

Coping with Private Capital Markets

By Roman Terrill

The Asian financial crisis placed the IMF and the world of international finance under intense scrutiny. The crisis' devastating impact on development led a number of groups to offer widely divergent policy prescriptions for coping with the effects of capital movements in a globalized economy. The principal difference among the many proposed solutions is the problem each attempted to solve. You will recall from the earlier discussion of the causes of the Asian currency crisis that there were three competing views of its precise origin. That same general grouping pertains to the proposed solutions as well.

One category of proposals required Asian governments to adopt the structural and regulatory reforms that accommodate the concerns of the international financial markets. The assumption was that if the markets have the information they need to make "rational economic decisions," then the sudden and somewhat irrational exodus of capital that decimated the Asian economies will not occur. The problem these proposals attempted to solve was the alleged failure of Asian companies and governments to provide the accurate and reliable information required to make proper investment decisions. Furthermore, these proposals would reform the legal and regulatory structures to allow "the international financial market" to operate more freely in Asian economies, which would increase the "disciplinary effect" of the markets. The IMF favored this approach.

Another broad category of proposals would attempt to reduce the influence of the international financial markets on developing and emerging economies. These proposals ranged from establishing credible fixed exchange rates via a currency board to regulating and taxing foreign investment flows. Proponents of this category of proposals often recognized that, if such a proposal were adopted, the benefits of financial globalization would be somewhat reduced. They contended, however, that the perils would be reduced as well. The problem this category of proposals attempted to solve, therefore, was the potential for the international financial markets to destabilize economies, particularly those of developing countries. These proposals would arguably sacrifice the potential for the financial markets to fuel rapid economic development, in exchange for some relief from the markets' potential to destabilize the economy.

The final group of proposals argued that the system for regulating financial flows needed to be changed on the international level. The proposals ranged from eliminating the

IMF and allowing the financial markets to operate freely, to substantially strengthening the IMF's regulatory powers. The problem these proposals addressed was the perceived failure of the international regulatory regime to adequately monitor private financial flows across borders.

A. The IMF Approach: Satisfy the Demands of the International Financial Markets

In order to prevent future crises, the IMF advised member countries to liberalize their economies further so that the market can operate more effectively and efficiently. By implication, these proposed solutions did not blame poorly operating international financial markets for the Asian crisis. Rather, they viewed the crisis as resulting from the failure of governments to create an environment where the market can operate properly. Had the foreign portfolio investors and bankers known the true financial condition of Korean firms, so the argument goes, less investment capital would have flowed into the country, and consequently less capital would have exited Korea and the rest of the region when the "truth" became known.

The answer, therefore, was to supply the markets with the information investors need to make informed decisions, and to provide the markets with the mechanisms to carry out those decisions. Countries worldwide can contribute to this objective by adopting and implementing a package of reforms similar to the ones imposed on the Asian countries after the crisis emerged. The IMF referred to this package of reforms as its prescription for "good governance."

1. "Good Governance" as a Remedy for Future Financial Crises.

When a crisis decimates an economy and the IMF is called in to assist in managing the recovery, the IMF is able to condition its lending on the adoption and gradual implementation of certain reforms—experts call this technique "conditionality."

The package of reforms imposed on (or accepted by) the Korean government reflects the IMF's vision of structural reforms needed for "good governance." However, the IMF lacks the authority to require member countries to adopt these reforms absent the power supplied to it by conditionality. Nevertheless, the IMF advised, and will likely continue to advise countries to take these measures to prevent future occurrences like those seen in Asia.

The substance of the IMF's good governance advice includes:

- Increasing the transparency of financial transactions.
- Increasing the transparency of corporate structure and valuation.
- Implementing "Western-style" bank regulations.
- Liberalizing trade policies.

a. Increasing the transparency of financial transactions.

