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International Capital Flows, the International Agencies, and Financial Stability

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The 1987 stock market crash moved around the world within a day, a reflection of the integration of the international capital markets that has erased most of the obstacles to capital flows erected during the Great Depression and World War II. Capital now flows freely among the major industrialized countries, and even though policymakers occasionally express their exasperation over the consequences, no one seriously believes that it is possible to stop it.[1] Many middle income countries are returning to the global capital markets as industrialized country investors search out emerging markets, and as the international bond markets welcome issues by countries that only a short while ago were regarded as hopelessly mired in debt. In brief, international capital markets are now as linked as they were in the heyday of the international gold standard a century ago.

Globalization of finance is one important aspect of the growing sophistication of the capital markets that has created concern about potential financial instability. The international context features prominently in several of the papers for this conference: Most extensively, the overview paper by Nakajima and Taguchi, who ascribe the asset price inflation of the late 1980s in part to the coordinated response to the stock market crash; the paper by Poole, who concludes that while increased capital mobility has reduced the independence of monetary policy, it has not changed the case for a monetary rule; and the paper by Frankel, which worries about the sustainability of the increased capital flows to developing countries and the possibility of a replay of 1982. The papers on bank regulation and safety nets by Benston and by Flannery pay little attention to the interna-

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**See* pages, pp. 28-33.

[1]However, Eichengreen and Wyplosz (1993) propose slowing international capital flows by imposing margin requirements on foreign exchange borrowings.

tional context beyond their discussion of the Basle capital adequacy standards for banks.[2]

The Basle capital standards embody two principles that are likely to become increasingly common as financial integration forces greater uniformity of regulations. First, the regulations are uniform across countries; and second, the responsibility for enforcing them rests firmly with national authorities. It is remarkable that the national authorities negotiating in the Basle group reached a strong and reasonably simple international agreement on an issue of great concern to a major domestic interest group—the banks. It is hard to believe that a similar agreement would have been achieved in the United States had the negotiations taken place in the domestic political arena. The Basle Committee along with other agencies is now attempting to expand the capital adequacy standards to cover market risk from traded securities held by banks. In time, they will probably turn to off-balance sheet items and derivative securities.

Because of the overlap between the activities of banks and securities firms in holding and trading marketable securities, there is a need to coordinate regulation of the banks and of securities firms. The Basle Committee along with the International Organization of Securities Commissions (IOSCO) is working on changing regulations to bring both types of firms under a common regulatory framework, and to harmonize their minimum capital standards.[3] However, these very complicated negotiations are not making much progress.

At the international capital markets become increasingly interdependent,[4] the pressure for uniformity in regulations is bound to grow. But as both the ongoing Uruguay Round and the negotiations over the regulation of banks and securities firms show, agreements may be very difficult to reach. No doubt it was easier to agree on the Basle bank capital adequacy standards because those negotiations involved only the central banks. But even without formal agreements, the mobility of international capital forces some convergence in regulations, including taxation. For instance, implementation by any one country of the Tobin short-term financial transactions tax proposal, which has the goal of reducing speculation, would fail unless all financial centers agreed.

The need to coordinate regulations is one consequence of international capital market integration. Well-chosen regulations will contribute to financial stability, and there is no doubt that the clear assignment of regulatory responsibility is an important advance. But growing cross-border capital flows, in particular, flows to developing

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[2] *See* Goldstein *et al.* (1992), Chapter IV. Goodhart also discusses the Basle standards in his paper for this conference.

[3] *See* Goldstein *et el.* (1993), Chapter IV, for details.

[4] It is common to attribute the growing integration of international capital markets to financial innovations (many of them associated with the spread of derivatives) and to technological improvements that have reduced the costs of communication. However, judging by economic criteria such as the correlation of short-term securities returns across international markets, the international capital markets were as closely integrated in the gold standard period as they are now. The telegraph was the key invention in linking capital markets.

countries, open up many other potential instabilities. It is to some of those issues that I will address myself today.

