Prescriptions for Recovery of the World Economy

Institute for International Monetary Affairs

Occasional Paper 7

IIMA

Institute for International Monetary Affairs

Symposium on Prescriptions
for Recovery of the World
Economy
February 1999

Occasional Papers

No.7

Prescriptions for Recovery of the World Economy

Published by
IIMA
Tokyo
1999

Contents

Opening Remarks

Toyoo Gyohten
President
Institute for International Monetary Affairs

The year 1999 is still packed with uncertainties for the world economy.

Japan is struggling to escape from a two year consecutive decline in economic growth, and banks are doing their best in order to say good bye to their bad loan problems. Whether they will succeed or not will become clear in the months ahead, and within this year at the latest.

The East Asian countries are suffering from a serious stagnation in their economies caused by the financial crisis. While some countries, like Thailand and Korea, are going to produce good results due to their great efforts that should be praised, they still have serious problems such as the banks' lack of capital, corporations' difficulties in fund raising and a soaring unemployment rate. Even in the economies of China and Hong Kong that were said to have been isolated from the East Asian crisis, the uncertainty is growing.

Looking at the West, through the introduction of the euro, Europe is expected to play an important role in the global economy, especially in the international financial market. Unfortunately, growth in the Euro area is estimated to slow down to around 2% compared to last year's near 3%, and the future outlook for the unemployment problem that has continued for many years is very serious.

On the other hand, the U.S. is still singing praises of its economic boom, but people are beginning to worry about how long the rising stock market and high consumer spending, which are supported by large current account deficits and a rapid fall in savings, will continue. As the season for politics comes close, there arises the danger of the revival of protectionism.

In the fragile economies like Russia and Brazil that collapsed last year, the situation is even worsening.

How to rebuild the world economy packed with such uncertainties and related risks to a more stable and strengthened structure has become an urgent task for all of us that are preparing for the 21st century.

The main purpose of today's symposium is to recognize the trend of the economy in each of these areas and countries, to point out the problems to be tackled, and to explore policy measures that should be taken.

Today, we have here five excellent panelists, representing Japan, East Asia, the U.S. , Europe, and an international institution.

We would like to start by asking each panelist to provide us with their views, each 15 minutes. After that we would like to ask our panelists to debate about their subjects and policies that will be given, whether they can provide common prescriptions for the global economy as a whole, and how they can be put into reality.

Then, we would like to have a question-and-answer session between the audience and panelists. We ask you to cooperate for a very deep and active discussion, since we do only have a limited time of two and a half hours.

Lessons from East Asia

Joseph E. Stiglitz
Senior Vice President and Chief Economist
World Bank

The crisis that began in Thailand in July 1997 has grown now to the point where it represents perhaps the most significant economic event since the Great Depression. Not only has unemployment and poverty in the region soared and output plummeted, but global growth has been serious affected. Indeed, by some calculations, even assuming a relatively rapid return of the global economy to sustained growth, the total loss of output, relative to the previous trend path, is in the hundreds of billions of dollars.

Pundits have drawn the new lessons from the crisis:

Improve your financial institutions
Improve corporate governance
Improve transparency

And they have used the occasion of the crisis to reinforce old lessons:

Do not run large current account deficits
Do not have an overvalued exchange rate

At the same time, they have admitted that some of the key lessons of earlier crises are not applicable:
Unlike the Latin American crisis, inflation was low, government deficits were low and, savings rates were high. The crisis was a crisis of private sector indebtedness, not public indebtedness.

These are good lessons, and countries would be well advised to heed them. Doing so will reduce the chance of a crisis, making a country less vulnerable, and perhaps reducing the magnitude of the downturn should a crisis occur. However, I do not think these are the main lessons that should be drawn from the East Asia crisis: following these precepts will surely not inoculate a country against a future crisis. To be sure, by definition, one will not have a financial sector crisis if one has a strong financial system - that is a tautology. The question is, what does it take to have a strong financial system. To be sure, with sufficient transparency, investors will not put their money into a country that is on the brink of a crisis, and the withdrawal of money will thus not pose a problem. But it may be important to recall that the last set of major crises occurred in Scandinavia, perhaps the set of countries with the most transparent institutions. And most of the relevant information - including the information about the degree of transparency and the problems in the corporate and financial sector - was not only available, but also widely discussed prior to the crisis. Western banks were lending to these countries, despite excessively high leverage in many firms. The experiences of Scandinavia well demonstrates that excessive investment need not be blamed on crony capitalism - even if crony capitalism might have exacerbated the underlying problems. Indeed, real estate bubbles, a central feature of the crisis in several of the East Asian economies, have been ubiquitous throughout the world. While weak (and badly regulated) financial institutions are both cause and consequence, one hardly needs to examine special features of the Asian economy to account for these bubbles, their eventual bursting, and the disruption that results.

I shall argue in this lecture that while there is an important set of lessons to be learned from the crisis, but the lessons are somewhat different from those being put forward by much of the popular press and many politicians in the more advanced countries. The lessons I would emphasize are these:

Rapid financial and capital account liberalization - without the commensurate strengthening of regulatory institutions and safety nets - exposes countries to high levels of risk that they are ill-prepared to absorb. The benefits of the liberalization, especially in countries with high savings rate, are limited, and further qualified by the costs of the disruptions that they are likely to experience. While capital account liberalization, through diversification, is supposed to facilitate growth at the same time that it reduces risk, in practice it seems to be associated with higher levels of risk without commensurate increases in growth or investment.

The international financial architecture has some fundamental weaknesses, as evidenced by the increasingly frequent and severe crises, which need to be addressed by the international community.

Among the reforms that are most needed are those which would stabilize short term capital flows and more effectively and quickly address systemic bankruptcy. They also need to strengthen their safety nets and try to reduce the vulnerability of their economy, including by strengthening automatic stabilizers.

Countries need to seek a congruence between the risks to which they expose themselves, the safety nets that they have provided for their must vulnerable, the automatic stabilizers that they have put into place within their economies, and the policy responses to crises when they occur.

In addition, I would argue that the crisis also serves to remind of *old* lessons - too easily forgotten:

Capitalist economies, without a strong government role, are prone to marked fluctuations *and frequent crises.*

Before the advent of strong financial regulation and deposit insurance, financial crises were frequent and led to severe economic downturns. Such crises were often associated with high leverage and/or real estate bubbles.

Without government intervention to restore the economy to full employment, economic downturns can be unnecessarily deep and prolonged.

Why Did People Miss the Crisis?

In the aftermath of any major event-and the Asian crisis qualifies as a major event-journalists and politicians inevitably search for explanations and interpretations. Their quest is understandable: they wish to identify some salient aspect of the economy that is awry. Ideally, they would like to draw some lesson that reinforces previously held viewpoints. Citizens and readers may want assurance that the calamity is not likely to touch them. The weaknesses that gave rise to the crisis are " foreign"-likely to befall those who, for one reason or the other, have not adhered to the rules of the game.

In the case of the East Asia crisis, the explanations may serve another purpose: Western lenders have a strong incentive to shift the blame - they, after all, diligently ascertained the creditworthiness of borrowers. How could they be expected to have done better, given the lack of transparency of the borrowers? Never mind that the lack of transparency was widely noted before, and that, if anything, the countries were becoming more transparent ![1]

Those who pushed forward the agenda of capital and financial market liberalization have still further motives in shifting blame. They clearly do not want to assume any of the blame for the crisis. There had been an active debate both within government and academia concerning precisely these issues. There were many, for instance, who worried that pushing the Koreans towards faster financial and capital account liberalization, before the associated regulatory mechanisms had been developed and before the high debt equity ratios could be reduced, was inviting precisely the kind of calamity that occurred. Critics that might well have said " I told you so" and taken a critical position untouched by `Monday morning quarterbacking' have been rightly recalcitrant on these matters, focusing instead on how to best proceed from here.

But while there is a natural quest for easy explanations, the burden on economists is heavier:

---

[1] See Furman and Stiglitz (1999).

As instructive as anecdotes may be, far more is required to explain the chain of events. If the errors in management of these countries were so obvious, the crisis should have been predicted. After all, the commonly cited variables were widely noted before the crisis. If one remembers the days before the crisis, however, it is clear that it was not expected. Credit ratings were favorable; risk spreads were falling; and few economists were sounding any serious alarms. Note that credit ratings and risk spreads represent summary statistics-overall judgments of analysts and the market. They represent the aggregation of the plusses and minuses that inevitably characterize any country. It does little good, after the fact, to cite some negative that was recognized, perhaps in a footnote, and respond “I told you so! Had you only read my footnotes carefully, you would not have invested there." Every nation's economy has problems, and if one only invested in countries in which there were no “warnings", no risks and no negative footnotes, one would invest in few if any emerging markets.

Perhaps more striking is the fact that even after the crisis had begun - and attention had begun to focus on potential weaknesses in the region - there was still little anticipation of the impending disaster. In September 1997, almost all knowledgeable opinion held that Indonesia had been unfairly contaminated by Thailand and that its quick policy response had successfully staved off the crisis. As late as December 1997 the Consensus Forecast for Indonesia still expected a positive 6.1 % growth. It was not just that people did not expect the crisis to occur: Even after the East Asia crisis attracted the attention and concentration of investors, they consistently underestimated its scope and severity.

