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WHAT FUTURE FOR INTERNATIONAL FINANCIAL INSTITUTIONS [1]

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The crisis is over; Brazil's President Cardoso has said so. After 2 years of collapses, from Asia to Russia and Brazil, all is well. Countries are in the recovery room, all bandaged up with IMF programs; markets respond with ebullience, scholars and policy makers try and draw the lessons on how to prevent or at least mitigate the crisis, the post-crisis treatment and the role of international financial institutions in that context.

Crisis times are times when bad ideas flourish and bureaucracies see a chance to widen their powers even if they have a large party of the responsibility for what happened. Strangely, of the two parties, bureaucracies and the market, the bureaucrats always manage to get to look better. The reason surely is san inherent populism, an intrinsic and visceral opposition to market forces left free. Two bad ideas stand out. First the notion that capital controls have ha a bad name in the past but now it is time to take a fresh look—if markets are irrational, lock them up! It is typical of bureaucratic failure to look for solutions in the neighborhood, or in the past, rather than to seek sweeping change. The other bad idea is, of course, to increase substantially the resources of the IMF, upgrade its arms depot, so that it can have more meaningful shootouts with the speculators. Armed to the teeth, the IMF will become the mother of all crises.

An entirely different strategy is to look for broad change by going to the very source of crises: the presence of central banks, the unwillingness to run clean financial systems and the unfortunate habit, promoted by the coincidence of political time tables encountering and credibility problems, to shorten and dollarize debts to the point where any dump in the road becomes a mega crisis. There are ready answers to these problems by looking for market solutions, far away from official agencies and the infusion of more bureaucrats with more money. But before turning to that issue, a word about international economic institutions more generally.

Coming out of World War II, with plight everywhere and the Great Depression presumption that markets o not exist or cannot function, that governments must and ought to be central to international cooperation, we created a hosted of organizations from the World Bank, to UN Regional Agencies and Regional Development Banks. Perhaps there were good reasons to have these agencies at the time. But surely it cannot be argued today that the UN Economic Commission for Europe serves *any* purpose other than to create jobs for bureaucrats and bring out late annual reports with data that anyone can pull off the internet a year earlier. Or is anyone able to argue that the Asian Development

[1] Remarks presented at the Brookings Trade Forum, April 15-16 1999.

Bank has a claim to doing something useful. I am not arguing that they do nothing or that what they do is always counterproductive; I am just asking whether there is a good reason to keep these agencies as part of the international architecture. And that goes for the Inter-American Development Bank, Unctad and more. Lets just close them rather than hanging on because you never know whether the old pair of shoes one day comes in handy. It won't because the people hanging out there have lost touch with the market economy a long time ago and, like most bureaucrats, are hostile to it in the first place. Are there exceptions: the World Bank could in principle provide an important function in focussing on world poverty, but that has unfortunately not been the dominant commitment. World Bank money goes to bailing out Mexico and Korea (i.e. Japanese loans to Korea). And then there is the BIS. Yes, it functions, has a focus and does not lose sight, it stays small and it is mindful of moving keeping in touch with its narrow mandate. Let's keep it.

Finally, the hardest question is the IMF. Do we need it, should we keep it? As a crisis detector, the IMF has been perfectly useless—asleep at the wheel in every instance. In many cases the board is to blame, helping partner countries to cover up. In many instances the bureaucracy got plain snowed by the client countries and did not have the imagination to look for bad outcomes. And in some instances the IMF took very bad bets on policy mars, as in Russia and Brazil, and plain lost. Clearly, a total shake up is essential: the board must learn that cover up is not a good idea, the staff must have a structure where raiding alarm is seen as positive, the managing director needs to be tough, like DeLarosiere in his time, and not someone who enjoys crises as the occasion to broaden the mandate.[2] There must be some measure of performance based advancement; people who sleep on the job can't be promoted. The IMF has to get with it, it needs revamping to focus on financial structures and crisis potential and away from bean counting and haggling about inflation targets being 6 or 7 percent.

A new focus for addressing the crisis issue revolves around three propositions each of which uses the market, privatization so speak, to reduce crisis potential. None is perfect and none applies to every single country, none and not even the package is panacea for prosperity and stability. But they will in many cases make for far more stable economies and if increasingly applied also transform emerging market finance into less of an adventure for countries and lenders alike. The steps to be taken are:

- Currency boards (or outright transition to the dollar or the Euro) to abolish central bank discretion, the great source of crises.

- Outsourcing of bank supervision by requiring financial institutions in emerging markets to have offshore lenders of last resort. This will promote a less gung-ho and vulnerable financial structure.

- Changing loan contracts, as proposed by the BIS, to have emergency clauses that stretch maturities and thus avoid meltdown currency crisis situations.

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[2] I have explored this issue further in my website http:/web.mit.edu/rudi/www

Here are some comments on each of these themes.