The international debt crisis of the 1980s is of course the most spectacular recent example of a deep financial crisis associated with international capital flows to developing countries. The revival of capital flows to many of the same countries, albeit not flowing in the same forms, reopens the questions I now take up. What were the causes of the debt crisis? What role did the international agencies, the IMF and the World Bank, play in creating and dealing with the crisis? What mistakes were made, and what can be done to prevent mistakes in future? Should we worry that another debt crisis is in the making?[5]

In the second part of this paper, I turn to the more general question of the potential role in support of domestic and international financial stability of the Bretton Woods twins in the international financial system. The question is particularly appropriate in the year before the fiftieth anniversary of the IMF and the World Bank, a year during which their purpose and functions will be subjected to renewed scrutiny.

I. The International Debt Crisis

The international debt crisis developed slowly in the 1970s after the first oil shock, matured with extraordinary speed during the second oil shock from 1980 to 1982, and was painfully resolved over the next decade.[6]

The source of the international debt crisis was the notion that the balance of payments surpluses of the oil-exporting countries should be recycled to the developing countries, to enable them to continue growing in the new high-price energy environment. Because the oil-surplus countries preferred to invest in industrialized countries, the recycling was undertaken through the intermediation of industrialized country banks, rather than by direct lending from the surplus countries to the borrowers.

Recycling created no special problems during the second half of the 1970s when the world economy was growing, inflation was high, and real interest rates were low. Table 1 presents debt data for the 1980s and early 1990s. Debt indicators in 1980 were high but not extraordinary by historical standards. The second oil-shock hit in 1979. In the next two years, the external debts of the large Latin American debtors to commercial banks doubled in nominal terms.[7] The debt-export ratio for Latin American debtors increased from 200 to 300 within three years, with the changes coming from both the numerator and the denominator. Of course, much of the debt flowed out immediately in the form of capital flight, but the official borrowers were left holding the debts.

[5]Jeffrey Frankel raises several of these issues in his paper for this conference.

[6]The African debt crisis has not yet been resolved. Heavy external indebtedness to the official sector places a significant burden on the African countries. However, grants far outweigh the servicing costs of the debt.

[7]Sachs (1989), Table 1.3, p. 9, shows the net liabilities of Argentina, Brazil, and Mexico to BIS banks rising from \$56.6 to \$104.5 billion from December 1979 to December 1981.

Table 1
Debt Indicators, 1980-92

(%)

	1980	1985	1987	1990	1992
Debt/Exports					
Debt-reporting countries	127.6	182.7	203.6	166.7	178.4
Latin America and Caribbean	195.5	312.9	366.4	254.2	248.4
Interest/GNP					
Debt reporting countries	2.2	2.6	2.2	1.8	1.6
Latin America and Caribbean	3.5	5.5	4.1	2.1	1.8

Source: *World Debt Tables*, Vol. 1, World Bank, 1992-93.

The debt crisis would be resolved over the next decade by the developing countries themselves, the creditor country governments, and the commercial banks. All three parties had contributed to creating the crisis. The debtors were for the most part pursuing highly expansionary fiscal policies, funded by external borrowing. Many of the debtors experienced a sharp worsening of the terms of trade, but the terms of trade cannot have been the whole story, for the country where the crisis was first recognized, Mexico, had *benefitted* from the oil price increase.[8] The creditor countries, notably the United States, tightened monetary policy at the end of the 1970s; the fiscal-monetary mix in the United States produced extremely high real interest rates by 1982. The increase in real interest rates from negative to high positive levels increased the debt-servicing burden virtually overnight. The worldwide recession that accompanied the (needed) tightening of monetary policy reduced developing country exports. The public sector contributed also because bank supervisors had failed to warn banks of the dangers of their growing exposure to the developing countries. The banks in turn contributed to the crisis by overlending, by not exercising caution in their loans, and by their herd behavior. The much-quoted statement by Walter Wriston that sovereign borrowers do not go bankrupt must have encouraged the banks to keep lending well beyond the point of prudence. It may just be though that Wriston was right—and that the outcome of the debt crisis a decade later shows that the authorities will not permit a sufficiently general mistake to do major damage to the banks.