After the crisis initially began, there was still a general sense of confidence in East Asia, so that the downturn would be short and shallow. To be sure, there were good reasons for this confidence - the East Asia miracle was real. Not only had GDP increased enormously, but also poverty had been dramatically reduced, literacy increased, and health improved. Overall, poverty rates for East Asia fell from roughly 60% in 1975 to roughly 20% in 1997.[2]

While it is fashionable today to say these countries were vulnerable, it should be remembered that for thirty years, they had demonstrated not only higher growth rates than elsewhere in the world, but less vulnerability: two of the East Asian countries had no years of negative growth, and two only one year - a far better record than any of the OECD countries. If they were vulnerable, it was a newly acquired vulnerability, suggesting that one should look for changes in policy (such as recently adopted policies of financial and capital market liberalization) as the source of vulnerability.

But vulnerability, if it is to mean anything, should mean that these countries had characteristics that increased the probability of a financial or currency crisis. That is a

[2] World Bank Statistical Information Management and Analysis (SIMA) database.

question that needs to be addressed by standard statistical techniques, not by the kinds of anecdotes that politicians, journalists, and a few economic pundits like. In a forthcoming Brookings paper, Jason Furman and I re-ran some of the leading crisis prediction models using data from 1996 in an effort to see if they would have predicted the crisis beginning in 1997. Looking at the plusses and minuses of each country, did the affected countries have a higher than average probability of a crisis? We found that although the models raised some warnings about countries like Brazil and Russia, they completely missed the crisis in East Asia - often assigning a lower-than-average probability of crisis for the key countries. (Our analysis included re-running the leading model looking at crises in the financial sector. According to these models, there were many more vulnerable countries; that is, if the countries of East Asia were vulnerable, so too are a host of other countries.)

To put it more plainly, if a variable like "lack of transparency" is alleged to be a "cause" of a crisis, countries that have that characteristic should have crises, and those that do not should not. But many of the most transparent countries (like those in Scandinavia) have been among those strongly affected by crises in the last decade, and many of the least transparent countries have not had crises. There are several factors that might jointly "cause" a crisis, and that is precisely why one needs to use more sophisticated econometric techniques which can take into account multiple attributes. Yet even these multiple attribute models suggest that the countries of East Asia were not really highly vulnerable - at least not from an ex ante perspective. The standard macro - economic and financial variables simply did not predict or add up to a crisis.

Knowing this should make us more forgiving of the domestic policies of crisis countries in the run-up to the crisis. If the best economic models say that the macro-economic policies were not heading towards a crisis, why should a Thai finance minister or Indonesian central bank governor have known better? It is hard to blame their policies when these policies - viewed in summary - did not seem wrong at the time. To be sure, Thailand had a current account deficit which (surely in retrospect) did not appear sustainable. But it was being used to finance private investment, and the private investment was presumably yielding a return in excess of the interest rate that would have to be paid on it. If one believes in private markets, such a deficit should have been sustainable. If one had confidence in private market investment decisions, only if one believed that the investment was predicated on a bail-out (i.e. that there were serious moral hazard problems) or otherwise entailed large government subsidies, should one have been worried.

There is yet another important implication of the East Asia crisis, especially critical as we consider reforming our international financial architecture: the fact that the East Asian countries were evidently vulnerable suggests that a wide range of countries are also vulnerable to possibly self-fulfilling crises. Those who believe that crises are always the result of bad fundamentals have not succeeded in identifying that set of fundamentals. And until they do, the presumption is and should be that crises can affect any or most countries.

Another one of the easy explanations for the crisis is that there was a loss of confidence. Some pundits and economists have begun to wander off into the realm of market psychology - a task for which they are eminently unqualified and in which their predictive powers seem eminently unimpressive. Repeatedly, they have asserted that some "package" or "action" would restore market confidence. And when it failed to do so, they produced a host of ex post explanations (reminiscent of Freudian psychologists of old, who could never be proven wrong): the country failed to faithfully execute their directives; some unanticipated (and presumably unanticipatable) event had occurred which had undermined the effects of the prescriptive. Too little attention was paid to the ranges in beliefs, access to information, and circumstances - and therefore different reactions - of the various participants in the market, from those on Wall Street to those in Jakarta.

In contrast to these largely unscientific and unsuccessful attempts to dabble into amateur market psychology, there has been serious research into formulating formal models, both of bubbles bursting (a central feature of the Thai experience) and of multiple equilibria. These models with self-fulfilling "crises" have drawn attention to the nature of the policy regime. The rules of the game determine whether multiple equilibria exist and affect the likelihood of a bubble occurring. The countries of East Asia had moved towards financial and capital liberalization over the last decade. This led to a large inflow of capital and the associated problems of real estate bubbles and exchange rate management. At the same time, the open capital account increased the possibility of a massive outflow of capital.

In our Brookings paper, we took a closer look at what could macroeconomic policy have done better, given the financial policies, and concluded that even in retrospect it is not obvious what the errors were. Different economists have come up with different answers to "what should have been done." For instance, there is little evidence of a serious overvaluation of most of the currencies, certainly not of Korea. There is some concern that had Thailand floated its currency, its exchange rate would have appreciated and reserves would have become smaller, making the eventual crash of the currency potentially even larger. While some have suggested that Thailand should have reduced government spending, it already was running a fiscal surplus, and its long run problems were related to an underinvestment in human capital and infrastructure. Should they have allowed the private sectors' seeming desire to build empty office buildings and crowded out needed public investment?

We know that bad public macro-policies can lead to crises. One of the lessons of the East Asia crisis is that the private sector can also make bad investments. Markets throughout the world - from the inception of capitalism - have been characterized by bubbles. There is such emphasis on financial sector regulation precisely because unregulated financial markets and financial panics have played such an important role in the volatility of capitalism. This is nothing new. The recent government intervention in the United States in the case of Long Term Capital Management (LTCM) demonstrates that even today, even with all the warnings that have been sounded about excessive leverage, seemingly well-regulated American banks have lent to a firm engaged in non-transparent transactions, resulting in higher leverage than evidenced anywhere in Korea. It is thus alleged that a single firm was in a position, through its immense bank leverage, to give rise to systemic risks for the global economy.

The econometric analysis provides one further lesson: the one new variable that appears consistently important in explaining which countries experienced a crisis is the ratio of short-term debt to reserves. This variable was omitted from earlier analyses, partly because it is hard to justify. Theoretically after all, in a country with convertible currency, domestic assets can be converted easily into foreign currency. The multiple equilibria models provide a possible rationale: if all investors come to believe that this is an important variable (or that others believe that it is an important variable) such that when that ratio exceeds a critical threshold, there will be a currency run on the country, then there will be a crisis when that variable exceeds that threshold.

For whatever reason, countries in which that variable is high have faced an increased probability of a crisis. This in turn has strong implications for capital account liberalization. Consider a poor country in which the ratio of short term, foreign-denominated liabilities to reserves is currently at the threshold (unity) and assume that a firm within that country borrows $100 million from an American bank paying 18% interest. The government of that poor country must then increase its reserves by $100 million, buying US treasury bills at 4% interest. In effect, that country is borrowing at 18% and lending at 4%. It is difficult to fathom whether that is a growth - enhancing strategy - though it is easy to see why the United States might find such a deal highly attractive.

There is a final and important lesson that emerges from this discussion: the need for robust systems, designed to take account of human fallibility and mechanical imperfections. Nuclear power plants and airplanes have redundant safety systems. If one part fails, the system will still work because there are additional back-ups. The system is designed, moreover, to survive the lapse of attention on the part of one engineer. Should our international financial architecture not exhibit a similar degree of robustness?

If there were a single accident on a road, it is reasonable to blame the driver. If however, there dozens of accidents at the same curve in the road, one should at least ask whether the road needs to be redesigned. To carry the automobile metaphor one step forward: in designing a car, before we put in a high powered engine, we need to know that there are both good tires and a good driver. Opening up capital markets was a potentially high powered engine (though in practice it did not prove to be the case). And at the time capital markets were liberalized, the tires (the regulatory systems) were far from up to the task of holding the road underneath the high power engine, and macro-management was evidently not up to the task of navigating the sharp curves.

Mitigating the Severity of the Crisis

No matter how hard we try to avoid crises, there will be crises. No country has avoided all real estate booms, although good policies can reduce their frequency. What can good policies do to reduce the magnitude of the downturn?

First, governments should work to put into place automatic stabilizers. In more developed countries, tax and welfare programs act as automatic stabilizers; in many LDCs, automatic stabilizers are weak or absent. Indeed, the structure of the East Asian countries had features that led to instability: the high leverage meant, for instance, that increased interests rate, even for short periods, had large adverse effects on net worth. And as net worth eroded, there would be a large contraction in economic activity and an increasing incidence of bankruptcy. The feedback between the real and financial sector served to exacerbated the impact of shocks.