Part of the IMF's agreement with Korea was an "Information Provision" which required the government to publish data on foreign exchange reserves every two weeks. The purpose of this provision was to inform the international financial markets of the ability of the Korean Treasury to back its currency and service its debt. Armed with this information, it was argued, the financial markets would purchase Korean government bonds and lend to Korean banks at rates commensurate with the strength of the Treasury's foreign reserve position. As a result, the markets would not speculate as to the strength or weakness of the reserve position and hurriedly divest when a "reserve panic" emerges, as they did during the crisis. Moreover, because the markets will be keenly aware of the Treasury's reserve position, the government will be compelled to maintain an adequate level of foreign reserves. This last point is an illustration of what is frequently called "market discipline."

The combined effect of this enhanced transparency is a more stable currency. For Korea, this meant that the won-to-dollar ratio would change more gradually over time as the Treasury's foreign reserve position changes, and as other market forces dictate. For other countries not subject to the IMF's conditionality requirements (i.e., if they have not borrowed from the Fund), the IMF is likely to "advise" them to take similar proactive steps to enhance transparency.

b. Increasing the transparency of corporate structure and valuation.

The IMF agreement with Korea established a timetable whereby Korean firms would gradually be required to publicly disclose audited balance sheets and profit and loss statements that conform to "[generally accepted accounting practices](#)" and other prudential standards. In sum, the Korean banking and financial industries were to be radically and irreversibly restructured.

It is difficult to explain these required reforms as anything other than what they were: Western views of good governance. The IMF believed the regulatory structure of the Korean banking sector was inadequate. Based in large part on the Japanese model of

banking regulation, the model exhibited profound weaknesses in recent years. The close cooperation of government regulators with commercial bankers led to allegations of rampant collusion, corruption, and fraud (particularly in Japan). Policymakers believed that by adopting the Basle standards, Korean banks would maintain adequate reserves and would avoid "corrupting" entanglements perceived as rampant under the old regime. With banks lending money to customers based on their financial merit and not on their connections to favored constituencies, the risk of accumulating large percentages of under- or non-performing assets would be decreased. And the increased reserve requirements would leave Korean banks better prepared to absorb potential losses.

c. Liberalizing trade policies further.

The IMF required Korea to eliminate its trade-related subsidies and to liberalize its import licensing and certification requirements, aspects of the country's trade regime that irritated its trading partners in the West. The aim of this required reform was to further remove the government from directing financial flows to favored industries. The IMF's position was that the Korean government had inefficiently used both public and private investment capital by subsidizing "export industries." The Korean government, and in fact most Asian governments, favored "export-enhancing investments" by extending special tax and regulatory treatment, and even government money.

The IMF would prefer that the financial markets determine the potential value of export industries. The market, so it was claimed, is better positioned than the government to judge the merits of channeling capital toward export industries. Proponents of the trade liberalization measures argued that the subsidies distract the government with non-financial considerations, such as the possible social and political benefits of a large industrial base, and it squanders money as a result. By eliminating these export subsidies, the Korean government would save itself considerable sums of money and would not further "distort" the Korean economic landscape.

Some observers perceive this and other aspects of the IMF package of reforms as a direct, and needless, assault on the Asian economic model. Jeffrey Sachs, a well-known economics professor, criticized the Fund on these grounds. He claimed that the Asian economic model of government-influenced, export-driven expansion was still a viable one. He believed the IMF wrongly concluded that the Asian model was responsible for the crisis and that it needed to be abandoned. So, while the IMF dismantled a critical component of Korea's export-growth strategy, voices both in and outside of Asia questioned the wisdom

and necessity of such an approach. In particular, some questioned whether IMF reforms such as these were designed to "solve the currency crisis," or if they were designed by the United States and other industrial countries to extract much broader economic concessions at a time when countries were particularly weak.

2. Good Governance May Help Stabilize Capital Flows in Emerging Economies, but Structural Reforms May Take Some Time.

The combined effect of the IMF's "good governance" strategy for member countries, whether voluntarily adopted or imposed as a term of conditionality, may be to stabilize capital flows. Through "good governance," markets will be better informed and thus will invest more wisely. This should help prevent the type of sudden and massive exodus of foreign capital that crippled Mexico in 1994-95 and now threatens the Asian economies.

From the IMF's point of view, the Asian financial crisis taught us that countries should accept and address the concerns of the global financial markets. To prevent future crises, countries should adopt the policies and implement the reforms that the financial markets deem "correct." If the financial markets are satisfied with a country's economic and regulatory environment, they may invest their money in the economy for longer periods of time—provided other countries do not offer better returns for their investment.