Once it was clear that the debtors could not service their debts without continuing infusions of money, which the private sector would not willingly provide, the debt

[8]Warner (1992) argues that it was the oil price decline in 1982, rather than the debt, that caused Mexico's difficulties.

strategy began to take shape. From 1982 to 1985 the strategy was one of concerted lending, with the official sector and the banks combining to provide the financing needed to meet adjustment plans approved by the IMF. At this point, the IMF was playing an essential role in preventing the failure of major United States and other banks. At the end of 1982, the exposure of the nine largest U.S. banks to the debtor countries was nearly three times their capital: Any realistic writedown of these assets would have put several of the banks into bankruptcy. That did not happen.

What would have happened had the international agencies not been involved? In the face of a major threat to their largest banks, national banking authorities would have found a way of avoiding widespread formal bankruptcies. The burden of the resolution of the crisis would probably have been different. In the event, the crisis was solved by increasing lending to the debtors, to enable them to service the debt. The alternative would have been to recognize early that the debtors could not pay, to write down their debts and thereby remove the uncertainty that dogged the debtors through the 1980s, and for the creditor governments to lend to their banks to enable them to restructure and survive the crisis. Perhaps in the process the creditor governments would have forced the worst-affected banks go out of business.

Which would have been the better outcome? From the view-point of the industrialized countries, it would probably have been better in the long run had at least one major bank been required to pay the price of its bad loans. That example would have helped discourage the herd behavior of banks. The developing country debtors would have preferred an outcome that wrote down their debts sooner rather than later. It has to be recognized though that the debt strategy of the 1980s resulted in the worldwide structural adjustment strategy, which has brought many of the previous debtors into the modern world. I believe that this outcome was attained earlier than it would otherwise have been because of the continual pressure from the external debt negotiations.

It is clear that the debt reduction phase of the strategy was delayed too long. By 1986, most academics were convinced that the indebted countries would not start growing again without debt reduction. They argued for debt reduction *in the context of tough adjustment programs*. By that stage, phased debt reduction could have taken place without endangering the international banking system. Nonetheless, the Baker strategy prolonged the period without officially-sanctioned debt reduction by another three years.

Opponents of debt reduction argued at the time that it would not be in the interests of the debtors, for it would keep them out of the international capital markets for at least forty years, as long as they were kept out after the debt crisis of the 1930s. In the event, the large-scale flow of capital to former debtors has resumed within a few years of their debt-reduction operations, and in some cases, notably Brazil, even before the Brady deal has been done. The late great Italian Finance Minister and economist, Luigi Einaudi, is often quoted as saying "The capital markets have the memory of an elephant, the heart of a lamb, and the legs of a hare." More likely, they have the memory of a crocodile, which

is supposed to be 24 hours.

What lessons should we draw from the debt crisis? First, we should expect similar episodes in future. It was after the debt crisis that the real estate crisis hit U.S. banks, and similar difficulties around the world are detailed in the Nakajima-Taguchi paper. It is unlikely that capital adequacy standards will prevent similar crises in future—crises on a scale that will lead to large-scale official intervention. The banks knowingly lend in herds, because safety in the form of government protection lies that way.

Second, recent lending patterns are not reassuring about the ability of the private sector to monitor and draw the correct conclusions from the behavior of governments. Governments that are very far from stability are able to raise large sums in the international capital markets. To be sure, they pay a sizeable premium, but as the credit rationing literature teaches us, that raises the likelihood of default.

Third, the international agencies, both the IMF and the World Bank, played an important part in financing and encouraging good economic policies, structural adjustment, that were pursued by many debtors during the 1980s, and that many of them continue to pursue in the 1990s.

Fourth, the international agencies provided a convenient coordinating mechanism through which the creditors were able to collaborate on the debt strategy, and in which creditors and debtors could in effect negotiate with each other over the strategy.

Without the international agencies, the debt crisis would likely have been over sooner. But it is also likely that the output decline in the indebted countries would have been greater, since they would have had to adjust more drastically to the cutoff of funding.

The next question is whether we should be worried about the potential for another debt crisis. Table 2 presents data on recent flows to developing countries. These increased markedly since 1990, and appear to have increased further since 1992 (not shown in the table). In particular, there appear to be large amounts of foreign funds in short-term markets in Mexico and other Latin American countries.

