

Nunnenkamp, Peter

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Liberalization and regulation of international capital flows: where the opposites meet

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Kiel Institute of World Economics
Duesternbrooker Weg 120
24105 Kiel (Germany)

Kiel Working Paper No. 1029
Liberalization and Regulation of
International Capital Flows:
Where the Opposites Meet

by
Peter Nunnenkamp

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Liberalization and Regulation of International Capital Flows: Where the Opposites Meet

Abstract

The paper discusses the pros and cons of capital account liberalization. Rather than contrasting liberalization and regulation of capital flows as irreconcilable antagonisms, we argue that capital account liberalization requires institutional and regulatory safeguards. Even though the effectiveness of specific capital controls cannot be taken for granted, we reject the view that financial globalization has deprived national policymakers of the means to protect their economies against crisis. In addition to national safeguards, we assess the chances for crisis prevention and resolution on the regional level and present options to overcome institutional deficits on the global level. We conclude that reforms of the international financial architecture can help prevent illiquidity and ensure a fair burden sharing in the case of insolvency, without aggravating moral hazard behavior of the parties involved.

Keywords: Capital account liberalization, financial crises, financial regulation, international financial architecture.

JEL classification: F30, G18

Peter Nunnenkamp

Kiel Institute of World Economics

24100 Kiel, Germany

Telephone: 0431-8814209

Fax: 0431-8814500

E-mail: nunnenkamp@ifw.uni-kiel.de

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I. ECONOMIC POLICY CONFLICTS

The trade-off between financial liberalization and financial sector stability is well-known from the debate on *domestic* financial reforms (Williamson and Mahar 1998). Theoretical considerations and empirical findings suggest that liberalized national financial systems promote economic growth in the longer run.¹ However, financial liberalization goes hand in hand with a higher exposure to financial crises (Demirgüç-Kunt and Detragiache 1998).

Various financial crises in emerging markets during the last decade point to a similar trade-off when it comes to capital account liberalization. Domestic financial liberalization and the removal of capital controls have in common that local financial institutions gain more room for risky transactions. This may not be a major problem if financial markets are functioning perfectly and a welfare-maximizing allocation of resources is ensured by intermediaries. This cannot be taken for granted, however, as asymmetric information prevails in financial markets. As a consequence, "financial markets will ... be affected to some degree by adverse selection, moral hazard, principal-agent problems, and herding behavior" (Eichengreen, Mussa et al. 1998: 2).

¹ For an overview, see Levine (1997).

Information asymmetries are particularly pronounced in cross-border financial flows (Griffith-Jones 2000). Geographical distance and cultural diversity render it more difficult to collect and correctly assess relevant information. Moreover, contracts are harder to enforce in international capital markets because of the sovereign risk involved. Hence, the benefits of capital account liberalization have to be balanced carefully against its risks. This is easier said than done: Economists have offered policymakers little on which to base their decisions. The economics profession is still struggling with major questions:

- Have countries without capital controls grown faster than countries that maintained controls (section II)?
- Were financial crises caused by capital account liberalization (section III)?
- How effective is national regulation in containing the risk of financial globalization (section IV)?
- Does regional cooperation provide a promising means to tie closer safety nets (section V)?
- In which way should the international financial architecture be reformed (section VI)?

The subsequent discussion of these questions reveals the lack of ready-made solutions. Yet, some conclusions may be offered (section VII). First, the chances for a successful capital account liberalization depend on the *overall* economic policy environment. Second, liberalization and regulation must not be considered to be irreconcilable antagonisms; capital account liberalization requires institutional safeguards and regulatory governance. Third, the optimal speed of liberalization may vary across countries, but recent financial crises provide important lessons on sequencing. Fourth, the threat of further financial crises will remain unless the institutional shortcomings characterizing the present international financial architecture are overcome.

II. WHY LIBERALIZE AT ALL?

With recent financial crises, "the burden of proof of the gains from free capital flows has shifted to the proponents of open capital markets who are being criticised for having offered more 'banner-waving' than hard quantitative evidence on the benefits of financial globalisation" (Reisen 1999: 7; see also Bhagwati 1998). Free international capital flows *may* support economic growth and prosperity, but positive effects cannot be taken for granted.