Secondly, the way in which financial policies are typically implemented contributes to instability. If capital adequacy standards are rigidly enforced so that when a crisis hits countries are at their limit, then as defaults rise and bank net worth declines, either new capital sources have to be found or lending must decrease. But the midst of crisis is hardly an ideal time for raising new capital, and as a result, lending typically contracts. This naturally further weakens the economy, leading to more bankruptcies, and lower net worth, and perhaps an even greater shortfall in capital adequacy. This emphasizes dramatically the difference between systemic policies and policies affecting an individual institution, a point to which I shall return later in the context of bankruptcy. Rigorous enforcement of capital adequacy standards in the case of an isolated bank facing troubles is markedly different from the rigorous enforcement of those standards in the case of a systemic crisis. (More generally, it can be shown that optimal regulation of banks should not entail excessive reliance on capital adequacy standards.)[3]

Thirdly, the strategy for dealing with financial restructuring has to be designed to mitigate, not exacerbate the economic crisis. A key goal here must be the maintenance of credit flows. Typically as an economy faces a crisis, credit flows are impeded. There can exist a bankruptcy chain: a bankruptcy of one firm will have adverse effects on suppliers and customers. As firms worry about the probability of bankruptcy of suppliers and customers, they curtail the availability of normal trade credit. Similarly, banks facing declining net worth and worsening prospects reduce the flow of credit. These normal reactions in an economic downturn are obviously exacerbated in financial crises. Weak

[3] See Hellman, Murdock, and Stiglitz (1998).

banks - banks that fail to meet the basic capital adequacy standards and are on the verge of insolvency (or beyond) - often need to be restructured. But this can be done in better ways or worse ways. In particular, they can be done in ways that impede the already limited flow of credit. The way financial restructuring was conducted in the case of the United States in the S &L crisis and recently in Indonesia provide examples of such success and failure. In the United States relatively few banks were closed down and most were merged with stronger ones - typically over a weekend so that customers of the bank barely noticed the change in management. In Indonesia by contrast, sixteen private banks were closed down, there were intimations that there were still more weak banks that might be shut down, and depositors were put on notice that they were at risk. The resulting run on the remaining private banks was no surprise, especially as there were safer alternatives: state banks (which many believed had the government's implicit guarantee) and foreign banks (which many believed were sounder.) But even if these safe havens had not been available, depositors could, as a result of the open capital account, have taken out their money and put it into foreign banks (thereby avoiding at the same time the downside risk of devaluation). As private banks thus were weakened, the supply of credit was further curtailed, contributing to the downward spiral of the economy.

Fourthly, governments must recognize that even countries with the most advanced institutional structures have had a hard time creating the regulatory environment that insulates them against the full impact of such shocks. Less developed countries have less capacity - and the very process of financial market liberalization has weakened that capacity at precisely the time that it needed to be strengthened, as government regulatory agencies found it impossible to compete against the booming private sector in retaining highly trained individuals. Moreover, less developed countries face greater risks (partly because their economies are smaller and therefore less diversified). And derivatives have made a task all the more difficult, with even the best regulators finding it a daunting challenge - as the Long Term Capital Management debacle this year made so painfully clear.

Fifthly, governments should complement automatic stabilizers with discretionary countercyclical policies, actively seeking to avoid or at least reduce the magnitude of the economic downturns that almost inevitably follow upon financial crises. In doing so, government needs to invoke all the basic lessons of modern macro-management:

- Policies need to take account of the fact that there are lags, and thus must be based on the forecasts of where the economy will be in six or nine months time. It simply will not do to base current policy on the current state of the economy, when there is overwhelming evidence that the economy is about to go into a major economic downturn. East Asia illustrates this point clearly: The economies were initially in rough economic balance (as evidenced, for instance, by the absence of strong inflationary pressures and by the government running budgetary surpluses); the major downturns of the stock market and the currency combined with the bursting of the real estate boom in Thailand and the rising tide of bankruptcy in Korea provided strong evidence of a deficiency in domestic aggregate demand. Additionally, the typically long lags in the export growth might have suggested that the growth of exports would be incapable of quickly filling the gap. Any one attuned to the lessons of modern finance - to the strong adverse impacts of financial crises on the availability of credit - might have predicted an even greater reduction in domestic demand and the possibility of exports growth being impaired by supply limitations.

- Though good macro-policy constantly makes adjustment mid-stream, as new information about the present state and the future prospects of the economy becomes available, it simply will not do to say (as I have heard more than once) that if a downturn does materialize, we will at that point advocate less contractionary policies. By then it is too late, and it will take months fully to reverse course.
- Sound macro-policy must take into account the non-linearities and irreversibilities: large economic downturns lead to massive bankruptcies, with a huge loss of informational and organizational capital. Restarting an economy after such a severe downturn is not easy.
- Sound macro-policy must take into account the risks - not only who bears the risks, but their asymmetries: I have already noted the difficulty of reversing a severe downturn. For an economy with a history of low inflation, even a moderate bout of inflation can be easy to contain and reverse. By contrast, the disruption caused by a deep recession can leave lasting scars - not just in the form of organizational capital but in the form of malnutrition and interrupted education among the very poor. Advocates of contractionary policies, of course, do not do so for its own sake. These advocates often discuss the pain - though the people who do so are seldom those who actually have to bear the pain, nor is there typically much discussion of the disparity between those who happen to have reaped the gain from the actions (like the real estate boom and speculative foreign borrowing) leading to the crisis and those who have to bear the pain. But they argue that pain is necessary - presumably to restore the economic strength of the economy. They often argue that the contraction (or at least the high interest rates and expenditure cuts that lead to it) is necessary for the restoration of confidence. Though this is more a matter for a market psychologist than for an economist[4] - and there is little empirical evidence to support that hypothesis - I remain convinced that it is very hard to restore confidence in an economy (bearing in mind the reaction of investors both outside and inside the country) that is going into a deeper recession or depression; worse still, since there is strong evidence that economic weakness gives rise to political and social instability, these instabilities reinforce the weakening of confidence in the economy.

---

[4] See Krugman (1998).

At the very least, those who advocate these contractionary policies have a heavy burden: not only do they need to establish that these policies are likely to succeed in restoring "confidence in the economy," but that there are not better ways - less painful ways, especially less painful to the innocent bystanders.

Finally, note that there is a curious logic in these policies: economic management is intended to maintain full employment and growth. To argue for contractionary policies - for a recession or depression today - one implicitly must argue that but for these policies, there would be an even worse economic future, a still worse recession or a prolonged period of much slower growth. Consider East Asia. Assume firms there had been encouraged to make full use of the bankruptcy laws (and, if the countries did not have laws with a good "Chapter 11," they had quickly passed such laws). The consequence would have been to put into place an effective standstill on debt (which remember, was private) - far preferable to what has happened so often, the nationalization of private liabilities. The *worst* that might have happened is that these companies would have a hard time accessing foreign capital in the immediately ensuing years (though the experience is that after an orderly bankruptcy, firms do regain access to capital markets rather quickly.) But with savings rates in excess of 30%, and with marginal returns in investment already relatively low, even this might have had a negligible effect on their growth - certainly the deep recessions and depressions might have been avoided. And in any case, firms in deep recessions or depressions typically do not have access to outside capital!

This brings me to the fifth major part of a strategy to mitigate the downturn: putting into place an effective bankruptcy law *designed explicitly to deal with systemic bankruptcies arising out of large macro-economic disturbances such as those associated with large devaluations and huge increases in interest rates.* Let me say a word about bankru-ptcy, an institution which until recently has received too little attention.[5] I have argued elsewhere that a keystone in the development of modern capitalism has been limited liability and bankruptcy laws.[6] Modern bankruptcy laws attempt to balance sometimes conflicting considerations: promoting orderly workouts so that business values can be retained and production losses can be kept to a minimum and providing appropriate incentives so that those engaged in risky behavior bear the consequences of their action. Incentive issues arise at a number of junctures: before the loan has been entered into; after the loan has been made but before bankruptcy appears imminent; before bankruptcy occurs, but after it appears that there is a significant chance of default; and after bankruptcy actually occurs. Different bankruptcy rules have different effects at each of these stages.

---

[5] Though its profound implications for economic theory has long been recognized. See, for instance, Stiglitz (1969) and Stiglitz (1972).

[6] See Greenwald and Stiglitz (1992).

Discussions of bankruptcy often center on equity: on the "rights" of debtors and creditor. While equity considerations are important, so long as the rules are clearly specified, the terms of the contract will reflect these differences in rules. For instance, a rule that gave debtors more rights after bankruptcy would typically be associated with higher interest rates at the time the loan was made. There are, of course, both efficiency and distributional considerations: the higher interest rates may, for instance, disadvantage good borrowers. (While going forward, it is important to have clarity about bankruptcy rules, there are difficult problems concerning how to deal with the current situation. Here, issues of equity are paramount: there needs to be a sense of fairness in burden sharing. I would argue that the central concern at this juncture however, should be the restoration of the economy, which includes designing rules with the appropriate forward-looking incentives. The long run incentive and equity issues need to be addressed within the context of the redesign of the underlying bankruptcy law.) In the international context, the flight of capital or withdrawal of short-term debt does not remove any of the actual factories.[7] The goal should be to ensure that these productive assets continue to produce and that the assets are not stripped away.

Systemic bankruptcy law needs to be distinguished from the bankruptcy laws prevailing in most countries, which are intended to address the failure of isolated firms. There are several salient differences:

- The inferences we can make about the quality of management when all firms face bankruptcy are markedly differ from the inferences which can be drawn when a single firm faces bankruptcy: there is a stronger presumption that an event that even a "reasonably good manager" could not have anticipated has occurred.
- While delaying the resolution of an isolated bankruptcy has no serious macroeconomic effects, delays in the resolution of bankruptcies affecting a significant fraction of the firms within the economy have marked aggregate consequences.
- Even ascertaining the net worth of a firm becomes difficult when there is systemic bankruptcy, since many of the assets of a corporation are claims on other firms that are themselves bankrupt. Ascertaining the net worth of any firm thus entails solving a complex, simultaneous equation problem.
- The resources required to work out an isolated bankruptcy are huge, and there are many critics of present U.S. practices who question whether the benefits are worth the costs. But how can a poor country, with 50% or 75% of its firms in bankruptcy, afford these costs? To put it another way, there are simply not enough bankruptcy specialists within the countries (and perhaps in the world at large).

[7] Except in extreme situations -- such as now seem to be occurring in some of the East Asia countries, where not only is there asset stripping, but the assets are being shipped abroad. Some of the so-called revival of exports is little more than a shipment of the productive assets of the country abroad -- hardly a victory for economic recovery!

