

What We Can Learn from the Asian Mess

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The world financial crisis that erupted a year and a half ago is over. Even Indonesia and Russia are doing better, and they are the weakest economies involved. Some lessons from this setback can help mitigate the severity of those that will surely come in the future. Unfortunately, much of the established economic medicine recommended is likely to make the patients sicker.

The Russian default, the collapse of many exchange rates, and the rapid withdrawal of capital from some economies led to a panic in the world of ideas as well as in international capital markets. Financiers, economists, and journalists asserted that many economies were in a Great Depression reminiscent of the 1930s that might not end until the next century. Paul Krugman, of the Massachusetts Institute of Technology, published *The Return of Depression Economics*, while prominent financier George Soros penned *The Crisis of Global Capitalism*, which warned about serious defects in the system.

Global capitalism, which is based on profit, may not be able to avoid periodic financial crises. Yet the rapid disappearance of the Brazilian crisis and the recovery of Asia demonstrate that it also has powerful strengths. The hunt for profitable opportunities limits the duration of crises by inducing foreign capital to return to economies with improved prospects for investments.

The crisis stimulated numerous, often contradictory, proposals for "reforms" in financial architecture. Many want to strengthen the International Monetary Fund by making it a lender of last resort or a global central bank. Others wanted to abolish the IMF entirely. Some advocated greater flexibility in exchange-rate systems, while others made the case for greater rigidity. There were suggestions for insurance for foreign investments, an international bankruptcy court, put options in bank credit, controls over movement of capital (especially short-term flows), and greater supervision of financial institutions.

WORST HIT. An international bankruptcy court and greater information about the portfolios of banks would be helpful, but the cases for most other proposals are weak. The most dangerous are the calls for "temporary" quotas and taxes on the international flow of capital. This recommendation ignores that decades were required to remove the so-called "temporary" control over capital imposed during the 1930s and '40s. Chile, years ago, introduced taxes on short-term capital inflows. But it began phasing out this tax just as it was being proposed as a model for others.

Exchange-rate systems have been the weakest link in the international capital market. The present episode and the 1995 Mexican devaluation clearly demonstrate that financial crises are more likely when exchange rates are pegged to one of the major currencies. The worst-hit countries during the recent crises, including Indonesia and Russia, pegged

their rates to the dollar without providing financial commitments to maintain these rates in the event of large capital outflows.

Flexible exchange usually provides the best protection against rapid withdrawals of capital. However, politics often work against flexible rates because they allow weak-willed and corrupt governments to easily expand government spending. The corruption in Russia and Indonesia demonstrate that many governments are too willing to spend precious resources to bail out cronies and weak state enterprises.

WITHOUT CLOUT. By contrast, rigidly fixed rates--either via currency boards, as in Argentina and Hong Kong, or through adoption of one of the international currencies (so-called ``dollarization")--do prevent countries from financing expenditures simply by printing money. These systems require nations to have foreign reserves as backing for their currencies. Dollarization is being discussed by Mexico and Argentina to impose more stringent controls over state spending.

Emerging economies should privatize government banks and open up the financial sector to foreign commercial and investment banks. This would give stiff competition to domestic banks and enable startups without political clout to gain access to the world capital market.

The strong recovery in many countries from their recent financial difficulties shows that global capitalism is alive and kicking. But the experience illustrates that pegged exchange rates have been a very weak part of the international financial architecture. Free-floating or rigidly fixed exchange rates should be adopted, but the choice depends more on domestic politics than on international economics.