According to a classical argument, international capital mobility is instrumental in allocating worldwide savings into their most productive use (Eichengreen, Mussa

et al. 1998; Institute of World Economics 2000). Capital mobility also renders it easier for a country to smooth short-term income fluctuations. Investment risks can be diversified on an international scale when capital flows are not restricted. Capital importing countries may gain better access to internationally available technologies, and capital inflows may help these countries to develop a sophisticated financial system at home.

All this is underlying the hypothesis that countries without capital controls should grow faster than countries with capital controls. However, the available evidence is in conflict with this hypothesis. Rodrik (1998) summarizes an empirical study on the link between capital controls and economic growth in about 100 countries: "The data provide no evidence that countries without capital controls have grown faster." Likewise, Grilli and Milesi-Ferretti (1995) do not find a correlation between capital controls and growth, once other growth determinants (such as initial income and human capital endowment) are controlled for. Stiglitz (2000: 1077) concludes: "The predictions of the advocates of capital market liberalization are clear, but unfortunately historical experience has not been supportive."

The empirical studies, on which Stiglitz relies, are flawed in several respects. Sample countries are typically grouped into two categories only (with and without capital controls), which ignores that the coverage and strictness of capital

controls varies considerably across countries. Quinn (1997) addresses this measurement problem by constructing an index reflecting the degree of capital account liberalization. In contrast to the aforementioned studies, this author finds a positive link between liberalization and economic growth. The question of causality remains open, however, since Quinn takes no account of the possible endogeneity problem, i.e., capital account liberalization being the consequence of rising per-capita income.

A further critique relates to the missing differentiation between various types of capital inflows (Reisen and Soto 2000). Most economists pin their hopes primarily on inflows of foreign direct investment (Reisen 1999: 7; Griffith-Jones 2000: 111). Even critics of capital account liberalization, including Stiglitz (2000: 1076), argue in favor of opening up towards direct investment and dismiss the option of complete isolation from international capital markets. In contrast to direct investment, short-term capital flows are regarded as particularly prone to crisis.

The empirical analysis of the growth effects of different types of capital inflows is still in its infancy. Soto (2000) provides evidence supporting the proposition that emerging markets should open up towards equity capital inflows, and should

discourage debt-related inflows when domestic financial systems are weak.² However, Soto's regression results and his policy conclusions with regard to financial opening are debatable.³ Hausmann (2000) forcefully rejects the idea that emerging markets should favor direct investment over other types of capital inflows. According to Hausmann, a higher stock of direct investment did not induce higher economic growth in the host country. Moreover, in sharp contrast to Soto (2000), he shows the growth effects of direct investment inflows to be weaker than the growth effects of long and short-term credits.⁴

There is further evidence against uniformly positive growth effects of foreign direct investment. According to Borensztein et al. (1998), growth effects are significant only if the recipient countries are relatively well endowed with human capital as a complementary factor of production. Nunnenkamp (2000a: 205) concludes from correlation analyses: "FDI must no longer be considered to be a homogenous phenomenon, in order to improve our understanding of the growth impact of FDI. ... It depends on time-varying and location-specific factors

² Soto (2000: 7) summarizes his findings as follows: "First, foreign direct investment and portfolio equity flows exhibit a robust positive correlation with growth. Second, portfolio bond flows are not significantly linked to economic growth. Finally, in economies with undercapitalised banking systems, bank-related inflows are negatively correlated with the growth rate. This result holds for both short- and long-term bank-related inflows."

³ Nunnenkamp (2000a) points to strange results for controlling variables used in Soto's regressions.

⁴ For a critical discussion of Hausmann's findings, see Nunnenkamp (2000b).

whether FDI and growth are positively correlated altogether, and which of these variables leads or lags the other."

In summary, the evidence on the growth effects of capital account liberalization is ambiguous. Even the plausible recommendation that emerging markets should rely primarily on less volatile capital imports in the form of direct investment lacks solid empirical foundation.⁵ Against this background, theoretical considerations according to which free international capital flows should have positive welfare effects fall short of establishing the case for rash and comprehensive capital account liberalization. The risks of capital account liberalization have to be clarified beforehand. Furthermore, the cost-benefit analysis of capital account liberalization has to consider the effectiveness of national safeguards against risk and the incentive structure embedded in the international financial system.