The most noteworthy aspect of the recent capital flows is that they predominantly take the form of foreign direct and portfolio investment. These present far less difficulties for the host countries than floating interest rate loans from commercial banks, particularly in the cases of FDI and equity investment because the risks are better shared with the host country. If there is a fear of instability in the current flows, it arises from the short-term investments that would flee rapidly in the event of instability, for example, a rejection of NAFTA, and would thereby put severe strain on the exchange rate. It may also be that the current flows of equity into emerging markets are being made on a herd basis, and that many investors will later be disappointed. If foreign investors decide to withdraw in a hurry, the emerging stock markets could be badly hit. However, there seems to be little systemic risk from such an event. The conclusion is that we do not yet have to worry about a repetition of the debt crisis.

Table 2

Aggregate Net Long-Term Resource Flows to Developing Countries, 1985-92

($ billion)

	1985	1988	1990	1992
Aggregate net flows	73.4	76.1	98.0	134.3
Private loans	21.8	14.5	11.4	25.9
Commercial banks	8.5	9.4	-4.1	
Bonds	6.0	3.9	3.2	
Other	7.3	1.3	12.4	
Foreign direct investment	11.0	19.7	24.0	38.3
Portfolio equity investment	0.0	0.0	3.8	8.1 (27.2)

Source: *World Debt Tables*, Vol. 1, World Bank, 1992-93.

Note : Figure in parenthesis in last column, last row is aggregate portfolio investment, presumably including bonds and short-term instruments.

The international agencies can help delay future debt crises by improving information about international capital flows. The IMF prepares regular reports on the global capital markets. So does the World Bank, through its quarterly report on international capital flows to developing countries, and the *World Debt Tables*. These publications, as well as those of the BIS, should help international investors as well as governments make better-informed decisions.

Even beyond their reports on the capital markets, both agencies can help inform international investors about the prospects in individual economies. The agencies have extraordinary access to information about the developing countries, but that information is not generally made public. There are good reasons that much information is kept confidential: Confidentiality makes it easier for governments to discuss their situation freely with the agencies; it is easier for the staff to make strong judgments if they are not public; certain subjects—such as a possible need for devaluation, or a potential financial crisis—could become self-fulfilling prophecies if made public. Nonetheless, there is a vast amount of useful information, and especially data, that the agencies could make public very quickly, and that would help international investors. For instance, the Fund's *Recent Economic Developments* publication, which provides the economic data and background on each country for an Article IV consultation, could generally be made available within a few weeks of the Board discussion. The Fund would of course charge for the publications.[9]

[9]These issues are discussed at greater length in Fischer (1993). Some critics are concerned that by making

II. The IFIs and International Stability

Aside from their potential role in helping increase the efficiency of international capital movements by improving the flow of information, what can the Bank and the Fund do to incease the stability of the international financial system? We start by asking what they do now, and then turn to changes that could be made as they enter their second half-century—recognizing of course that both agencies have been evolving during their first half century.

The Bretton Woods twins were set up after World War II to help prevent a repetition of the breakdown of the international economy and to help restore a functioning international economy. Together with the GATT, they have contributed to the extraordinary success of the postwar international economy.

They have contributed in several ways. First, the World Bank through its project lending and later through its adjustment loans has helped increase the flow of resources to the developing countries. Equally important, the expertise that comes with the projects, and the generally good economic policies that come with the adjustment lending, make an important contribution to raising the implementation capacity of the borrowing country. Similarly, the IMF expertise, and the need for countries to be able to deal with the IMF, helps developing countries improve the standards of their own policymaking.

Second, conditionality has played an important role in helping developing countries carry out politically difficult but economically useful policies. This point needs to be made carefully: Policies undertaken only to obtain the Fund or the Bank financing are unlikely to be succcessful; but a government that needs external support and funding to undertake policies it owns[10] will benefit from conditional support from the international agencies.

Third, the international agencies have consistently pushed for sound macroeconomic policies and for market-oriented policies. The World Bank's emphasis on trade liberalization has been particularly important in this regard. The pressures from the Bank and the Fund to pursue market-oriented policies have helped create the drive to integration with the world economy that is increasingly evident in developing country policies—especially because these pressures have been accompanied by loans.

These contributions of the Bretton Woods twins have mostly affected the developing countries. In strengthening their economies, the international agencies have contributed in an important way to international economic and financial stability. The agencies will

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such information public, the international agencies would be trespassing on the territory of private sector consulting firms. Perhaps so, but the market for information is generally one with externalities; in this case, the externality arises because the agencies need to collect the information for their own purposes, and once they have done so, the marginal cost of making it available is very low.

