rate is allowed to depreciate. Five years of lowering interest rates has shown that there is no way to maintain the exchange rate and generate monetary expansion. Recent legislation has freed the Bank of Japan formally. But formal freedom means nothing economically if the Ministry of Finance dictates exchange rate policy and continues to keep the exchange rate fixed.

Some will see devaluation as an attempt by Japan to expand through exporting. This is a half-truth. Devaluation will initially increase Japanese exports and reduce imports. As the economy recovers, incomes will rise. Rising incomes are the surest way of generating imports of raw materials and sub-assemblies from Japan's Asian neighbors, and computers, software, machinery and other exports from the United States and the European Union.

The U.S. Treasury and the Japanese Ministry of Finance have offered one fiscal nostrum after another. None has worked to restore growth and end deflation. The Bank of Japan has just gained its independence from the Ministry. It should use it in the interest of Japan and its hard-pressed neighbors. Let money growth increase until asset prices start to rise.

If Japan expands; Asian exports to Japan would expand demand in the troubled Asian countries. The principal beneficiaries will be those countries that restructure by breaking up government protected and subsidized industries. As these countries expand, others would benefit, and economic growth would be restored in Asia.

Since 1971, the IMF has been looking for new things to do. It has now solved its problem by creating moral hazard, allowing international banks to avoid the risks they undertake by imprudent lending. The IMF encourages the behavior that creates the problems. It engaged in subterfuge by refusing to call the Indonesian cessation of payments a moratorium. It adds to instability by urging price increases even when
there were riots in many parts of Indonesia. Only after the riots brought the government down did the IMF modify its demands. To prevent an even larger future financial crisis, we must end this system and create very different arrangements in its place.

If loans denominated in foreign currencies are withdrawn suddenly, solvent borrowers with excellent long-term prospects, are unable to repay their short-term loans on demand. Neither they nor their local banks may be able to obtain sufficient foreign exchange to prevent default.

One solution is to have a true lender of last resort. Unlike the IMF, a true lender of last resort does not subsidize borrowers. It charges a penalty rate -- a rate above the market rate -- and requires good collateral. It offers to lend at a penalty rate to anyone offering proper collateral.

These requirements are not arbitrary. They are essential. The penalty rate means that the lender of last resort will usually do no business. Borrowers will only come when they cannot get accommodation in the market place at market rates. Similarly, the requirement to offer good collateral induces banks and financial institutions to hold such assets. This reduces risk, and encourages safety and solvency. Unlike the IMF, a true lender of last resort does not create moral hazard.

Would such a system work? The system is field-tested. It is the system used in Great Britain after 1866, when London was the center of the world financial system. It worked well through good times and bad.

The second proposal eliminates the main source of the problem. If banks were truly international in scope, they would operate in many countries. Local lending in local currency would be part of their mixed global portfolio. Banks would diversify currency risk within a global portfolio, lowering overall lending risk.

This reform is not an idealized, textbook solution. London banks used this system in the nineteenth century. Citicorp, in particular, has tried to follow this strategy in recent years. Regulations to protect domestic banks in many countries from competition prevents Citicorp and other foreign banks from following this sensible strategy of relating risk to return within a diversified loan portfolio. The financial services agreement, accepted by members of the World Trade Organization last year, is an important move in this direction. In the proposed system, global banks would internalize the risk, or hedge the risk if they chose to do so.

Let me give an example. The U.S. financial system experienced many crises and failures. For most of its history, banks were local, often restricted by law to serving a local market. When the corn, wheat or cotton crop failed, the bank often failed because its loans were not diversified. Eventually, after many bad
experiences, the U.S. has moved toward a regional and perhaps countrywide, banking system. Loan portfolios are more diversified than in the past. In addition, brokers group loans from a diverse group of borrowers and offer securities based on the loan portfolio. This permits banks to hold a diversified portfolio of mortgage, automobile, credit card or other loans that were not previously available to them. Banks are safer because their loans are, at last, more diversified.

In the recent past, when semi-conductor prices fell or, earlier, when its chemical industry posted large losses, Korean banks experienced large losses, much as local banks in Iowa, Minnesota, Texas, or Oklahoma, suffered from a decline in agricultural prices in the 1920s and 1930s, or as Texas banks suffered from a decline in oil prices in the 1980s, or as Swedish, Swiss, Japanese and Australian banks suffered from a decline in local property prices.

The U.S. has now strengthened its financial system by letting banks branch regionally. European banks are beginning to merge transnationally and to operate branches in other countries. The next step is to strengthen the global system. IMF bailouts, and government-enforced restrictions on competition, impede this solution.

Financial crises in Latin America in the 1980s, Mexico in 1994-95, and now in Asia should alert governments to the need for fundamental reform. More money for the IMF delays reform of the international system, encourages moral hazard, and subsidizes risk. Fundamental reform begins with global banking and a true lender of last resort.

Let me close with a few words about the fallout from the Asian countries as it effects other countries, particularly China and the United States.