III. WERE CRISES CAUSED BY LIBERALIZATION?

As mentioned earlier, information asymmetries are particularly pronounced in international financial markets. This invites the question whether recent financial

⁵ Corsepius et al. (1989: 5) argued in the late 1980s already: "Neither form of capital inflow [direct investment or credits] can be judged unambiguously superior to the other, and thus recommended for all countries."

crises followed almost automatically from capital account liberalization. At first glance, the economics profession seems to be widely apart once again:

- Stiglitz (2000: 1079) relates the increased frequency of crises to capital account liberalization and claims: "It is clear that not only there is no compelling empirical case *for* capital market liberalization, there is a compelling case *against* capital market liberalization."
- Dornbusch (1998: 23) argues in favor of unrestricted capital flows: "The capital market offers an important supervisory function over the temptations of poor economic policy."
- Fischer (2000: 5) considers it a "cheering observation", that "policy-makers in almost all developing countries have no intention of reversing the process of capital account opening, ... despite their concerns over the recent crises".

Analyzing the run-up to financial crises systematically, Williamson and Mahar (1998) show that financial liberalization preceded most crises (see also Kaminsky and Reinhart 2001). Furthermore, South Asia may have prevented contagion from the East Asian crisis by maintaining capital controls. However, serious financial crises also occurred in several countries that had not liberalized

international capital flows.⁶ Some crises in countries with an open capital account had nothing to do with financial openness.⁷ Finally, the findings of Williamson and Mahar (1998: 62) suggest that "supervision is a crucial element in avoiding the progression from liberalization to crisis".

Hence, liberalization is not at odds with regulation. Actually, preventive regulatory measures are necessary to ensure the success of liberalization.⁸ Putting apologetics aside, the degree of consensus within the economics profession is more advanced indeed than the quotations at the beginning of this section suggest. Fischer (2000) considers China and India to be well advised in pursuing a cautious and gradual approach to capital account liberalization. Dornbusch (1998: 20 and 23), though generally opposing gradual liberalization, points to some prerequisites to successful liberalization ("clean-up *followed* by opening"; emphasis added) and observes "a shocking lack of appropriate supervision". Stiglitz (2000: 1075) comes fairly close to the qualifications made by proponents

⁶ Examples are: Argentina (1989), Venezuela (1994) and the Philippines (1981); for details, see Williamson and Mahar (1998: Table 8).

⁷ For instance, this applies to the Savings and Loan crisis in the United States.

⁸ Put differently, the core problem frequently has been the "inadequacy of prudential supervision and regulation, whose consequences are simply magnified by liberalization" (Eichengreen, Mussa et al. 1998: 21).

of capital account liberalization when he criticizes a rash liberalization without setting up an effective regulatory framework.⁹

IV. WHAT NATIONAL POLICYMAKERS CAN DO

Despite recent crises, hardly any country has abandoned or reversed the process of capital account liberalization (Fischer 2000). This surprising observation may be partly because the effectiveness of capital controls has been undermined in a world of highly sophisticated financial markets (Cooper 1998). Market participants may circumvent controls by referring to innovative financial derivatives. It is therefore arguable whether discretionary controls are instrumental in containing financial volatility and alleviating economic adjustment processes (Institute of World Economics 2000).

Yet emerging markets can protect themselves against the vagaries of international financial markets. National policy options are not restricted to imposing discretionary capital controls, but include shaping the regulatory system and the

⁹ It is interesting to note that Stiglitz considered financial regulation to be fairly advanced in East Asian countries in 1996, i.e., shortly before the financial crisis erupted in these countries: "What is remarkable is that East Asian governments undertook actions (such as prudential regulation) similar to those taken by more industrial countries, and that they did so at an earlier stage of development. Moreover, these regulatory initiatives succeeded without the abuses that often accompany them elsewhere" (Stiglitz and Uy 1996: 272).

macroeconomic framework. This section addresses these three issues in reverse order.

Macroeconomic policy: When financial globalization is blamed for having caused recent financial crises, it is frequently ignored that some crises had a fairly conventional character. For instance, Brazil's crisis of 1999 can be attributed to fundamental macroeconomic inconsistencies (Dornbusch 1999; Nunnenkamp 1999). It is of course true that the economic costs resulting from inconsistent macro policies can mount tremendously because of the herding behavior of foreign investors. However, the causes of crises must not be confused with their effects: Under conditions of financial globalization, macroeconomic policy has a more important role to play.