Experience tells us that adopting the deep structural reforms required to improve governance is easier said than done. The political, economic and social consequences of such a massive restructuring effort are so great that only a deep crisis in a country or region may help implement changes relatively quickly. Knowing that not all countries will become models of financial and macroeconomic management, the IMF has taken steps to increase its capacity to react to another crisis, should one occur.

3. In the Meantime, the IMF has Taken Steps to Improve its Effectiveness.

Mindful that not all (perhaps not any) member countries will "cure themselves," the IMF has been preparing to play an increasingly important role in fostering sustainable economic development around the globe. The Fund has therefore proposed several initiatives to secure its role as a key player in a financial world dominated by the private capital markets.

a. Special Data Dissemination Standards (SDDS).

After the 1994-95 Mexican financial crisis, the IMF drafted the Special Data Dissemination Standards, a "transparency" device designed to encourage governments to voluntarily disclose statistical data via computer to the financial markets. The Standards articulate the method by which critical measures of economic and financial performance are to be calculated. Since the SDDS' inception, forty-two countries have subscribed. The IMF has since created the Dissemination Standards Bulletin Board, which discloses to the public, via the Internet, the information obtained through the SDDS system. Following the Asian financial crisis, the IMF began considering proposals to expand membership in the SDDS, and to improve the quality and quantity of the information it produces. It is hoped that financial flows will be more stable with a steady, reliable source of financial information upon which to base investment decisions.

b. The Fund hoped improved liquidity would help it meet future crises.

At the 1997 Annual Meeting of the IMF held in Hong Kong, the Fund's Executive Board requested and received approval for a 45% increase in IMF quotas. The purpose of the increase was to align the Fund's reserves proportionally to the growing global economy. The Executive Board also saw this as necessary to permit the IMF to react more quickly to future crises similar to the ones that shook the Asian economies. What is significant about the increase in quotas is that it represented the IMF's belief that the institution must continue to grow with the global economy. This served as an implied response to an increasingly vocal minority that believed the IMF was losing its relevance in a financial world dominated by private capital markets.

B. Proposals to Reduce the Influence of Private Capital Markets on Individual Countries

The IMF was mindful that the private capital markets will be the primary source of financing for future economic development around the world. It took the position that member countries should make the structural and policy adjustments necessary to ensure their participation in the global market. The IMF carved out for itself the role of facilitating the meaningful participation of developing countries in those markets. Additionally, the Fund viewed itself as the only institution capable of responding to financial crises that may result from the active involvement and influence of the financial markets.

Others suggested that the answer to future crises is not to make reforms designed to satisfy the concerns of the financial markets, but rather to reduce the influence of those markets on individual countries. One way to do this would be to have emerging economies

adopt more flexible exchange rates, perhaps using a "band" within which the currency's value could fluctuate. By moving away from fixed exchange rates, central banks would remove the "targets" for speculators' bets ("I'll make money if Thailand devalues the baht - and I'm betting the central bank doesn't have enough reserves to hold the published peg!"). This is a lesson that many have drawn from the crisis of the European Monetary System in the early 1990s. Some policymakers, however, are not convinced that emerging economies can safely move away from rates fixed to hard currencies like the U.S. dollar. This is because fixed rates have prevented volatile fluctuations in the values of their currencies, thereby facilitating international trade and investment.

Another set of proposals, described below, seek to limit the impact of fast-moving capital (sometimes called "hot money") on the economies of individual countries through other means. The proposals vary widely, but they do have at least one thing in common: the IMF and other powerful players in the financial world have mixed feelings regarding their implementation.

1. Some Believe Currency Boards Can Withstand Capital Flight and Speculative Assaults on a Country's Currency.

In each of the countries seriously affected by the Asian financial crisis, the government attempted in vain to defend its fixed or pegged exchange rate. The central banks of these countries intervened in the currency markets to prop up the value of the domestic currency against other currencies, primarily the U.S. dollar. The financial markets lost confidence in the ability of each central bank in question to continue exchanging the domestic currency for the dollar at the pegged rate. Eventually, most of these countries were forced to devalue their currencies and to allow the currency markets to set the exchange rate. Some observers believe that replacing central banks with currency boards might solve the forced-devaluation problem. The currency board would be an independent and very transparent institution with more than enough reserves on hand to meet the demands of the investors.