- Most importantly, bankruptcy proceedings are often prolonged, and while there are significant costs to the delays (which themselves may be a manifestation of one of the inefficiencies that often arise out of bargaining problems with imperfect information[8]) under systemic bankruptcy, the social costs are systemic, and may significantly exceed the private costs: the macro-economic consequences of delay are simply too great to bear.
- There is not a single Pareto-efficient set of bankruptcy rules, as some of those pushing bankruptcy laws on less developed countries seem to suggest. There are fundamental trade-offs in the design of bankruptcy laws, a point made evident by the heated debate over reform of the bankruptcy laws in the United States during the past year. In short, the task of the economic adviser is not to tell the country which bankruptcy law to have, to give it a single "prescription," but to lay out clearly the consequences of alternative models. I worry that some of the advice now being proffered falls far short of this ideal.

These reforms in bankruptcy law - a speedy "chapter 18" in which the presumption is that existing management would remain in place, a financial plan would be presented which would restructure the liabilities (e.g. forced debt to equity swaps, with foreign debts valued at a rate, say, the higher of the current rate and 30% below the average rate prevailing over the preceding six months) with existing management / shareholders able to retain sufficient equity interests to provide them with adequate incentives). These "default options" would provide the backdrop for a speedy resolution of the debtor-creditor bargaining problem. To be sure, this proposal (one of many that could be discussed) is one which puts a higher premium on debtor rights compared to those that creditor committees might propose. Critics would say that this will have dire consequences for the flow of capital; it will force borrowers to pay higher interest rates. But that is precisely the point: currently, borrowers are not paying the full costs of the risks that their (collective) actions impose on society. This bankruptcy law would put the two in closer alignment. (Moreover, in some models with multiple equilibrium, these new rules might in fact result in the elimination of the bad equilibrium - the equilibrium with a low exchange rate. Knowing that the losses of debtors are limited under the new bankruptcy code, the exchange rate is not "forced" to the lower level at which bankruptcy occurs. In these models, changing the rules in the way proposed might result in the rules themselves never having to be brought into play.)

Finally, the cornerstone of any policy attempting to mitigate the severity of a financial crisis arising from the volatility of short term capital flows must attempt to address the fundamental market failures associated with that volatility: the fact that some of the costs (risks) associated with those capital flows are borne by innocent bystanders - the workers and small businessmen who are crushed either by the direct impact of the volatility or, more commonly, by the extreme macro-policies that are pursued in an attempt to moderate crisis effects on exchange rates. While I have written

[8] See Farrell (1987)

extensively elsewhere on those policies,[9] let me here make but three observations.

- Such policies need to be comprehensive: they need to include not only the elimination of those distortions which have, in the past, encouraged short term capital flows, but also policies which ensure that banks and financial institutions do not undertake excessive exposure. But while good financial market regulation can go a long way, that is not sufficient: corporations themselves may engage in excessive borrowing in foreign denominations, as the experience in Indonesia where two-thirds of the borrowing was undertaken by corporations, has brought home forcefully. (To be sure, Malaysia shows that tight regulation of banks - requiring them to look at the exposure of the firms to which they lend, can put a significant damper on corporate foreign borrowing.)
- Such policies can work, as the experience of Chile has demonstrated, where a policy which might be interpreted as a tax on short-term, foreign-denominated debt has succeeded in lengthening the maturity structure of the foreign debt with little discernible impact on overall capital flows. Other proposals also look promising, such as those limiting the deductibility from the corporate income tax of short-term foreign denominated debt.[10]
- Such interventions can be thought of as dams, dams that do not stop, only temper the flow of water from the top of a mountain down to the sea. Without the dam, there are floods that bring with them death and property destruction. By contrast, with the dam, not only is the death and destruction reduced, but the water itself can be channeled into more constructive uses.

Critics of such interventions have argued that such interventions will impede the flow of capital and represent an interference with the free workings of the market. Again, let me repeat: there is a market failure; these flows give rise to systemic risks which have large impacts reaching far beyond those directly involved in the financial transaction. It is intellectually incoherent to argue that there is a need for bail-outs (or more broadly, that a government should take actions which have such adverse macro-economic effects on its economy) and at the same time maintain that one should not do something to address the underlying problems that give rise to these problems. If there are contagion and systemic risks, there are externalities. It is no more justifiable to complain about the adverse effects of such interventions in dampening capital flows than it would be for a steel producer to complain that a tax on its air pollution induces it to produce less steel. In both cases, those engaging in socially costly activities are being asked to bear more fully the social costs of their actions.

---

[9] See Stiglitz (1998a, 1998b).

[10] There are some significant administrative advantages with this proposal. Any proposal has to worry about two key issues: the use of derivatives to circumvent the regulations and the movement of borrowing offshore. These problems can be addressed, at least in ways in which the foreign denominated indebtedness imposes less of a threat on the country's own macro - economic stability.

Mitigating the Consequences

No matter how effective we are in reducing the frequency of crises or in designing policies that mitigate adverse macro-economic consequences, such crashes will occur and will lead to economic downturns. A major lesson is that we must put into place safety nets, institutional arrangements that help the most vulnerable within society absorb these shocks.

This will be difficult for many less developed countries. Even in more developed countries, the agricultural and informal service sectors are often inadequately covered by unemployment insurance. These sectors of the economy loom large in many LDCs. We need to recognize the “ limbo" stage in which many LDCs find themselves: they have trod sufficiently far down the transition road into a modern economy that many of the traditional informal safety nets - provided by families and villages - have weakened, but they have not yet gone far enough down the development path that they have been replaced by adequate formal institutions.

For most LDCs, there is simply no safety net that can substitute for economic policies that maintain the economy at full employment.

Concluding Remarks

It is a much quoted adage that those who do not understand the past are doomed to repeat it. I do think a dispassionate look at East Asia is imperative. In doing this, we have to avoid two dangers. The first is the journalistic anecdotes to which I referred earlier - looking for easy explanations, particularly explanations that provide us comfort that the calamity was brought on by some mistake of those upon whom the disaster has fallen, leaving the rest of us in more virtuous countries relatively immune. Certainly, the contagion that spread around the world in the aftermath of the Russian crisis has eroded much of the comfort for those who believed that following “ good" policies would protect them against the ravages of short term capital market volatility. Secondly, we cannot rely on our 20/20 hindsight. We need to take seriously what people knew and expected to happen at the time. Moreover, we need to look carefully at the explanations offered up by various participants in the market: each has an incentive to provide explanations which serve their own interests - from shifting blame, to assuring others that the basic policy framework that has been at the center of policy is appropriate.

If there are four central lessons that I draw, they are these: First, hasty and poorly designed financial and capital market liberalization played a central role in these crises, a far more important role than the host of other commonly cited factors. Secondly, there are important reforms in the global financial architecture - including reforms in the bankruptcy laws and attempts to stabilize the highly volatile flows of short term capital - which are essential if the advantages of globalization are to be achieved without imposing undue risks. Thirdly, economic models that fail to integrate modern financial economics into an analysis of the real sector simply will not do. Too much of the analysis in the recent crisis focused on financial variables - victory was declared when exchange rates were stabilized, even as the economies were plunging into deep recession. Attention needs to be placed on the social, structural, and human dimensions, on the implications of the policies for unemployment, bankruptcy, the flow of credit, as well as for the overall strength of the economy.

Fourthly, and most importantly, there needs to be greater congruence between the exposure to risks, the ability to bear risks, and the policy responses. Small countries are like small boats on a rough sea. Even with a well-steered, sturdy boat, they are eventually likely to be hit broad side by a big wave. Knowing this, they should have a good set of safety vests, and they should take great care in venturing into dangerous shoals. The less developed countries, even before they had fully mastered the techniques of steering and before all the holes in the boat were fully plugged, were reconfigured to make them (supposedly) more sleek, but less stable, and encouraged to set out into some of the stormiest seas and worst conditions possible - and no time was given to make sure that everyone had a safety vest. The results were predictable. Let us take to heart these lessons.

References

Farrell, J. 1987. "Information and the Coase Theorem" *Journal of Economic Perspectives* Vol 1(2). Falls 133-29.

Furman, J. and J.E. Stiglitz. 1999. "Economic Crises: Evidence and Insights from East Asia." *Brookings Papers on Economic Activity*. Macroeconomics 2:98.

Greenwald, B. and Stiglitz J.E. 1992. "Information, Finance and Markets: The Architecture of Allocative Mechanisms," with *Industrial and Corporate Change,* Vol 1(1). 37-63.

Hellman, T., K. Murdock, and J. E. Stiglitz. 1997. "Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?" Stanford Graduate School of Business Working Paper.

Krugman, P. 1998. "Why Aren't We All Keynesians Yet?" Fortune. August 3.

Stiglitz, J.E. 1969. "A Re-Examination of the Mogdigliani-Miller Theorem," American Economic Review, 59(5), December. 784-793. (Presented at the 1976 meetings of the Econometric Society, Washington, D.C.)

———.1972. "Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-Overs," Bell Journal of Economics, 3(2), Autumn. 458-482.

———. 1998a. "Towards a New Paradigm for Development: Strategies, Policies, and Processes" Paper given as the Prebisch Lecture at UNCTAD, Geneva. October 19.

———. 1998b. "Beggar - Thyself vs. Beggar – Thy - Neighbor Policies: The Dangers of Intellectual Incoherence in Addressing the Global Financial Crisis". Paper presented as address to Annual Meetings of the Southern Economics Association. Baltimore, November 8. (Forthcoming in Southern Economics Journal).