The macroeconomic challenge is marked by the impossible trinity of exchange rate stability, monetary autonomy and free capital flows (Krugman 1998a). Governments refraining from capital account restrictions have to tolerate exchange rate fluctuations or to give up monetary autonomy. The combination of free capital flows and exchange rate stability requires the subordination of monetary policy to the exchange rate target. The combination of free capital flows and monetary autonomy requires flexible exchange rates, as an exchange rate peg lacking credibility may be easily attacked by speculators.

Hence, the economic policy implications of rising international capital mobility reach far beyond specific financial regulations. It is the consistency of macroeconomic policies which matters in the first place if emerging markets want to attract capital inflows on a sustainable basis.¹⁰

Regulatory framework: It is no longer disputed that the efficiency and stability of financial systems depend on appropriate institutions entrusted with regulation and supervision. Domestic financial markets have to be sufficiently developed and strictly supervised before international capital flows may be liberalized completely.¹¹ This is not a lesson to be derived only after the Asian crisis, but rather a forgotten insight of the debate on the timing and sequencing of liberalization in the 1980s.¹²

The Asian crisis confirms that financial intermediaries must bear the risk of financial transactions, in order to ensure an efficient intermediation and reduce the susceptibility to crisis. State interference in lending decisions of banks and the socialization of financial risk through (explicit or implicit) government guarantees should therefore be avoided. Moreover, Demirgüç-Kunt and

¹⁰ For the choice of an appropriate exchange rate regime and recent developments in exchange rate policy, see IMF (2000a).

¹¹ Meanwhile even the IMF concedes: "Countries need to prepare well for capital-account liberalization" (Fischer 1998: 2).

¹² For an overview, see Funke (1993).

Detragiache (1998) show that the likelihood of financial crises diminishes if state authorities fight corruption and enforce the rule of law.

In supervising financial intermediaries, national institutions can make use of international best practice with regard to financial safety standards. The enforcement of minimum capital adequacy ratios appears to be particularly important. The Basle Accord of 1988 mandated a capital-asset ratio of 8 percent. It can be argued that a higher ratio would be appropriate in emerging markets characterized by a riskier environment (Williamson and Mahar 1998: 64).

It is more difficult to decide on when to subject local financial intermediaries to competition by foreign banks (Institute of World Economics 2000: 20 f.). On the one hand, free entry of foreign banks to domestic financial markets promises efficiency gains and transfers of management know-how. On the other hand, market opening may trigger a wave of bankruptcies as long as local banks cannot cope with foreign competition (Eichengreen, Mussa et al. 1998: 27).

This dilemma is particularly serious if local banks have accumulated a substantial stock of non-performing loans due to distorted incentives in the past. Frequently, the bad debt problem can only be overcome by creating an independent agency for winding up non-performing loans and by recapitalizing the banks. The clean-up of balance sheets, combined with replacing the management of banks, would

counteract the temptation of fragile banks to engage in a gamble for resurrection, by pursuing excessively risky financial transactions. However, institutional reforms must ensure that future lending decisions of banks are no longer distorted by bail-out expectations. In other words, the government must credibly present the clean-up of balance sheets as an once-and-for-all operation and bank managers must face effective sanctions in the case of misconduct.

Capital controls: Since the Asian crisis, many economists share the view that specific restrictions on capital flows are needed in addition to an appropriate regulatory framework.¹³ This applies to controls on capital *inflows* at least. The Asian crisis has led even the IMF to conclude: "A case can be made that countries with weak financial systems should restrict short-term inflows" (Fischer 1998: 5). Chile is often presented as a showcase in this context. Capital inflows in the form of loans and portfolio investment were subject to a non-remunerated reserve requirement in Chile in 1991–1998. This means that Chilean authorities relied on price-related measures, rather than imposing quantitative inflow restrictions. The aim was to discourage speculative inflows by applying a uniform reserve quota and a uniform deposit period to all maturities. This

¹³ *The Economist* (September 12, 1998: 86) argues: "Indeed the distinction between capital controls and sensible bank regulation can become blurred."

approach had the effect that the (implicit) tax was higher for short-term capital inflows.

In sharp contrast to Chile, Korea started capital account liberalization at the short end, and maintained significant restrictions on direct investment inflows until 1998 (Williamson and Mahar 1998: Table 5; Eichengreen, Mussa et al. 1998: 52 f.). As a result, the structure of foreign debt was more prone to crisis in Korea than in Chile; short-term obligations accounted for 68 percent of Korea's foreign debt in 1997, whereas this share was 43 percent in Chile.