The critical difference between a central bank and a currency board is the range of permitted activities. In a traditional central bank system, the bank can increase the supply of the domestic currency by selling bonds and lending at discount rates to commercial banks. The bank might do this to finance a government deficit or, in the case of discount lending to banks, to finance desirable projects, such as export-oriented industries. When the domestic currency is pegged to a foreign currency, the central bank has to be careful not to allow the

increases in domestic currency to undermine the stability of the peg. To a certain extent, the failure of the Asian central banks to maintain this balance led to the devaluation of their currencies.

By contrast, a currency board in its purest form is not allowed to engage in such activities. It can increase the supply of the domestic currency only when its supply of the foreign reserve currency increases. At the very least, reserves must be matched on a one-to-one basis with domestic currency in circulation - a system that triggers market-driven interest rate movements designed to ensure adjustments to movements of capital. This means that, unlike the Asian (and Mexican) central banks that ran out of reserves because of investors' decisions to pull capital out of the country, currency boards would always have sufficient reserves to meet the demands of investors. Speculators would therefore be less tempted to bet against the fixed rate.

Currency boards have a long and controversial history, reaching back to colonial rule. Some countries have undoubtedly benefited from their use - Hong Kong and Argentina are frequently cited examples. Still, there remains a significant debate in the academic and financial communities about the wisdom of their use in Asian countries and elsewhere. Experts have noted that currency boards are only as credible as the policymakers who run the banking and financial systems. Even if currency boards can be implemented credibly, the rules they operate under can cause devastatingly high interest rates.

This debate became unusually prominent when the President of Indonesia suddenly and unexpectedly announced tentative plans to adopt a currency board in his financially beleaguered country. The response from the international financial community was swift and almost wholly negative. In a remarkable display of collective power, the U.S. government, the IMF, and central banks from around the globe hurriedly convinced President Suharto to abandon this idea.

2. Taxing Spot-Currency Transactions (the Tobin Tax) May Inhibit Speculative Activity.

Rather than strengthening a country's peg, other proposals would limit the ability of foreign investors to easily liquidate their investments, which helps fuel the rapid depreciation in the value of the domestic currency. These proposals fall under the general category of "capital controls."

One such proposal is the Tobin tax (named for the economist who first proposed

the idea). Imposed on spot-currency transactions (immediate deals, usually with a two day settlement), the tax is designed to punish those who quickly enter and then exit an economy. A tax on spot-currency transactions may prompt investors to reduce their short-term holdings of a currency and increase their longer-term holdings. If an investor has a long-term interest in the sustained value of the currency, he is less likely to benefit from its near-term depreciation. Furthermore, taxing spot-market transactions will discourage speculators from waging an attack on fixed exchange rates because the cost of rapidly entering and exiting the domestic currency market will be increased. As a result, speculative activity is both discouraged by favoring long-term investments, and by increasing the cost of the attack. Investment capital that does come into the country will generally be for longer-term growth and will be less likely to leave suddenly and create the type of crises seen in Mexico and Asia.

Taxing these transactions, however, raises problems traditionally associated with taxes. First, they are often difficult to enforce. For instance, if Brazil were to tax spot-purchases of its real, investors might easily avoid the tax by purchasing the real in a non-taxing country, neighboring Argentina for example. Second, savvy investors have usually found ways to evade transactional taxes. In the financial world, for example, investors are able to take synthetic positions in a currency through the derivatives markets without actually purchasing the currency. Third, these taxes often have unintended consequences. Transaction taxes like these often result in reduced liquidity in the domestic currency market and unwanted decreases in overall capital inflows.