Remarks from Thailand

Virabongsa Ramangkura
Former Deputy Prime Minister, Kingdom of Thailand

I was asked by the organizer to touch upon the situation in Southeast Asia and East Asia, but, with your permission, I would like to take Thailand to illustrate the region. I believe that the situations in Indonesia and South Korea are not very much different from what is happening in Thailand. Probably Malaysia is not much better either.

A lot of people outside the region think that we have been doing very well, that we are on the road of recovery, and that probably Thailand will be the first country that will be out of the mess. But I have a different idea. I am still quite pessimistic at the moment, or at least less optimistic than the people outside the country.

Thai economy has been contracting throughout last year. The economy contracted by 8%, resulting in import drop by 40%, which is a historical record that our import dropped by that magnitude. Our export, instead of increasing, dropped by eight percent, resulting that our current account became surplus within a few months after the crisis. The current account surplus has made our exchange rate stabilized to a certain extent.

At the moment because of the level that matches to the economy, the currency crisis and the financial crisis have caused great damages to financial system. By the end of last year, the non-performing loan in the system reached 43% against 25% predicted at the beginning by the Fund. You can imagine, if the 43% of the credit of the whole system is not performing, how can all banking system stay. At the same time we have adopted the extreme austerity program that tried to squeeze, and tried to press financial institutions to upgrade their standard to the BIS standard, resulting then that they had to downsize their size severely in order to avoid recapitalization. When the credit was squeezed, interest rates had been high for too long, banks were trying to downsize themselves, and the tight money situation became the result. Last year, the total system suffered the loss of about 220 billion bahts, which was greater than the existing capital fund of the whole system. Therefore the whole banking system needs recapitalization of more than one trillion bahts, which is about 20% of GDP. It is impossible that the whole system can acquire just a few capital in order to live up to the BIS standard.

At the moment, financial system stopped functioning after the severe damages occurred throughout last year. Although the government has changed their policy from tightening money supply to pumping money into the system, the peculiar situation happened: overnight money market rate has dropped sharply within one month from over 20% to only 3% at the moment. Deposit rate has dropped quickly from 15, 16% to only 5%. However, the lending rate, that does not respond as good as the deposit rate, leaves the big margin. The reason for this is that, during the time they squeezed the tight money situation, and that the austerity program was adopted by our government, the real sector had been pressured severely by the tight money situation. The result is that insolvency occured not only in financial system, but also in the real sector and in the business sector. About 80% of our business are unbankable at the moment, because the debt-to-equity ratio became unbankable and if it is not possible for the bank to lend any more money to test insolvent business. Therefore, not only banks, finance companies and other financial institutions bid huge recapitalization, but also the real sector and the business need huge amount of capital to be injected so that they will become bankable again. The problem probably is similar to the case of Japan seven or eight years ago. The economy stopped responding to the reduction of interest rate at the moment. In order to make balance in the financial system, because financial institution has been placed to live up to BIS standard, the government tried to put pressure on the real sector by trying to speed up the judicial system reform and so on, and that created a great deal of political pressure in the Parliament and among the business circle.

The tension has been increasing at the moment whether we have been going in the right direction to remedy our economy, or we are going in the wrong direction and the depression probably may be coming in the very near future. If you go to Bangkok at the moment, the really popular question that you will hear is “ when will the economy stop sliding down?" Everywhere people are asking this question. Some people are more optimistic. They are asking how long we will stay in the situation. Many times when my friends ask me these two questions, I tell them the right question is when we will stop sliding down.

The atmosphere in Thailand is really pessimistic. The prescription or the direction given by our advisor from the Fund is how to attract fund from outside so that our economy will recover. Therefore all the progress, whether it will be success or failure, will be based upon the external capital inflow. If capital fails to flow in, the whole program will face the failure, including the policy proposed by Professor Stiglitz. There has been a lot of discussion in Thailand, what we shall do with this situation. There are many uncontrollable factors, such as what will happen to Japan this year or next year, what will be happening in China, whether Hong Kong, Singapore, and Taiwan will go down, what will happen to Brazil, and whether the IMF prescription given to Brazil will be similar to that had been adopted by Thailand.

All these are external factors that we should not be optimistic about. What can we do domestically? Should we go on, raising the standard of our financial institutions? Should we raise the financial standard of our companies in the real sector? What will happen if the economy ceases to respond to interest rate change? A lot of people believe that probably if we cannot live up to international standard, and our economy remains contracted, we have to go back to what we were ten years ago. There has been demand that probably we may leave our financial institutions including banks to the standard that we were living with ten years ago by giving them time to recover. If political pressure already started against the IMF package, and the recommendation of judicial and legal reform becomes more and more serious, the economy at the moment becomes deteriorated.

In addition, it is likely to be deteriorated because of the commodity price collapse plus the bad draught that has happened in the region. The economic hardship will be a major issue in Thailand as well as in the region. So if probably we want to have a balance between the standard of our financial institution and the standard of legal and judicial system, it is really difficult politically. Even if we are successful in having legal reform, the efficiency in the judicial system is something that nobody can do anything about. The balance may come either way. You can raise the standard of financial system and have legal and judicial reform, or lower the standard to what we were ten years ago to match with our level of development at the moment. This is the issue that has been seriously discussed within the country.

Another point I want to mention here is that very little or no attention has been paid to the real sector at all. The package has been adopted, but assistance that has been given is mainly concentrated in financial sector. The issue that has been addressed is the infusion of capital in the financial sector, but actually the real sector has been really crucial factor for economic recovery at the moment and in the future. How can we make our factories running, when they are using only 50% of their capacity at the moment? How we can make them bankable again is the major problem. Injecting liquidity is already useless now. People probably think that the crisis at this time is not an individual country crisis, it is a regional crisis. Therefore it is beyond any particular country's effort or resources to cope with the problem. The matter has to be done collectively, regionally. And this is the question, of who can take the initiative.

The Miyazawa Fund is welcome in Thailand and in other countries in East Asia, but I feel that the Miyazawa Fund again, like the IMF fund, will go to the public sector. The world now is a world of the private sector, and the currency and financial crisis started because of private sector indebtedness, not public sector debt.

The public sector is not real problem. The problem is private sector insolvency. How can we go from Miyazawa initiative to trust in a fund or a mechanism that can go directly to the private sector, not in the form of loan, but in the form of equity, because equity is badly needed, not loan at the moment? If the real sector is adequately recapitalized, then probably financial institutions can start to function again. The world at the moment really depends upon only single currency, that is the US dollar that causes a lot of problem, and probably we may have to think that we should have more balance for the medium of settlement, the idea of creating new currency in the region probably will be the issue in the near future. These, I think, are the factors that we have to concentrate this year. I believe that the economy in Southeast Asia, including South Korea, is still far from recovery.

Remarks from the U.S.

John Lipsky
Chief Economist and Director of Research
Chase Manhattan Bank

The topic of the Symposium is critically important: What can be done to help reverse the global growth slowdown that has been underway since Asia's crisis began in mid-1997? And how can the international financial and economic system be made more stable?

Global growth this year likely will be the slowest of the entire 1990's, perhaps no more than one percent. At the same time, the rise in volatility and the heightened risk in global financial markets - that reached crisis proportions during September / October last year - has not been reversed or solved in any meaningful way.

Recent developments aren't purely negative, of course. In particular, the industrial countries of Europe and North America have moved toward sustainable price stability, accompanied by relatively low budget deficits, or in the case of the United States, a budget surplus. With no end to the expansion in sight, low inflation and relatively low interest rates have boosted investor optimism, powering equity market values higher, further reducing the cost of capital to corporations.

The potential for new progress is particularly evident in Europe, where the creation of the euro hopefully will enhance momentum toward regional integration and structural reform. The Japanese economy also is showing signs of structural improvement, if not yet of stronger growth. These latter two issues will be covered by other speakers today.

My main point should be obvious. That is, the latest developments have created both dangers and opportunities to an unusual degree.

I am going to address three issues today: First, I am going to discuss the U.S. outlook, and explain why I am optimistic, but still expect a substantial slowdown in 1999 U.S. growth. In addition, I will discuss briefly the role of hedge funds. Finally, I will make a few remarks about the current debate with regard to what is now called “ the international financial architecture".

The U.S. Outlook

First; the U.S. outlook: One of the most clearly positive aspects of current developments has been the exceptional recent performance of the U.S. economy. Of particular note, the U.S growth has exhibited impressive resilience during the past year and one half, despite falling growth elsewhere. More broadly, the current U.S. expansion is now the longest peacetime expansion on record, following the 1982-90 expansion, that was the second longest on record.

This U.S. "Long Boom" is notable in itself. Nonetheless, the U.S. performance has been particularly impressive during the past three years. Sustained brisk growth has reduced the unemployment rate to thirty-year lows. Despite the low and falling unemployment rate, however, unit costs have not accelerated. Rather, broad inflation measures have slowed to the lowest pace in more than 30 years.

Sustained strong growth in business fixed investment has been concentrated in high technology equipment. Productivity gains have been accelerating, following a 25 years' slowdown. These developments have encouraged optimism that the U.S. economy's long-term growth potential may be increasing, at least to some degree.

With growth strong, unemployment low, and inflation slowing, it is not surprising that interest rates have fallen substantially. Together, these factors have pushed the federal budget into a surplus last year of about $70 billion dollars, an outcome unimaginable only a few years ago. Moreover, the latest budget forecasts - that we consider broadly plausible - indicate that the surpluses could be sustained far into the future.