[10]The first World Bank study on adjustment lending in 1989 identified a country's "ownership" of its program as a key determinant of the success of the program.

doubtless continue to do so in their second half-century.

What more could the agencies do? They are under pressure to change the emphasis of their lending, to support the private sector, to deal with gender issues in development, to condition loans on environmental policies, and so on. Important as these issues are, I will not deal with them in any detail here. There are some common elements though: These pressures often come from industrialized countries, sometimes from non-governmental organizations, and they are generally resented and resisted by both the developing countries and the agencies. Then as time goes by, it begins to be understood that the pressure groups have a point, and some of what they suggest becomes embodied in the conventional wisdom of development. Of course, it would be silly to accept every fashionable suggestion that comes along, but the record shows that more open-mindedness would not hurt.

I will conclude with two more points, one about the Bank, one about the Fund. The World Bank was originally expected to act more as a guarantor of private investments than as a direct lender. By acting as a guarantor, the Bank would encourage the flow of private investment directly, by reducing the risk of international investments, and also indirectly, by having to work more closely with the private sector. The Bank has occasionally revisited the possibility of acting as a guarantor of private investments, but has never been able to find an effective way of doing so. Its newest subsidiary, MIGA (the Multilateral Investment Guarantee Agency) has been set up to guarantee against political risk, and is beginning to get off the ground. But MIGA does not cover economic risks.

Potential private investors frequently ask the Bank to take a more active guarantee role. Whether they would still want the Bank to participate if it charged market prices for the guarantees could only be discovered if the Bank were to undertake this task. It is a possibility that bears reexamination as private sector flows to developing countries increase.

The IMF's articles of agreement require it to "promote international monetary cooperation ... [by providing] ... the machinery for consultation and collaboration on international monetary problems." The Fund is also required to "promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation" (Article I).

The Fund does provide the machinery for consultation and ccollaboration on international monetary problems. There is probably no forum in which more serious regular discussion of international financial issues takes place than in the Fund's Executive Board. Further the Fund Board has on occasion served as the locus in which decisions on international monetary issues are ratified. However, the decisions are made elsewhere, genarally by the G-7. This is no surprise, for the Fund Board is an unwieldy group in which to negotiate.[11]

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[11]It is probably also true that improvements in communications since 1945 have made for greater centraliza-

The real challenge for the IMF is whether it will ever be able to resume its role as the guardian of the international monetary system, promoting exchange stability and orderly exchange arrangements. It lost that task when the world moved to flexible exchange rates in 1973, and it has yet to find another central monetary task. To be sure, it takes part in G-7 discussions, and has been charged with the task of developing indicators of world economic conditions, but its G-7 role seems to be limited.

So long as exchange rates among the major currencies continue to float, the Fund is unlikely to regain its role as the guardian of the international system. And at least in the next decade, there seem to be little prospect of a return to fixed rates among Japan, the United States, and Europe. Of course, the Fund can help promote fixed rates between developing countries and trading partners, a trend that is likely to accelerate if the Argentine fixed exchange rate policy succeeds, and as the attraction of currency board solutions for high inflation countries increases.

In the meantime, the Fund will have to earn its way into being heard on international monetary issues through the quality of its analysis of economic issues, and in particular by suggesting improvements in the current system. It already contributes internally through Article IV consultations and Board papers on major issues, and in public through the *World Economic Outlook*, and these analyses are usually of high quality. If the Fund comes to be seen by both governments and the public as the premier applied macroeconomic policy analysis institution, it can gradually regain its role in the international system. That could happen in two ways: Either the Fund itself could become the central organization in the international system, or the G-7 will find it useful to give the Fund a more active and important role in its deliberations.

The Fund now performs many useful functions, and contributes to the efficient functioning of the international system. But it will not be able to reclaim its pre-1973 role until the G-7 allows it to do so. At present the G-7 sees no need for any institution to fulfill that function. If it ever does, the IMF will again be in a position to make a major contribution to inceasing the efficiency and stability of the international monetary and financial system.