A broad consensus exists that the sequencing of capital account liberalization in Korea was highly problematic. It is more disputed whether Chile can serve as a model. Dornbusch (1998: 22 f.) acknowledges the effectiveness of controls in Chile, but questions whether "countries with poor governance can effectively manage the situation in the way honest Chile has". The effectiveness of capital inflow controls is debatable for several reasons.¹⁴ It generally appears that the effectiveness is eroded over time, as market participants increasingly succeed in circumventing controls. The maturity profile of Chile's foreign debt improved only when stricter controls were imposed in the second half of the 1990s. Furthermore, Chile's approach seems to have had limited effects on the volume

¹⁴ For a detailed assessment, see Institute of World Economics (2000), Eichengreen, Mussa et al. (1998: Appendix IV), Buch et al. (1998), and the literature given there.

and volatility of net capital flows, on interest-rate spreads and on the real exchange rate.

Despite these qualifications, precautionary restrictions on short-term capital inflows are widely considered reasonable. By contrast, discretionary controls on capital *outflows*, implemented in Malaysia in September 1998, have gained little support, even though Krugman (1998b) argued that outflow controls are a better choice for a country whose currency is attacked than steep rises in interest rates or a sharp depreciation of the exchange rate. The government of Malaysia claims to have validated Krugman's view, by pointing to the country's rapid economic recovery from crisis (*The Economist*, May 1, 1999: 75).

It is fair to say that the concern of many economists turned out to be exaggerated, according to which outflow controls would have tremendous costs and would impair Malaysia's access to international capital markets for long. Yet even Krugman (1999) concedes that Malaysia's economic recovery "has not exactly proved the proponents right. For there is a recovery in progress throughout Asia". Moreover, the controls came into force only when financial panic was subsiding and the ringgit had already fallen by some 40 percent. Hence, the verdict is still out as concerns the effectiveness and costs of capital outflow controls imposed to fight a speculative attack.

Summary: The effectiveness of specific capital controls cannot be taken for granted. Nevertheless, the above discussion contradicts the view that financial globalization has rendered national economic policy obsolete. It largely depends on the macroeconomic, regulatory and institutional framework in particular countries whether capital imports are used productively and whether financial risks are contained. Capital account liberalization amounts to "putting a race car engine into an old car" (Stiglitz 2000: 1075) only if national policymakers fail to create the preconditions for a successful liberalization (Stiglitz: "checking the tires and training the driver").

V. WHAT REGIONAL COOPERATION CAN ACHIEVE

It may be too heroic an assumption that financial crises would be a matter of the past once national policymakers pursue consistent macro policies and tackle regulatory deficits before liberalization. Still, the failures of global financial markets have to be addressed (see also section VI). The conventional international crisis management has been harshly criticized since the Asian crisis. Especially the critique leveled at the IMF has led Asian governments to consider regional means of crisis prevention and resolution.¹⁵

¹⁵ For a more detailed presentation, see Institute of World Economics (2001).

First moves towards "monetary regionalism in East Asia" (Dieter 2000: 27) suggested that East Asia would turn away from the IMF. In fall 1997, Japan proposed setting up an Asian Monetary Fund (AMF), in order for the region to have a larger say in how to prevent and resolve future crises. The idea to design a regional alternative to IMF policy met with stiff opposition, and was soon given up at the request of the United States. Yet Bergsten expects (2000: 19): "In the medium term, at least, the most important changes to the world's financial architecture are likely to come from the new regional arrangements being fashioned in East Asia by Japan, China, South Korea and the ten members of the Association of South-East Asian Nations (ASEAN)."

Plans of the so-called ASEAN+3 group for mutual financial assistance have taken more definite shape since 2000. A regional system of currency swaps shall enable participating central banks to draw on part of the partners' currency reserves when crisis is looming. In addition to a regional liquidity fund, ASEAN has created a surveillance mechanism, based on early-warning indicators, which shall reveal critical developments and allow for timely policy adjustments. Peer pressure shall help correct economic policy failures in participating countries. Dieter (2000) anticipates further steps towards an Asian regionalism on financial issues, e.g. by establishing regional institutions in the area of bank regulation.