I chose China not only because of its size but because the Chinese devaluation in 1994 was one of the contributing factors to the Asian problem. When China devalued, the prices of Chinese shoes, textiles, and other exports became less expensive than similar exports from Thailand, Indonesia, Malaysia, Korea, the Philippines and other countries. Several of these countries had begun to have difficulties maintaining the growth of their exports to Japan. There were two reasons. First, Japan's economy was stagnant. Second, many of the now troubled Asia countries had sustained their competitive position in the Japanese market by pegging their currencies to the dollar. As the dollar fell against the yen, their prices in yen remained competitive.

In 1995, the dollar reached a low of 80 yen, then began to rise. The Asian countries, with about 1/3 of their exports to Japan, now faced two problems. As the dollar appreciated against the yen, prices for their exports to Japan became more expensive. The Chinese devaluation gave China an edge.
Many have noted that a new Chinese devaluation would make the adjustment of the now struggling Asian economies more difficult. A large devaluation by China, with slow growth in Japan, would start another round of price adjustment, increase the already severe pressure on fragile banking systems, and renew the crisis. So far, China and Hong Kong have resisted devaluation.

If prices and exchange rates are misaligned, as they appear to be, China's decision not to devalue requires China to slow inflation or even to deflate. The reason is that sooner or later, prices for exports in dollars or yen must adjust. If the adjustment does not come through devaluation it must come from disinflation or deflation of domestic prices. I do not know enough detail about China's economy to know how large the disinflation or deflation must be. But it seems highly likely that China's economy must slow to make the adjustment. This process appears to be underway. Industrial production and consumer prices declined in the first quarter of this year.

Continued failure by Japan to undertake a bold policy of monetary expansion leaves North America and Europe as the principal sources of demand for Asian exports. Demand from these areas must remain strong if a prolonged and devastating crisis is to be avoided.

The conventional view of the United States is that its economy is slowing. A few months ago, many Wall Street economists and professional forecasters claimed that the U.S. was headed for deflation. Prices would fall, they said, because of falling prices of Asian exports in dollars.

This was a mistake, in my opinion at the time. It has not happened. One mistake neglects that the U.S. inflation rate is made at home, not in Asia. A second mistake was to confuse spending and output, demand and supply if you like. Typically growth rates of real GDP and domestic demand move closely together. In present circumstances, the U.S. is acting as one of the main engines of the Asian economies so there will be a large gap --- equal to as much as 3% of GDP --- between growth of U.S. domestic output and foreign supply and the growth of domestic aggregate demand. The much remarked signs of slower growth, and reductions in the Federal Reserve's central forecast to the range 2 to 2-3/4% for 1998, should not be misinterpreted. Growth of U.S. domestic demand remains strong. There is little evidence of slowdown in domestic spending.

Similarly, reported rates of inflation are misleading. Reductions in oil prices or a decline in import prices resulting from Asian devaluations are one-time events that mask the underlying rate of inflation. These one-time changes have no bearing on the medium-to long-term prospects for inflation.

Inflation Chart here
The Federal Reserve's responsibility is to control the longer-term rate of inflation. Although they now give lip service to the longer-term, they have been slow to act. I therefore expect, not deflation, but moderately higher inflation.

Let me close by returning to a main theme, the role of the International Monetary Fund, quoting from a paper by Professor Charles Calomiris of Columbia University:

"In the United States, we learned during our Savings and Loan debacle that subsidies for risk taking could lead to large losses from unwise, high-risk investments. The losses to taxpayers from that experience (roughly 3 percent of 1990 GDP), however, were small compared to what has been happening in developing economies over the past 15 years---an era that has seen an unprecedented epidemic of high-cost bank insolvency. Studies by the World Bank and the IMF have documented some 90 episodes of severe banking crisis since 1982. In more than 20 of those cases, the bailout costs to developing country governments have exceeded 10 percent of GDP. In roughly half of those cases (including the estimated losses of some of the current Asian-crisis countries) losses have been in the range of 25 percent of their GDP (see Caprio and Klingabiel, 1996a, 1996b; and Lindgren, Garcia, and Saal 1996).

"These facts warrant emphasis. This string of enormous losses is unprecedented, and is occurring during a relatively stable period of positive global economic growth.

"What can explain the enormity of loss since 1982? Surely not "shocks" of unprecedented magnitude (like oil price hikes, wars, or global downturns in demand), since such influences have been absent during this period. The explanation for the new epidemic of worldwide banking instability is the roller coaster of risk produced by the choices of banks in developing economies---choices that are the byproduct of government subsidies for risk-taking.

Why are banks behaving so differently now from the way they behaved previously? The answer is simple. Prior to the 1980s, banking systems did not subsidize risk nearly as much as they do now. The wave of partial economic and financial liberalization that swept through the developing world in the 1980s and 1990s has been enormously beneficial in many ways, but it should not be confused with true economic liberalization. While many countries have opened themselves to world trade, have privatized many important sectors of their economies (including their financial sectors), and have moved away from direct governmental control of domestic credit, a key flaw in the new era of liberalization has been an expanded, and unhealthy, partnership between government and private business."
As long as the system of IMF financial bailouts remains, the world financial system, and the world economy, will remain at risk.