Given the striking contrast of the U.S. economy's performance with that of other G-7 countries, it is natural to wonder what factors explain the exceptional U.S. results, and to ask whether they will endure.

In my opinion, the United States - among other things - is finally reaping the benefits from 20 years of sustained anti-inflationary monetary policy. During that period, the Federal Reserve has been more forward-looking in its analysis, more decisive in its actions and more clearly focused on achieving low inflation than was the case previously. As a result, not only has inflation fallen persistently, but expectations of future inflation also have declined, reflecting the growing credibility of the U.S. policy.

The resulting drop in long-term interest rates has encouraged capital-intensive investment, while new funding instruments have been developed that are particularly suited to financing investment in new technologies.

For example, it should not be surprising that innovations such as venture capital funds and high-yield debt - in addition to new equity issuance - have been used frequently to fulfill the substantial up-front capital requirements that characterize much of the latest advances in communication and other network-based technologies.

The point here is straightforward: The combination of sustained anti-inflationary monetary policy and financial deregulation have played an important role in improving U.S. economic performance.

Other factors have been important as well, of course, including the success over the past twenty years of gradually restoring fiscal balance. Moreover, for the first time in three decades, taxpayers and investors no longer fear huge, unanticipated increases in the federal deficit - events that in fact had occurred in the 1960's, the 1970's and again in the early 1980's.

One conclusion is that the good U.S. performance of the past few years resulted more from good policy than from good luck. Thus, there is reason to think that the relatively favorable U.S. performance can be sustained in the future, if policies remain appropriate.

But that does not mean that there are no risks, or that the rapid growth pace of the past few years can be sustained unaltered. In fact, many analysts have pointed to potential vulnerabilities of the US expansion: For example, the U.S. current account deficit widened last year to nearly 3.5% of GDP, similar to the deterioration that occurred in the mid-1980's. Put another way, continued U.S. economic growth appears at present to depend upon large inflows of foreign capital.

However, comparisons with the mid-1980's are misleading: Today, the dollar likely is modestly undervalued. In the mid-1980's, it was grotesquely overvalued. The recent widening of the U.S. trade deficit has not reflected a surge in imports, as was the case 15 years ago. Rather, the principle problem is a shortfall of exports, caused mainly by weakening economic growth outside the United States. If global growth were to be restored, the U.S. deficit would be reduced significantly, as would the use of foreign saving.

Nonetheless, with the current account deficit widening at a record pace last year, the U.S. expansion depended entirely on the willingness of households to expand consumption spending in inflation-adjusted terms at a pace much faster than the increase in real disposable income. As a result, the household saving rate fell to record lows.

According to the Chase Research forecast, this rapid consumer spending growth will not be sustained in 1999. Rather, we expect that spending will slow gradually to be more in line with income gains. If so, GDP growth this year will diminish to a pace of about 1%, down from about 4% in 1998. Rather than emphasizing the implied risk of an eventual downturn, it would be more accurate to characterize our forecast as one of a natural re-balancing of household finances, following the unprecedented impact of two major windfalls - that is, record wealth gains and unexpected real income gains - whose effects are waning and that are not likely to be repeated. As a result, while there is good reason to expect a slowdown in growth, there is no reason to expect that we have reached an end to the U.S. expansion.

To understand the U.S. outlook, it is necessary to ask why consumer spending has remained strong, especially during last year's second half. Many observers claim that this was solely a result of the "wealth effect" of rising stock and real estate prices on household balance sheets. Households feel wealthier, so the story goes, and therefore they spend a higher percent of their income....in fact, all of it and more. According to this view, the Federal Reserve's rate cuts last year helped to spur the stock market, boosting consumption.

This view also would suggest that future U.S. growth depends more than anything right now on Wall Street. To the optimist, this means that the U.S. economy will continue to expand at a rapid pace, despite the lack of saving. To the pessimist, the United States risks suffering the after-effects of its own "bubble economy", especially if the U.S. stock market weakens, as many expect.

To the optimist, the expansion is secure: According to this view, there is no reason to expect households to slow down their spending: Consumer confidence is high, job growth remains strong, and interest rates have fallen. As a result, the stock market isn't under threat.

To the pessimist, it is easy to conclude that U.S. equity values are too high: After all, aggregate corporate profits probably declined last year, and it is likely that they will decline again this year. In this pessimistic view, the US equity bubble surely will burst, dropping the US into a recession.

Although the latest U.S. GDP figures have encouraged the optimists, my Chase Research colleagues and I do not agree fully with either view. However, we have concluded that the "wealth effect" boost to U.S. spending has been over-estimated. If the recent past is any guide, the increase in consumer spending last year was about twice as high relative to wealth increases as would have been expected. Either U.S. households suddenly have become highly sensitive to wealth increases, or an additional explanation is needed for the 1998 consumption surge.

Moreover, claims that the U.S. equity market is in a bubble phase ignore the clear 1997 inflection point in the market's rise. That is, between the end of Fed tightening in February 1995 and the outbreak of the Asian crisis in July 1997, the Dow Jones Industrial Average increased at a compound annual pace of 30%. Since then, the equivalent rate has been about 9%. This doesn't mean that a stock market drop is out of the question - markets can go down as well as up. But it does suggest that the market hasn't been as "irrationally exuberant" as some critics have claimed. Still, unless there is a new acceleration in stock market gains, the wealth effect should begin to wane this year.

In our view, the unexpected drop in inflation last year was the extra element that explained the strength of consumer spending. Even after Asia's crisis had begun in mid-1997, 1998 forecasts anticipated U.S. inflation of 3% or higher. The unexpected drop in inflation last year to about 1.5% or less converted last year's 4% average wage gains into a substantial increase in real wages, helping to boost spending. At the same time, the drop in inflation eroded corporate profits, as firms were unable to pass on wage and other increases, as they had anticipated. In effect, the sudden decline in inflation transferred income from producers to consumers.

In typical U.S. cyclical slowdowns, rising capacity utilization rates and declining unemployment eventually produce higher inflation and interest rates. These factors generally lead to slowing job growth and stagnant wages, thus providing a signal to households to slow their spending. Last year, these slowdown signals simply were not transmitted.

In the absence of the standard warning signals, therefore, it was not so surprising that household spending growth surged when measured in real (that is, inflation-adjusted) terms. Only some of this spending was financed by realizing capital gains on equities. Much more was financed by new borrowing - after all, household debt service burdens reached an all - time high.

We expect, however, that income growth and job gains will slow this year, weakening spending. With profit margins squeezed, and with pricing power diminished, corporations will have to reduce the rate of unit cost growth in order to restore profits. The signs of such action already are emerging. For example, the volume of layoff announcements associated with corporate restructuring has surged back to the record highs recorded during the so-called “jobless recovery" of 1993 / 94. At the same time, corporations likely will try to restrict real wage increases this year by slowing nominal wage increases. If these trends are sustained, as we expect, consumer spending growth likely will slow to about 2% in real terms, from more than double that pace in 1998.

At the same time, the continued slowdown in growth outside the United States, mainly in Europe and Latin America, will continue to weaken the U.S. external balance, although not at the record pace of 1998. Moreover, the rise in excess capacity, the drop in corporate profits, and the rise in credit spreads in the U.S. corporate bond market all indicate that business fixed investment will slow somewhat from the double-digit pace of the past few years.

Thus, despite widespread expectations that the U.S. expansion will remain rapid, the Chase Research forecast is much more muted. But there is no reason to expect that the

United States will have reached the end of the “ Long Boom".

This is a very positive outlook, despite the expected slower growth, in part because we expect that inflation will fall again in 1999. Even more important, we expect that the low inflation will not be viewed simply as the result of temporary external factors. Rather, with inflation expectations still well above actual inflation - and with wage gains slowing - the surprise of 1999 will be the sustainability of low U.S. inflation for years to come.

Not surprisingly, then, we are optimistic about the likelihood of a new U.S. bond market rally that will carry long-term Treasury yields into a 4% - 5% range. At the same time, we expect that the Federal Reserve will lower the funds rate by about 75 to 100 basis points by the end of the year, simply in order to establish a neutral policy stance. We also expect the dollar to strengthen moderately versus the yen, as Japanese monetary policy appropriately becomes more expansionary. The dollar likely will remain strong against the new euro.

I should warn you that these views are not at all consensus views. Right now, market prices suggest that the Federal Reserve is expected to hold rates steady, and my guess is that most analysts and investors expect the bond market to remain within current ranges.

Hedge Funds

Turning to the issue of the role of hedge funds, much has been made about the hedge funds' importance in fomenting last year's severe financial market turmoil. And I expect that you are aware that a recent Federal Reserve report has been critical of private sector risk management in the case of Long Term Capital Management.

No doubt, the importance of the hedge funds in the 1997-98 financial market instability will be debated for a long time. Rather than enter into this debate, however, I would like to express my confidence that these funds are not likely to represent a significant new threat to stability anytime soon.

As a result, I am somewhat concerned that the policy debate about the hedge funds could lead to recommendations that easily could cause more harm than good. For example, the claim that hedge funds should be compelled legally to increase their disclosure sounds reasonable. It should be recognized, however, that U.S. hedge funds typically operate off-shore. Therefore, implementing binding reporting and control requirements could imply the creation of a debilitating and bureaucratic system for registering offshore transactions.

The impact of such a move easily could stifle markets, without any clear gain.

In fact a note of clarification likely is worthwhile here; Despite typical press reports, the problems that afflicted LTCM's creditors largely reflected their relations with securities firms, not with U.S. commercial banks. The involvement of those few U.S. commercial banks included in the " rescue" effort reflected mainly concerns about the potential weakness of securities firms, rather than their direct exposure to LTCM.