The IMF has raised no principal objections if IMF activities are complemented, rather than replaced by regional arrangements.¹⁶ A swap mechanism along the lines of the ASEAN+3 model may indeed prove insufficient to fight financial crises. Participating countries may be hit by a *common* shock, which is fairly likely within one particular region. Moreover, it remains to be seen whether economic policy failures are easier to correct through peer pressure of neighboring countries than through IMF surveillance and conditionality. Skepticism seems justified, especially with regard to Asia where this idea was born:¹⁷ "How that will work is a mystery: forthright mutual criticism is hardly one of the region's strongpoints" (*The Economist*, May 13, 2000: 83).¹⁸

VI. HOW TO REFORM THE INTERNATIONAL FINANCIAL ARCHITECTURE

The idea of an AMF has won appeal not least because little progress has been achieved in reforming the international financial architecture (Bird and Rajan

¹⁶ See Horst Köhler's remarks made at the press conference of the IMF and World Bank meeting in Prague on September 9, 2000 (<http://www.imf.org/external/np/tr/2000/tr000920.htm>).

¹⁷ The disenchanting experience of ASEAN and APEC in liberalizing current account transactions on a regional level adds to skepticism.

¹⁸ Even though Bird and Rajan (2000) support the idea of an AMF, these authors, too, question that Asian governments are more inclined to follow policy advice coming from a regional institution than adhering to the IMF's advice.

2000: 138). The global architecture needs to be overhauled, as recent financial crises have revealed not only policy failure on the national level, but also institutional deficits on the international level (Nunnenkamp 2000c; Institute of World Economics 2001). Reform topics cover a broad spectrum:¹⁹

- Greater transparency and improved data availability shall provide market participants with better information.
- Financial standards shall take effect on a worldwide scale. Standards laid down in the Basle Accord of 1988 are revised, in order to overcome regulatory distortions revealed by the Asian crisis (Reisen 1999: 25).²⁰ It is under discussion to fill regulatory gaps, notably with regard to highly leveraged institutions, in order to stabilize the global financial system.
- The role of the IMF shall be defined more clearly. Both, IMF lending and IMF conditionality are on the agenda in order to help prevent future crises and resolve unavoidable crises more effectively (Williamson 2000).
- The private sector (i.e., commercial banks and portfolio investors) shall take part in international crisis management. Private sector involvement aims at a

¹⁹ Various reports on the state of affairs in reforming the international financial architecture are to be found on the IMF's homepage (<http://www.ifm.org>).

²⁰ The built-in bias in favor of short-term lending is particularly noteworthy in this context.

fair burden sharing at times of crisis, and may help prevent the deepening of crises caused by coordination failure.

The IMF and finance ministers of G7 claim to have made substantial progress in reforming the financial architecture (Bundesministerium der Finanzen 2000: 3).²¹ However, this is true for only some reform issues, including transparency and accountability. Critical issues such as the future role of the IMF remain unresolved, and others such as an obligatory private sector involvement met with the resistance of banks and various governments (Nunnenkamp 2000d). Several years after the outbreak of the Asian crisis, it is therefore highly debatable whether the international crisis management is better prepared to deal with financial crises.

Two major challenges remain: the provision of emergency finance to avoid illiquidity in hard currency, and a reasonable burden sharing between debtors and creditors in the case of insolvency. The dilemma is to react quickly and forcefully when crisis is looming, without fueling moral hazard of debtors, private creditors and governments.

²¹ "Taking stock today I think we can state that the international financial system is more stable thanks to lessons learned and various measures to increase transparency" (Köhler 2000: 4).

Some reform proposals ignore the trade-off between fighting crises effectively and limiting moral hazard, and should therefore be rejected. The demand for putting an end to IMF lending (Lal 1998) is a case in point. Eradicating IMF-induced moral hazard in this way would come at the cost of more serious contagion in the absence of a financial safety net. The existence of moral hazard under conditions of insufficient information does not establish the case against emergency lending. Rather, safety nets must be designed in a way that moral hazard is contained.

New multilateral institutions could be created in analogy to existing national institutions. National models are underlying proposals to set up an international lender of last resort, an international bankruptcy court and an international financial supervisory agency. However, such an approach may not only involve tremendous administrative costs, but is also likely to be resisted by governments unwilling to see national sovereignty compromised. Furthermore, proposals to create multilateral institutions in analogy to national arrangements tend to ignore that moral hazard is more difficult to contain when various sovereigns are involved.