The currency board issue is by now well established. Argentina has shown that a currency board solution does away with inflation, with exchange rate (though not credit) fears. It lengthens the horizon, is supportive of a shift from speculation to investment with a long view. Of course, there are arguments why a currency board is an extreme solution. Extreme compared to what, surely not recurrent mega crises. Tropical experiments have had their time on the stage; they should now give way to hard money as the single best development strategy.[3]

National monies are, of course, an expression of nationalism and liberation on one hand and of a potential scope for macroeconomic policy to enhance economic performance on the other. In a more limited and often abused fashion, they are a source of fiscal revenue. None of these reasons are plausible today. Open capital accounts have done away with independent interest rate setting, too much money printing has done away with money illusion, endemic inflation and devaluation policies (or catastrophes) have undermined economic horizons and the chances of sustained growth. The private sector has dollarized spontaneously to get away from the expropriation policies of their governments. In this sense, it is time to get back to an agenda of governance and that includes as the top priority, solid money. Most emerging market economies cannot convince their residents or the capital market that their national institutions are capable of delivering good money on a sustained basis.

Having a central bank has become a liability. The notion that a central bank could cut interest rates below that set by the ECB is just inconceivable. Rates are ECB+ national credit risk premium + national monetary experiments premium and the latter is huge. The world capital market, and domestic investors, charge high premia for the option to practice devaluation and inflation. That is counterproductive and hence a good central bank is a central bank that has been closed. *Unconditional, unilateral disarmament of the central bank is the first best option.* Hence *outsourcing* money services by a currency board or full dollarization is the right strategy. The experience in Europe with the Euro in many ways suggests the benefits Latin America can derive from such a strategy.

Of course, there are arguments against hard money. Two prominent ones are these: What happens if the monetary policy set by the center is bad? It is a joke to raise the issue in the case of say Poland or Brazil. And here is the other concern, how about the government revenue from money creation? With currency board, discretionary money creation and the accompanying inflation are gone. True, but cutting record interest rates on the public debt and the savings on this account surely far more than outweigh the benefits of printing money.

And there is another, critical question. Can a country afford to part with the exchange rate? Does that not mean an unreasonable burden placed on domestic wage price

[3] This discussion draws on my paper "Lessons for Latin America from the Euro." It is available at http:/web.mit.edu/rusdi/www.

adjustment. The counter argument is this: countries do *not* in fact allow the exchange rate to work; they user quasi-fixed rates for disinflation only to wind up with overvalued currencies and a collapse. It is also the case that flexibility of exchange rates, at the discretion of the authorities means risk premia in the capital market. At the very least, the exchange rate discussion should consider the trade-off between flexibility and capital costs.

Consider next the banking issue. Stan Fischer of the IMF has said that a currency board arrangement turns a balance of payments crisis into a banking crisis. True, capital flight will mean reserve losses, a shrinking of the monetary base, high interest rates and capital market trouble. And if the banks are bad, high interest rates will cause casualties. But is that any different from what would happen in any other exchange rate arrangement? If the central bank just pegs the rate it can for a while afford to lose reserves but after that either the exchange rate goes or the bank or most likely both. A shift to a currency board may well provide the focus for dealing with this key issue.

Under a currency board, the central bank no longer can provide the lender of last resort function. What are the alternatives? The Treasury is the natural place to provide lender of last resort services. Failing that, offshore lenders can fill the gap. In fact, it would be thoroughly healthy system to require in exchange for a banking license a full external lender of last resort commitment. In that event the external stand-by lender would do the due diligence and would do the monitoring that national authorities in emerging markets have so much trouble doing. Argentina has gone some steps in that direction, doing far more of this is a good idea.

The notion that the lender of last resort functions should be domestic is strange because most of the time the situation is one where capital flight puts both domestic money and domestic credit in question. Lenders of last resort will charge for their service and they will charge risk premia for bad balance sheets. The charges will be the incentive to the owners of banks to improve their capital structure and asset management. It is a market-based system that fully carries the promise of much better banks. What governments are unwilling to do in principle and unable to accomplish in detail can be done by the market at the shortest notice.

Consider finally the issue of loan contracts. In the emerging market crises, from Mexico to Brazil, short-term debt far in excess of reserves was always the issue. Governments shortened the maturities to get to the next election or the private sector borrowed on the easiest terms, meaning short term. But the large short term liabilities in foreign exchange, and of course uncovered, would become the dr9iving force for a massive depreciation of the currency once the snowball got rolling. Attempts to cover created a shortage of foreign exchange and refusal to roll over meant even more of a demand to try and repay. It is obvious that long term contracts would have avoided much of the problem. Markets would not have thinned out, stabilizing speculation could have played a role. The obvious way to get there, on a free market basis, is for governments to require rollover provisions in external borrowing. The mechanism should be automatic so that if the state of contingency is determined and declared, by say the BIS, all debt maturities are automatically extended and the run is thus called off.

Evidently, banks will not make such loans unless they are compensated for the risks. They will charge more, the more precarious public policy. But it is also clear that their demands will be dampened by the fact that collapse as in the past 3 years is no longer the case. If nobody can get out, the currency won't blow up and massive bankruptcy will become unlikely. That rates should on balance be higher is even in doubt. Public policy intervention to create good equilibria—state contingent contracts that conditionally lengthen maturities—does away with distress. It reverts crises to the old slow motion kind rather than the present rapid action model. The fact that the scheme is market based implies, of course, those incentives will be at play. Better countries will command better credit terms because lenders risk being locked up just as they wish most fervently to escape. Hence everything points just in the right direction for governments to have an interest in running better policies and having sounder institutions. Combined with currency boards and offshore lenders of last resort, this provision would turn emerging market finance into sound long run investment. Sound and dull, exactly what is needed. The market-based solution surely does away with the need for a more powerful IMF rapid action force.

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