3. Chilean Capital Controls are Intended to Reduce Short-Term Capital Inflows.

Even though the overwhelming trend is toward capital account liberalization, some countries have maintained capital controls. Chile, one such example, emerged from the 1980s as one of the strongest economies in Latin America. This strength attracted a great deal of foreign investment. As we have discussed in previous sections, the steady inflow of foreign capital tended to have a destabilizing effect on the Chilean peso. Initially, capital inflows caused inflationary pressure, which invoked an increase in interest rates, which in turn caused the peso to appreciate. This instability created difficulties for the Central Bank of Chile, which was trying to manage its pegged exchange rate. Chilean policymakers decided that the inflows and outflows of foreign capital were creating too much volatility for the Central Bank to manage by adjusting interest rates.

To combat the destabilizing effect of financial flows, and especially those flows which seemed to enter and exit with minor changes in interest rates, the Chilean government introduced a fairly complex system of capital controls in 1991. The new rules said that if a Chilean firm borrowed in a foreign currency, that firm was required to keep a corresponding deposit at the central bank of Chile. The amount of the deposit that would eventually be paid to the government in the form of a tax would gradually decline as the length of the investment period grew. If the deposit stayed for less than a month, then the tax rate was 95%. If the deposit stayed for one year, the tax was 30%; for five years it was 0%. This system effectively made the foreign lenders (investors) pay dearly for short-term investing in Chile. The result was a steep initial decline in the amount of short-term capital flows in and out of Chile.

4. Relational Investment May Encourage Long-Term, Cooperative Behavior Between Host Countries and Foreign Investors.

Professors Enrique Carrasco and Randall Thomas have proposed that developing countries should actively encourage longer-term relational investment, as opposed to the more volatile, and frequently short-term, portfolio investment. Portfolio investors' principal interest in investing in developing countries is to acquire financial assets that produce high returns relative to other investments. Portfolio investment now constitutes a significant share of total cross-border capital flows, making it an important factor in development financing.

The problems identified with these investments stem largely from the motivation for making them. Portfolio investors are motivated by the profits the investments generate. When those profits are insufficient relative to other investments, or are jeopardized by macroeconomic factors, portfolio investors have a powerful incentive to liquidate their holdings and take their investment capital elsewhere. If a crisis of investor confidence develops, as it did in Mexico and Asia, portfolio investors can seriously destabilize an economy by liquidating their holdings en masse, a process known as capital flight.

Relational investors, on the other hand, tend to take a longer view than do the average portfolio investors. A relational investor (more specifically the manager of a large fund compiled from the savings of smaller, similarly situated investors) purchases a large but non-controlling interest in a company, and then "monitors" the performance of the company over the long term. The relational investor's motivation is to ensure the long-term performance of the investment. The investor (or fund manager) will often monitor the performance of the company's management to ensure that sustained profit remains the

number one objective. Relational investors are less concerned about temporary uncertainties of exchange rates so long as they know the fluctuations will fade away. If this type of investment can be encouraged on a large-scale in the developing world, it is hoped that the perils of periodic portfolio investment flight can be reduced.

The hard part, of course, is to encourage the relational investor without unduly discouraging other forms of foreign investment. To achieve this, Professors Carrasco and Thomas suggest that developing countries enact restrictions on short-term capital inflows (see Chile), and that guidelines be drafted to encourage relational investing. Persuading the IMF to participate in such an endeavor may be quite difficult, however.

5. Prudential Limitations on Financial Transactions May Inhibit Speculative Activity.

Another method of restricting capital inflows, often related to the taxation proposals, is to prohibit, or sharply limit, certain types of financial transactions. In Malaysia, for example, the monetary authorities became concerned with the large volume of short-term bank deposits being purchased by foreigners. Such activity is often a sign, although not always an accurate one, of speculative activity. To restrict this activity, the Malaysian authorities prohibited domestic residents from selling short-term certificates of deposit (CDs) to foreigners. The result of this regulation was that maturing CDs could not be rolled-over and, therefore, short-term capital inflows declined.