The intended effects on the functioning of international financial markets may well be achieved without setting up new multilateral institutions.²² Instead of

²² For an overview on reform measures in the subsequent areas, see IMF (2000b).

creating an international lender of last resort, it would be sufficient to extend the toolbox of the IMF in order to stabilize the global financial system when market panic threatens to result in a credit crunch.²³ The combination of a sufficiently funded crisis facility (Williamson 2000: 16), possible IMF lending into arrears and an obligatory private sector involvement in crisis management could prevent illiquidity and expedite rescheduling. At the same time, moral hazard would be limited if the terms of emergency financing were conditioned on mutually agreed pre-qualification criteria.

Likewise, the aims of an international bankruptcy court could be achieved by more modest means, on which a consensus may be easier to reach. Provisions in international bond and debt contracts, e.g. rules on collective representation, sharing clauses and roll-over options, may help overcome coordination failure (Eichengreen 1999: 65 ff.). Such provisions would be conducive to temporary standstills of private investors and creditors; the provisions counteract the incentive of individual market participants to collect their claims at the first sign of trouble, which may transform liquidity problems of debtors into insolvency. Proper application and enforcement of innovative contract

²³ Fischer (1999) has presented a proposal, according to which the IMF would come close to an international lender of last resort.

provisions could be supervised by a committee of creditors and debtors along the lines of the London Club.

Finally, the development of guidelines for national financial standards provides an alternative to setting up an international agency which would have to supervise all financial institutions operating internationally. Existing multilateral organizations (e.g. Bank for International Settlements, Financial Stability Forum) are working on guidelines, in order to improve transparency and accountability.²⁴ However, emerging markets should be sufficiently represented in decision processes (Griffith-Jones 2000). Moreover, emerging markets are in need of technical assistance for implementing mutually agreed guidelines.

By defining guidelines multilaterally, institutional competition between national systems of financial regulation would not be eliminated. The non-binding character of guidelines, in combination with the aforementioned provisions in debt and bond contracts, would strengthen the incentive of international investors to carefully assess both, the solvency of a particular debtor and the effectiveness of financial regulation in the country in question.

²⁴ It should be noted that Article IV consultations of the IMF include financial supervision in member countries.

VII. SUMMARY

There is no panacea in dealing with international capital flows. Yet one can draw some conclusions related to liberalization and regulation. The relevant question is *how*, rather than *whether* to open the capital account. Even critics eloquently opposing wide-ranging capital account liberalization are not arguing in favor of banning all sorts of capital inflows. Hence, it does not make sense to contrast liberalization and regulation of capital flows as irreconcilable antagonisms. To the contrary, capital account liberalization requires institutional and regulatory safeguards in order to limit financial risk. It is here where the opposites meet.

The optimal timing of capital account liberalization may vary from country to country. Emerging markets with weak national financial systems, in particular, are well advised to proceed cautiously with capital account liberalization. Regulation and supervision are not only required with regard to cross-border capital flows, but also in domestic financial markets.

Financial globalization has not deprived national policymakers of any means to protect their economies from crisis. Apart from specific financial regulations and institutional safeguards, success or failure of capital account liberalization depends on the macroeconomic framework. Policy consistency with regard to

monetary, fiscal and exchange rate policies is crucially important to fend off speculative capital inflows and a subsequent bust.

The timing and sequencing debate offers some lessons which seem to have escaped the attention of policymakers in some emerging markets. The Korean case, in particular, confirms earlier insights that a country becomes prone to crisis if capital account liberalization starts at the short end, while long-term capital inflows (notably direct investment) remain restricted. It appears to be reasonable for countries with weak financial systems to limit short-term capital inflows, even though the effectiveness of specific capital controls cannot be taken for granted.

In addition to preventive measures taken on the national level, institutional deficits of the international financial architecture have to be overcome in order to reduce the risk of further crises. Progress in reforming the international financial architecture is still limited. Asian attempts at crisis prevention and resolution by means of regional cooperation in terms of surveillance and emergency financing may complement the international crisis management, but are no substitute for reforms on the global level.

The global challenge is to prevent liquidity crises and to ensure a fair burden sharing in the case of insolvency without aggravating moral hazard of the parties

involved. A combination of measures seems to be suited best to escape from this dilemma. The package should include: a sufficiently funded crisis facility, pre-qualification mechanisms for defining conditions of access to financial support, and a closer involvement of private creditors in crisis resolution.

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