Introduction

The preface of a 1992 publication from the Forum on Debt and Development (Fondad), *Fragile Finance: Rethinking the International Monetary System*, included the following statement: "In the face of dangerous instability of global financial flows it is high time for policymakers to seriously rethink the role they should play in a market-based international monetary and financial system. National as well as international monetary authorities seem to be lagging behind rapid developments in capital markets and to have little control over dramatic swings in these markets". In 2000, this appeal seems to be as urgent as before. Over the past eight years, we have witnessed a number of serious financial crises affecting economies, businesses and, most importantly, the living conditions of millions of people around the world, particularly in the developing regions. As it turns out, the globalisation of financial markets during the 1990s not only increased opportunities for prosperity and growth in developing countries, but also the risks of misery and recession.

While policymakers in both national and international institutions have been discussing and implementing policies which they hoped would create stability and prevent financial crisis, success has been limited at best. Moreover, some of the applied policies – particularly the ones based on the belief that free flowing capital is good for all and thus deregulation should be pursued by all means – may even have contributed to the propensity for crisis. Indeed, crises cannot and should not always be prevented. But it is indisputable that the incidence of crises in the 1990s has been so dramatic, frequent and difficult to contain that crisis prevention has become a priority issue. Much thinking, discussion and action is needed to find and apply appropriate remedies. Terms like 'herd behaviour' and 'contagion' point to the fact that economics is still about human behaviour – it cannot exclude the psychology of 'irrational' action.

This book consists of four parts. The focus in the first part is on new strategies for dealing with the *inherent* instability of financial markets. According to Jan Kregel, professor of economics and a specialist in international finance currently working for UNCTAD, new strategies are greatly needed. In his view, they should be preceded by a thorough, alternative diagnosis of why these financial crises occurred in the 1990s. Kregel offers his own diagnosis which differs from the mainstream thinking. He stresses that the total amount of private capital flowing to a developing

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country usually has very little to do with the recipient country's real development needs. Capital flows tend to overshoot initially and then, when sentiment changes, undershoot. Kindleberger's classic study, *Manias, Panics and Crashes*, still applies.

The second contribution in this section is from Bill White, the chief economist of the Bank for International Settlements in Basel. He believes that the different manifestations of instability and crisis – volatility, misalignments and contagion – can be addressed adequately by the existing approaches and initiatives in the so-called Basel community. He would, however, also welcome more radical thoughts about how the financial system might be reformed because he recognises that financial globalisation – with many agents, complex financial instruments and high speeds of change – has brought not only benefits but also a heightened tendency for financial instability and crisis.

The analyses by Kregel and White are enriched by the comment of former deputy governor of Mexico's central bank, Ariel Buira, and a floor discussion including a number of prominent international experts. The issues tackled include the prevention of excessive surges of capital inflows, the lack of global economic governance and need for a global regulator, and the selection of the most appropriate exchange rate regime.

The second part of the book examines how financial markets work and the implications for more effective supervision. In a provocative paper, Martin Mayer, a long-standing specialist and author of books on the behaviour of bankers and other participants in the world of finance, tries to change the terms of the debate. One of his observations is that central banks are the source of moral hazard – commercial banks know that they run very little risk because in times of crisis, they will always be rescued. Another observation by Mayer is that banks are supposed to have information that others lack, but in reality they do not. And while it is believed that dynamic hedging reduces risk, it turns out to be a source of general instability.

Mayer's paper is commented upon by Age Bakker, a Dutch central banker and professor of economics, and Warren Mosler, a practitioner in international finance. Their analyses are followed by a floor discussion in which, among other things, arguments are suggested for improved regulation of capital outflows from *source* countries and limiting the capital inflows in *recipient* countries to amounts that are consistent with their absorptive capacity. Other issues discussed include changing the remuneration system for money traders – in order to reduce their incentive for short-term money trading – and increasing the managers' and shareholders' responsibilities for wild shifts in global capital flows by rewriting the corporate charters of financial institutions.

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The third part of the book deals with the national and regional responses to the instability of financial markets. Mohamed Ariff, director of the Malaysian Institute of Economic Research, assesses the East Asian response and draws a number of policy lessons. One is that Asian banks and corporations felt so protected by their governments that they engaged in reckless borrowing and lending. Hence, better national regulation and supervision is needed. Another lesson is that financial liberalisation and deregulation proceeded too quickly and were not properly sequenced. He argues that financial sector reform must first focus on *domestic* financial markets, and that *external* account transactions should be fully liberalised only as a last step. Since the Asian crisis was also in part caused by large swings in international, short-term capital flows, action is needed in source countries and at the international level as well, says Ariff. If not, international private creditors will continue to assume excessive risks, comfortable in the knowledge that they will be bailed out if the situation becomes critical.