As such, this indicates that in assessing the potential difficulties, the primary focus should begin with the relation of securities houses to hedge funds. In the U.S. context, this is an issue for the Securities and Exchange Commission, rather than for bank regulators.

At the same time, it is reasonable to expect that bank reserve requirements with respect to hedge fund lending should be reviewed. While changes in these requirements may be adopted, market conditions and heightened lender caution already has limited the leverage of hedge funds even in advance of any regulatory action. Finally, bank lending to hedge funds overwhelmingly remains covered by high-quality, liquid collateral.

My principal point should be clear: The hedge funds at this time do not represent a significant threat to financial stability, even in the absence of new regulatory and legal measures.

International Financial Architecture

I was asked to comment on the implications of recent events for the " architecture" of the international financial system - as it is now called typically. This is a topic that defies a simple summary, so my remarks will be very limited.

First of all, the events since July 1997 have demonstrated that the international crisis management system is itself in crisis. In short, our " system" - the ad-hoc combination of the IMF supported by key G-7 countries - is not well adopted to a world of open capital markets in which cross-border financial transactions take the form of marketable securities.

A market-based system works well if market discipline is effective. Such a system cannot rely for regulation primarily on discretionary, after-the-fact attempts to throw together IMF-led " rescue packages", complete with instant structural reform programs. This point has become recognized widely during the past year.

I will leave aside today any theoretical discussion about whether open international capital markets - if implemented sensibly - spur long-term economic efficiency and stability. Despite the problems of the past few years, and the widely-reported remarks of prominent skeptics, the proposition that capital market liberalization is a justifiable goal still seems to be accepted widely. The challenge is not to define an alternative to market liberalization, but rather how to reach the goal of openness successfully, while avoiding new episodes of financial and economic disorder.

Just as the success of the post World War II system was based on the gradual move toward more open current account transactions - coordinated through the IMF and the GATT - today the IMF's Articles of Agreement should be amended to include capital account liberalization as a goal of IMF membership. In that case, the international community can organize and supervise the liberalization of capital account transactions on a gradual, rational basis. But this measure, that was endorsed by the IMF's Interim Committee as recently as the 1997 IMF Annual Meetings, seems to have fallen to the side in the wake of recent troubling events.

Rather than attempting to discuss "international financial architecture" in any detail, I will only suggest that the current discussions underway in many forums are not likely to result in any sweeping agreements any time soon. By the way, this topic is summarized very well in the current edition of the London-based Economist magazine ("Global Finance", January 30th. 1999). As is pointed out there, a basic problem for the current debate is that the three most widely-held goals for reform - including preserving national sovereignty, cushioning financial market instability, while benefiting from global capital mobility - likely cannot all be achieved at the same time.

In practical terms, the latest reform effort likely will produce results that are modest, rather than grand. The industrial countries should improve their own markets, including a review of bank capital requirements, and expanding disclosure requirements. For the emerging market countries, proposals for contingency financing facilities should be explored, especially in the context of IMF-sponsored programs.

Globalization is Regionalization

Finally, the 1990's have not been the decade of globalization, as is usually claimed, as much as it has been the decade of regionalization. The growth in trade, capital flows, and financial flows has been much more rapid within regions than between regions. Chase Research discussed this point in some detail in our October 1997 publication.

The practical implications are clear: The moves toward European financial integration already are profound, but they are far from complete. One way or another the financial ties between the United States, Canada and Latin America are going to become even more intense.

The greatest challenge for regional integration, however, is found here in Asia. Nowhere has the trend toward greater regional flows been more striking. Asia's economies continue to undergo dramatic change. Japan is embarking on a profound period of structural reforms. The outcome of Chinese reforms is not yet certain, nor is that country's timetable set for increased financial openness. Thus, it is difficult to imagine the exact role of an “Asian Monetary System" or “Asian Monetary Fund" at this time.

In practical terms, the most powerful aid for Asia would be a restoration of Japanese growth, and success in implementing structural reforms.

Remarks from Europe

Norbert Walter
Managing Director of Deutsche Bank Research and Chief Economist for the Deutsche Bank Group

I've been living through the life of a forecaster for twenty-five years and I've always tried to be consistent. However, if you are forced to listen to an American economist and truly adopt his numbers into your international model, you are dead. Therefore I always quarrel with my American colleagues, as today with John Lipsky. I am very much in line with his thoughts about the repercussions of the world economy upon the US financial system and its inflation rate. But, for growth purposes, I insist to say that the only remaining domestic economy is the United States economy. They have been "robbers" for good reasons: They have done their homework in the last fifteen years at home and the consequence is that they now have a buoyant economy. Yes, there are some distortions, and there are difficulties. And there will be more important ones further down the road.

Talking about 1999 I insist that my forecast is for the US economy considerably more bullish than John's. My GDP growth forecast for the United States economy in 1999 is three percent rather than one percent growth. John's one percent growth forecast implies that GDP in the course of this year will not be higher than it was at the end of last year. It must be lower because the carry-over into 1999 already is the one percent growth John is talking about. So I hereby single out the United States as the locomotive for the world economy. If I give up this assumption, I'm in trouble!

We have already heard from some of the Asian countries that the Asian crisis is far from over and I'm pretty sure that I cannot preempt the presentation of Sakakibara-san on Japan. Nobody can preempt his presentations, that's obvious, but if I may dare, he probably won't overcome the deflation that certainly is holding its grip upon the Japanese economy these days. I therefore assume that Asia continues to be in recession and that the most important country in Asia, Japan, remains in deflation, which will be an additional burden and an additional difficulty we will need to discuss in the future.

Turning to Europe, we are now very happy to have good money for the continent as a whole. The Euro. Despite all the ink being used and wasted in the "pink press", this distrust seems to dominate much of your thinking. There were some farsighted politicians and a number of courageous farsighted businessmen in Europe, that insisted on the parochial approach to live in a globalized world with currencies that are dwarfed by the size of the country. When driving through Europe, you are dealing with a new currency every hour. That's not terribly economical. And if I talk to my American friends how they would feel about fifty currencies in each of their states, they ask me whether I am out of my mind. And they are correct.

But Europe behaved in the past as if we needed a currency for each state. We obviously didn't, and now we've got a new and a good currency, because the institution that is issuing the new currency, the European Central Bank (ECB), is a rock solid institution built on an architecture that was imported from the United States after World War II and proved successful for fifty years at the Deutsche Bundesbank. So now we've got one good money that investors can rely upon. Unfortunately, we don't have a good economic policy, and that is the same combination we had in Germany before the advent of the euro. Good money, the deutsche mark, but lousy fiscal policy. That is not particularly farsighted. Politicians are always concerned about the short term and rely on the pay-as-you-go system instead of a funded system that can handle the implications of the future. This is traditional socialist heritage, which is still holding a grip on us. Some of our countries in Europe, rather the voters of these countries like my own one, Germany, now decided again to go left in order to try more of what has proven not to be good advice. However, there is hope that a new generation of European leaders, namely Tony Blair and hopefully Gerhard Schroder will start pushing for the necessary structural reforms soon. Today, Europe is on a mixed path with good money and bad economic policy. I sincerely hope for Europe's future to correct the second part and I do hope that the Americans will help us. When the Asian continent has recovered, hopefully they will help us, too.

A few words about the economy itself. In 1996, 1997 and partly even in 1998, the European economy was supported mainly by export growth and by the terms of trade improvement. There were few cases where we had strong domestic demand. But there are some cases, be assured, in some niches, where nations know how to perform good economic policy. So, for example, Ireland, Portugal, Finland and the small countries, at the periphery of Europe, indeed have undertaken very pragmatic approaches to overcome the structural deficiencies of their own economies. And they are growing fast. The only “tiger" economy being left in the world economy is the Celtic tiger: Ireland. This country has been growing at a 8% rate for the last 3 years, after growing for more than 5% through the last 10 years. They have a real estate boom, high investment activity and they are an immigration country. You'll like it. The unfortunate thing about Ireland is that it is too small to be important. The same holds true for Finland and Portugal. Portugal is governed by a socialist government that has learned its lessons. It understands that you have the need to take care of their market as a “friend" rather than an enemy, which is very difficult for socialists. But once they have understood, they deliver perfect solutions and a really perfect performance.

After all this luck in Europe, we now run into a period where export growth is decelerating, because the markets we are delivering goods to are in bad shape. And secondly, we don't have the domestic demand to make up for it. Of course, everybody has two instruments to stimulate the economy-monetary policy and fiscal policy.

Monetary policy in Europe fortunately is done by the ECB. In January, Europe started with a money market rate of three percent. It's not yet 0.25 percent (as in Japan) so we do have some leeway compared to other countries that may need some stimulation. A reduction in interest rates in Europe, would be against the needs of countries in the club that do have a real estate boom like Ireland, Portugal and Finland. They would wish an interest rate going up rather than down. But again, they are not weighty and therefore at the end of the day the monetary policy still has leeway in Europe and will help stimulate the economy.

But with respect to fiscal policy we have to wait for a full blown recession in Europe before we can use fiscal policy to stimulate our economy. The Stability Pact doesn't allow the more important countries to add to the stimulation before they are in deep recession. And this recession is being defined as a recession of an excess of 0.75 percent of GDP decline.