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tion of authority in all international organizations, private and public. Head-quarters must have more control now than it did then, with the result that principals make more decisions and representatives fewer.

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The Sixth International Conference of Institute for Monetary and Economic Studies Bank of Japan Tokyo, October 28-29, 1993

A. Program of the Conference

THURSDAY, OCTOBER 28

Morning

Opening Statement

YASUSHI MIENO, *Governor, Bank of Japan*

Keynote Speeches

ALLAN H. MELTZER, *Carnegie Mellon University*
STANLEY FISCHER, *Massachusetts Institute of Technology*

SESSION I: **Recent Changes in the Financial System — Background and Consequences**

Chairman: SILAS KEEHN, *Federal Reserve Bank of Chicago*

PART 1: *Toward a More Stable Financial Framework: Long-Term Alternatives — An Overview of Recent Bank Disruptions Worldwide*

ZENTA NAKAJIMA, *Bank of Japan*

Discussants: EDWARD FRYDL, *Federal Reserve Bank of New York*
WILLIAM WITHERELL, *Organization for Economic Cooperation and Development*

PART 2: *Monetary Policy Implications of Recent Changes in the Financial Systems in the United States and Europe*

WILLIAM POOLE, *Brown University*

Discussants: GÖRAN LIND, *Sveriges Riksbank*
RICHARD F. SYRON, *Federal Reserve Bank of Boston*

Afternoon

SESSION I: **Continued**

Chairman: KEIMEI KAIZUKA, *University of Tokyo*

PART 3: Recent Changes in the Financial Systems of Asian and Pacific Countries

JEFFREY A. FRANKEL, *University of California at Berkeley*

Discussants: ROBERT T. PARRY, *Federal Reserve Bank of San Francisco*
GRAEME J. THOMPSON, *Reserve Bank of Australia*

PART 4: Changing Behavior of Private Banks and Corporations in Japan

NAOYUKI YOSHINO, *Keio Universitry*

Discussants: ULRICH BAUMGARTNER, *International Monetary Fund*
AKIYOSHI HORIUCHI, *University of Tokyo*

FRIDAY, OCTOBER 29

Morning

SESSION 2: ***Prudential Policy and Financial Stability***

Chairman: ARNOUT H.E.M. WELLINK, *De Nederlandsche Bank*

PART 1: Prudential Regulation for Banks

MARK J. FLANNERY, *University of Florida*

Discussants: MARVIN GOODFRIEND, *Federal Reserve Bank of Richmond*
FRANCO PASSACANTANDO, *Banca d'Italia*

PART 2: Safety Nets and Moral Hazard in Banking

GEORGE J. BENSTON, *Emory University*

Discussants: PFIERRE DUGUAY, *Bank of Canada*
KAZUHITO IKEO, *Kyoto University*

Afternoon

SESSION 3: ***Role of Central Banks in Maintaining Financial Stability***

Chairman: DAVID W. MULLINS, JR., *Board of Governors of the Federal Reserve System*

PART 1: Monetary Policy Rules and Financial Stability

BENNETT T. MCCALLUM, *Carnegie-Mellon University*

Discussants: HERVÉ, HANNOUN, *Banque de France*
MERVYN KING, *Bank of England*
THOMAS C. MELZER, *Federal Reserve Bank of St. Louis*

PART 2: Price Stability and Financial Fragility

CHARLES A.E. GOODHART, *London School of Economics*

Discussants: HORST BOCKELMANN, *Bank for International Settlements*
FRANCO BRUNI, *Bocconi University*
JERRY L. JORDAN, *Federal Reserve Bank of Cleveland*

Concluding Summary

EDWARD J. KANE, *Boston College*

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Deputy Governor, Reserve Bank of New Zealand

ROBERT T. PARRY
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WILLIAM POOLE
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Executive Director, Banque Nationale de Belgique

MUKHLIS RASYID
Director, Economics and Statistics Department, Bank Indonesia

KUNIHO SAWAMOTO
Director, Institute for Monetary and Economic Studies, Bank of Japan

ANITA SISON
Acting Associate Director, Department of Economic Statistics, Central Bank of the Philippines

RICHARD F. SYRON
President and Chief Executive Officer, Federal Reserve Bank of Boston

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