As you may recall, however, from the earlier discussion of the Asian currency crisis, this measure, adopted in January of 1994, was wholly inadequate in terms of preventing a financial crisis. The Malaysian government, in fact, abandoned this regulation in August of 1994 out of concern that it was reducing overall foreign investment in the economy. In 1997, of course, the Malaysian economy was one of the first to be hit hard by the Asian currency crisis. This illustrates one of the critical problems with these types of proposals. While they are often effective in initially reducing short-term capital inflows, that reduction is often achieved at a price deemed unsustainable by the regulatory authorities. Thus, they may not present a "permanent" solution to the problems associated with potentially destabilizing capital inflows.

In the wake of the devaluation that devastated Malaysia, President Mahathir Mohammed called for even broader restrictions on the speculative activity he viewed as the chief cause of the crisis. In public speeches that coincided with the crisis, Mahathir denounced currency speculation (and particularly, prominent currency speculator George

Soros) as unnecessary, unproductive, and immoral. Initially, he called for an outright regional or global ban on currency speculation. After this idea was dismissed as unrealistic, President Mahathir amended his position and instead called for currencies to be linked to the economic indices of the countries concerned. It is his view that tying the value of currencies to objective economic criteria would eliminate the sometimes "irrational" behavior of the markets, and would prevent "politically" motivated assaults on currency values. President Mahathir has accused George Soros of organizing a sell-off of Asian currencies because these same countries admitted Burma to the Association of Southeast Asian Nations (ASEAN). Soros has, in fact, been a vocal critic of the Burmese government and has repeatedly called for Burma to be excluded from ASEAN, but he denies Mahathir's charges of politically motivated trading. Ultimately, the IMF and the World Trade Organization requested that Mahathir and the Malaysian government draft a formal proposal.

6. The IMF Wants to Amend its Charter to Give it Control Over Domestic Laws Governing Capital Controls.

The IMF has given considerable treatment to the issue of capital controls. Chile's perceived success in reducing short-term capital inflows and their attendant volatility and the crises in Mexico and Asia, have persuaded developing countries to consider adopting similar measures. The IMF's stated view is that while such capital controls might be desirable in the short term, their utility often diminishes rapidly as investors develop ways to evade them. The long-term goal, the Fund maintains, should be the continued liberalization of capital control regimes. To help ensure that it can steer the countries of the world in this direction, the IMF proposed that Article VI of the IMF Charter be amended to allow the institution to regulate the capital controls of member countries.

Currently, Article VI of the IMF Charter grants to member countries the power to impose controls on international capital flows so long as there is no meaningful effect on current account transactions (relating to trade). While recognizing that many countries see capital controls as necessary in the short term, the IMF views the free movement of capital across borders as the foundation for the continued growth of the global economy. If the Charter is amended to give the Fund jurisdiction over member countries' capital control regimes, it will likely permit the continued use of some forms of capital controls. However, it is equally likely that the IMF will encourage such countries to phase out capital controls it deems of questionable economic value. Given this prospect, the wisdom of implementing a new capital control regime in any country is questionable.

C. Proposals to Reform the International Monetary System

The first two groups of proposals for avoiding future financial crises have generally focused on policies which countries could implement given the existing international regulatory regime. This last group of proposals focuses more on reforming the international monetary system as a whole. They either call for the creation of new institutions, new powers for existing institutions, or for the elimination of institutions altogether.

1. Indonesia's Crisis Illustrates Why Some Think the IMF Should be Abolished.

An increasing number of well-known voices in the international community, former United States Secretary of State George Schultz for example, called for the abolition of the IMF. In an era when private capital flows to developing regions dwarfed the size of IMF credits to those same countries, some suggested that the IMF was losing its relevance in the international financial and monetary systems. In addition, critics increasingly suggested that the IMF's prescriptions were too frequently counterproductive. These critics had four principal complaints: (1) that the IMF directs money to countries that are not capable of putting it to efficient use; (2) that the promise of IMF-sponsored bailouts creates a moral hazard by encouraging unsound macroeconomic practices in recipient countries; (3) that the overly cooperative political nature of the institution often leads it to support repressive or incompetent regimes that might otherwise fail; and (4) that the IMF, despite its impressive resources, frequently makes bad decisions that are counterproductive, and that needlessly interfere with the operation of financial markets.