Ricardo Ffrench-Davis, one of ECLAC's most experienced economists, looks at the role of domestic policies in stabilising capital flows in Latin America. He sketches the surges in capital flows to Latin America, reviews the main macroeconomic effects of these flows, compares the contrasting experiences of Mexico and Chile, and assesses the common features of the Latin American and Asian crises. The policy lessons he observes include: private market agents should not be fully free to determine the volume and composition of capital inflows; indiscriminate liberalisation of capital accounts can be highly detrimental to productive investment and to the welfare of the majority of people and firms; governments should focus on the management of booms, rather than the crises since the latter are, in many respects, the consequence of badly managed booms; and last but not least, since there has been a notorious lack of appropriate monitoring of international financial markets, it is high time to reconsider the international financial order.

In his comment Zdeněk Drábek, a counsellor at the WTO and former high-level Czech official, agrees with all of the policy lessons suggested by Ffrench-Davis with the exception of one: that countries should not indiscriminately open the capital account. In Drábek's view, once a country has liberalised its capital account, it cannot go back to capital inflow restrictions – because of the credibility issue.

György Szapáry, deputy president of Hungary's central bank, complements the discussion on the experience of emerging economies with financial markets by looking at the responses of the Czech Republic, Hungary and Poland to the recent Asian and Russian crises. He observes that the more rigid exchange rate regime in Hungary has performed better (e.g. by protecting competitiveness) than the more flexible exchange regimes in the Czech Republic and Poland, although he notes that the difference in performance cannot be attributed solely to the exchange systems.

The question of restricting the *in*flow of capital or, in the recent case of Malaysia, the *out*flow of capital, is debated in the ensuing floor discussion. Participants agree that capital controls can fulfil a positive role. Jack Boorman, director of policy development and review at the IMF, admits that the policy community has learned a lot over the last five years about what is sensible in capital controls. If a country decides to liberalise its financial markets, its domestic financial system must be able to withstand the confrontation with international markets, Boorman observes. Other issues addressed in the floor discussion include the lessons that Asia can learn from Hungary's recent experience with policymaking, the level of Asian growth rates that would be sustainable in the long run, and the proper balance between export-led growth and domestic expansion.

The fourth part of the book focuses on gaps in the international institutional framework. Stephany Griffith-Jones, a leading policy-oriented academic and currently deputy director of international finance at the Commonwealth Secretariat, gives an overview of where we currently stand. She first looks at improved transparency and information on developing countries as one way of dealing with currency crises, and she analyses the limits of this approach, as well as the need for improved transparency on international financial markets. She then examines the need to fill global regulatory gaps, and discusses the recently created Forum for Financial Stability. She subsequently deals with the appropriate provision of official liquidity in times of crisis, including a discussion of the recently created IMF Contingency Credit Line (CCL). Finally, she discusses how the private sector can be more involved, both in crisis prevention, via private contingency credit for example, as well as in crisis management, via amendment of bond clauses or via standstill arrangements for example.

Griffith-Jones' paper is commented upon by Jack Boorman of the IMF and John Williamson who, until recently, was the chief economist for South Asia at the World Bank. Boorman assesses the progress made in transparency and standards. He also dwells on the private sector's involvement in crisis prevention, which he considers the most important issue now under discussion, and the provision of contingency financing through the CCL. Williamson focuses his comment on the CCL. He sees an inherent conflict between the provision of additional liquidity through the CCL to head off crisis, on the one hand, and the resolution of crisis through a standstill, on the other.

In the ensuing floor discussion the rationale for the CCL is thoroughly debated by a number of experts including György Szapáry who sees a number of problems with the CCL. He suggests that it is perhaps not intended for the good countries that are exposed to contagion, but for the countries that might actually be the source of the crisis – which is a different issue. Other points of discussion are the need for a better connection between regulatory and macroeconomic issues, possible alternative ways to solve liquidity problems, and the role of information. Jan Kregel argues that more information would not have prevented the Asian crisis, a view which Jack Boorman disputes.

In the preface to this book György Surányi, president of Hungary's central bank, observes that financial globalisation, which has both benefits and costs, is inevitable. As he says, we live in a global world and have to understand it as much as possible in order to improve the functioning of financial markets. The following pages make an important contribution to understanding and, I hope, improving the management of these markets.

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