The IMF, not surprisingly, disputed each of these criticisms. As to the first contention, it had at times gone out of its way to justify the role it played in the international financial system. The Fund claimed that, while private capital flows are undoubtedly the engine of world economic development, it remains the only multilateral institution that can encourage countries to implement the reforms necessary to attract and maintain those very flows of private capital. Moreover, it alone is capable of responding to the economic shocks caused by the inherently volatile nature of private capital, especially portfolio investment. The IMF was so convinced of its unique power that it rejected Japan's proposal that a separate Asian Monetary Fund be established, wherein Asian countries themselves would respond to financial crises in the region. The IMF and the United States, reacting to this obvious threat to their global authority, organized other Asian countries against such a proposal. Ultimately, the Fund supported a more modest ASEAN proposal for an Asian standby fund designed to back up IMF programs should they prove inadequate.

As to moral hazards, the IMF was quick to point out that its alleged "bailouts" were by no means painless, either for the member government or for the investors who stood to lose even more money but for the IMF's assistance. For instance, the Fund claimed that its agreement with the Korean government imposed financially austere conditions in exchange for the extension of credits, and that equity investors, despite the assistance package, lost considerable sums of money. Moreover, the IMF claimed that there was little evidence that the financial markets altered their investment decisions because of the belief that they would be bailed out in the event of a countrywide financial crisis.

The third and fourth criticisms tended to rely more on individual examples of allegedly misguided decisions on the part of the IMF. Opponents of certain governmental regimes frequently criticized both the IMF and the World Bank for "propping up" dictatorial or otherwise repressive regimes in El Salvador, Panama, China, and, recently, Indonesia. The critics questioned the merits of assisting in the development of economies headed by undemocratic and often violently repressive governments. Similarly, opponents of the IMF pointed to individual circumstances when the institution's advice to member countries seemed terribly misguided.

Consider the following example of the IMF's involvement in the Indonesian crisis, described in another section of the E-Book. The IMF's response to the crisis was widely criticized by observers who claimed that the Fund's stabilization plan exacerbated the run on the Indonesian currency. A confidential report, authored by the IMF, seemed to lend support to this criticism. The report, distributed to member countries and formally titled "The Indonesian Standby Agreement: Review Under the Emergency Financing Procedures," described how the IMF's forced closure of several Indonesian banks backfired by further eroding confidence in the banking sector, rather than boosting it. In the report, IMF officials admitted that they misjudged how the Indonesian people would react to the closure of banks deemed insolvent by the Fund. IMF economists were of the opinion that the closure of 16 particularly weak banks would inspire confidence in the banks that remained open. In fact, the closings caused further panic. The report concluded that "these closures, however, far from improving public confidence in the banking system, had instead set off renewed capital flight to safety." Indonesians withdrew some \$2 billion following the initial closures. This required the central bank of Indonesia to prop up these banks, which further complicated measures to prop up the value of the ringgit. Some critics pointed to a similar episode in Mexico in 1995 as evidence that the IMF frequently prescribes the wrong economic medicine for countries experiencing financial difficulty.

The IMF, in the same report, attempted to deflect such criticism by blaming President Suharto for failing to faithfully adopt the structural reforms prescribed by the IMF. It claimed that this failure, and not its decision to close insolvent banks, caused the continued deterioration of Indonesia's economy. Nevertheless, the revelation of the IMF's admitted mistake fueled criticism that its stabilization plans were misguided, and aided those critics who called for the abolition of the Fund.

Overall, these criticisms of the IMF all have some degree of validity. It is also probably true that the world economy could "get by" if the Fund were slowly dismantled. However, the reality is that the IMF retains the qualified support of its member countries. Indeed, in the United States, where the bulk of both IMF funding and IMF criticism is located, the United States Congress has tentatively approved continued financial support for the institution. An appropriations bill, H.R. 4569, was passed by the House of Representatives on September 17, 1998. The bill proposed funding the IMF with a \$18 billion budget and also contained certain requirements that it reform itself to address some of the concerns mentioned above. Assuming continued support from the U.S. (it has the largest quota subscription and therefore the greatest voting power) the future existence of the IMF seems secure.

2. George Soros Proposed Creating a New International Loan Guarantee Body.

George Soros, an international financier and frequent target of criticism for the activity of his speculative hedge funds, called for the creation of an international institution to guarantee international loans. Mr. Soros argued that the Asian banking crisis threatened to engulf not only international banking but also international trade. He proposed that an international Credit Insurance Corporation be established as a sister institution to the International Monetary Fund. Its purpose would be to guarantee international loans for a modest fee. In exchange for the guarantee, borrowing countries would be forced to publish extensive financial data. The new institution could then use the information to put a ceiling on the amount of credit it would guarantee, leaving creditors to risk their own money above that limit.

Mr. Soros' call generated much attention from the financial and academic world. Some said that the proposal is overkill. They claimed that, on the whole, international banks are perfectly capable of assessing risk without the aid of a new institution. Others responded that the Korean crisis, and the United States' own Savings & Loan crisis, demonstrated that bankers have been phenomenally bad at risk assessment. Mr. Soros

admitted that his proposal would only succeed if the international banks thought they would benefit from such an institution. He believed that a global monetary crisis caused by the potential collapse of the Japanese banking system might serve as impetus for such a proposal.

3. The Market Should be Allowed to Function, Resulting in Bankruptcies.

Despite the decidedly cold-hearted appearance of the argument, some observers of the Asian currency crisis called for an approach that simply let the crisis run its course, without the intervention of the IMF or any other governmental actor. By allowing companies and banks hit by the crisis to go bankrupt, so the argument went, economic assets could be transferred from incompetent owners to more competent ones.

A company that goes bust can be put into the country's existing bankruptcy system (assuming it has one) and can then be sold to the highest bidder, usually someone convinced that they can successfully operate the company. Creditors who lent the incompetent former owners money would recover only their share of the proceeds generated from the sale, as determined by the bankruptcy proceeding. In the end, the owners who mismanaged the company are thrown out, the bankers and other investors who miscalculated the creditworthiness of the company lose a lot of money, and the company may be reorganized and restructured so that it operates efficiently.

This argument assumed that the reason the company failed was because of its internal mismanagement. In fact, at least in Asia, companies that were the darlings of global mutual fund investors just prior to the crisis suddenly saw their stock values plummet for reasons only distantly related to the management of the companies. Moreover, as the Asian currency crisis abated, those mutual fund investors reinvested in the very countries they so quickly abandoned earlier. Obviously there was more at play than mismanagement or incompetence. Still, the proposal had an element of fairness to it that may not be immediately apparent.

All investments involve risk. Generally speaking, the more risk involved in the investment the more expensive it is for the borrower to obtain funding, and consequently the more a creditor or investor can charge for the use of the funds. Risk assessment is therefore one of the fundamental components of any investment decision. Occasionally, despite the best attempts at risk assessment, an investment that seemed wise goes bad, and the investor and borrower lose money. Take, for example, the Texas oil economy of the mid-1980s.

Some of the largest banks in the world made loans to oil interests and related borrowers in Texas on the assumption that the price of the oil they owned would remain at around \$30 a barrel. For reasons beyond any Texan's control, the world price of oil fell to about \$10 a barrel. Consequently, borrowers defaulted, and the banks lost tremendous sums of money as a result of the liquidation of these assets in bankruptcy sales. The Texas economy has since been radically transformed, and it is now less financially reliant on oil. In other words, Texas survived its oil crisis, and some say it is better off for it.

The question, then, is whether the IMF or any institution should even attempt to prevent massive loan defaults and bankruptcies resulting from currency crises. Two answers come to mind. First, if the many bankrupt companies are wholly liquidated, some developing countries face the prospect of potentially destabilizing levels of poverty unless there is some form of intervention. Second, if the IMF fails to intervene, financial crises may spread to other countries or regions—the so-called "contagion" or "ripple effect."

Following the Mexican financial crisis of 1995, the IMF was often asked to comment on when and where the next Mexico would occur. In its various musings on the subject, the IMF never voiced any concern about Korea, or much of Southeast Asia - neither, of course, did the governments of the world, nor the financial markets for that matter. Predicting future financial crises is tough work. Preventing them may be even tougher.

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