A few words about the consistency problem that we are all facing. We have to suggest that forty percent of the world economy are in recession, including Japan. We see capital flows into safe havens and these have helped to bring down long term interest rates in developed countries. This is part of the success story of developed countries. The housing market in the US cannot be explained without long term rates being in the vicinity of four to five percent. European housing market cannot be explained either without the help of capital flows into Europe. Of course, these capital flows into safe havens have a counterpart. It is the high risk premium in the countries where the capital came from. And the risk premia in some countries are excessively high. And this implies that the world now has excess capital in the mature world and extreme scarcity of the capital in the emerging or developing world. So you have scarcity of capital where you need capital, and you have excess capital where you don't need it.

That's not exactly helpful for the longer term prosperity of our globe. We've talked about the contagion effects that are translated through trade ties financial markets ties and slumping commodity prices. I would, however, suggest that the US and Europe will not only benefit from the low interest rates for investment in their region, but they will be helped additionally in the medium term by the reduction of commodity prices. Normally this happens with a lag, so I'm pretty sure that we should not talk about a vicious circle forever. I'm now in the fifth cycle of my forecast's lifetime and I'm pretty sure that it will not be the last. Therefore I safely assume that there will always be reasons for turning.

A few words about the international coordination of macroeconomic policy. This so far seems to be a taboo for the United States Treasury, and I don't understand why. I believe I remember that there was such a thing as a Plaza Accord and it seemed as if the Americans had an interest in getting help to restructure their economy. They believed that the exchange rate is an important element. The world should address this problem again despite the constant brokerage of Larry Summers and Bob Rubin. The world still faces a problem: The important partners don't cooperate. But we have to cooperate in terms of macroeconomic policy, including the exchange rates. We know that you earn your credibility by sound domestic policies, yes, but we have learned as well that there are contagion effects and that there is such a thing as imported credibility.

How would you explain the reduction of interest rates in Italy from 1993 to 1998? There was reduction of long term interest rates from above thirteen percent to five percent within four years time. Would you explain that by sound domestic Italian policies? If not, there is something to be said about imported credibility. We should not forget about this lesson, and we should not ridicule people who suggest currency boards for certain circumstances in certain cases. Those who are advocates of floating rates should understand that if everybody wants to float and everybody wants to devalue, there is a systemic problem, and these damn guys who suggest this solution shy away from addressing this systemic question. If everybody now talks the poor Chinese into certain solutions, that only causes the second round of avalanches in Asia. We therefore should think of macroeconomic policies and their coordination, including the exchange rate systems. We all agree that there should be a better regulation in safeguarding market excess and are out for suggesting a world regulatory authority. We are sure that the Europeans and the Americans will listen. Or will there be an ongoing fight about the regulatory environment as there is an ongoing fight on bananas? So on occasion, it's quite interesting to suggest international regulatory authorities but we have to make sure that we adhere to their ruling.

If you have a regulatory authority on the global level, then the question arises on who will be the lender of the last resort. If the regulatory authority goes to the super level, the lender of last resort goes to the super level as well. How to identify the global tax payer to bail out? It may be an interesting question but very difficult to answer. Therefore better improve the regulatory authority at the national and the regional level. We cannot request the leadership of only the super power, the US. This nation cannot possibly continue to be between benign neglect, belly and boasting. We need a “better" US. It is very obvious that Europe cannot be a contributor to what I have been talking about if we do not learn to speak with one voice. We are dwarfing ourselves at this time by asking for more numbers to remember when people talk to us. Kissinger put the right question. He asked: What is the number to call if I call Europe? Today we have at least one answer. It is the European Central Bank's number. But we have not yet found the institution at the political level that could do the same thing for Europe. So we badly need exactly that.

Let me conclude in saying a few words on the region. I do not believe that we want to save the region in 1999 and 2000, and not only in 2005. I don't believe that the requests for structural reforms are enough. But I do believe Japan and Asia's troubles request a favorable international environment and a favorable international environment includes a yen that will be weak for a number of years. That is 140 yen to the US-dollar and, in order to be precise, I put the US-dollar to the Euro rate at 1,20. These are the rates that I believe would be helpful to get some of the excess capacity of Japan's economy being used in order to allow this country to solidify, to consolidate its bad loan problem over a period of three to five years. However, this doesn't make sense if we don't have a determined reform in Asia which is the precondition for international support.

I would not go through the list of arguments that have been mentioned already but I agree with our Thai friend. We have to come up with new ideas. We, the G3 world, have to come up with an idea that I would coin "Marshall Plan for Asia". And this is the real economy, not alone the financial world in Asia. We need to have an international system that makes the equity capital available for the infrastructure improvement of Asia, i.e. India, Sri Lanka, Thailand, Malaysia, you name it. And if this is equity financed by worldwide investors and managed by capable international firms at the exchange rates I just indicated, the necessary equipment for a buildup of Asian infrastructure is being provided. If this happens I think we'll live in a better world, not only in 2005 but probably in 2000 already.

Remarks from Japan

Eisuke Sakakibara
Vice Minister of Finance for International Affairs
Ministry of Finance, Japan

I would like to use the full advantage of being the last speaker and present my opinion using the comments and remarks of the previous speakers.

First of all, there is much that I agree with Dr. Stiglitz's analysis of the Asian crisis and his prescriptions for the reformation of the international monetary system. As a matter of fact, the Japanese government has been criticized by the International Monetary Fund and the U.S. Treasury because we seem to be in agreement with Dr. Stiglitz on so many things. This is not to say that there is some special relationship between the Japanese government and Dr. Stiglitz, rather that we think that what he says is very appropriate. I believe this comes from the fact that the World Bank and the Japanese government are in a similar position, which is that although we are both a part of the system, we are in a rather fortunate position of not having to defend our past decisions as the IMF and the U.S. Treasury have to do. This must be the reason why we are taking the position that we are.

On the other hand, I was quite shocked to hear Dr. Virabongasa's analysis. The general belief is that the Thai economy has bottomed out or is on the way to do so and that 1999 will be a good year for the economy. These beliefs are generated mainly from English newspapers and U.S. investment banks. But Dr. Virabongasa has given us a different picture and we must seriously consider his analysis, especially whether the “revolution" in Thailand is truly bearing the fruits it is supposed to bear.

Dr. Lipsky's comments were very effective and persuasive. I felt as if I were listening to Larry Summers, the Deputy Secretary of the U.S. Treasury. I am amazed at the growing intimacy of Wall Street and Washington recently and although I am not sure if it is the Treasury that is echoing Wall Street or Wall Street that is echoing the Treasury, it seems clear that they share the same strong optimism.

Dr. Walter's comments, too, were fascinating but I had the impression that he was reflecting not the views of the Ministry of Finance of the present German government but rather the views of the Bundesbank. “Good money, bad policy" probably meant “good Bundesbank, bad Ministry of Finance". I think he gave us a very vivid description of the present German financial scene and I was very interested in his analysis.

Here I would like to emphasize that we have not overcome the crisis that began in September / October of last year, which we and the United States have discussed vigorously. The United States lowered its interest rates three times and the Brazilian package was finally formed. However, Brazil is again in an unstable situation. With the arrival of Stanley Fischer there today, we are witnessing the so-called Stanley Fischer effect, in other words the Real strengthened somewhat. But it is still uncertain whether Brazil will be able to overcome the present crisis or not.

I strongly believe that we should be very much aware of the fact that we are still in the midst of the global financial crisis. Aren't Wall Street and the U.S. Treasury too optimistic? Europe cannot avoid being in a sort of euphoria with the birth of the euro. We must allow the Europeans to be somewhat complacent because what they had pursued for 50 years has come to fruition. But at least the G7 countries should have a stronger sense of crisis. Dr. Walter commented that benign neglect on the part of the United States is not acceptable. I am not sure if the U.S. government is necessarily choosing to pursue a policy of benign neglect, but if they are, I do think that is a mistaken policy. In the end, all crises affect financial centers, first and foremost, Wall Street. If history tells us anything, I believe that if we look at the situation in the long run, the present crisis will affect Wall Street.

I believe there are three major problems. First is the fact that in the wake of the information and communication technology revolution, financial innovation and financial engineering are progressing at a sensational rate and their leverage has increased quite remarkably. It is said that the leverage had decreased somewhat at the end of last year, but it is still quite high. This indicates that there is still a vast amount of liquidity. The fact is no system has yet been created to handle this vast amount of leveraged liquidity in the financial sector, nor do the financial authorities have the means to do so.

Another point we must note. It is said that there are about 70 million people who invest in Wall Street, which is about half of the working population in the United States. This is a completely different picture from what it was 10 or 15 years ago. Looking back over the past 10 or 20 years, if there were financial problems, the strategy would have been for experts to get together and discuss how to overcome the crisis. This involved mainly banks, including investment banks. But now, it is not possible to form a strategy just by gathering the banks. There are different types of fund managers in the market and we must now consider how to integrate them into the system. Dr. Lipsky said that it is virtually impossible to control the hedge funds, but we must remember that the U.S. investment banks operate almost in the same way as the hedge funds, and there are various copy funds, as well. So it is useless if we just single out the hedge funds. It is crucial to consider how to integrate various funds, including the pension funds, into the international system.

Needless to say, the authorities including the IMF, the World Bank and the G7 have to change their role drastically, too. Concerning the new international financial architecture, Dr. Lipsky commented that " the current discussions underway" " are not likely to result in any sweeping agreements any time soon". I agree with the analysis that objectively speaking there is hardly a chance that such a system will be created in the short run. But I must also point out that if such a system is not created, crisis will evolve in the medium term. I predict that in the next year or two, it will be a catch up game between the evolution of crisis and drastic innovation.

I would now like to point out three problems which we should address. First is the problem of capital flow. It is most urgent to figure out how to monitor the leveraged liquidity that is driven by the information and communication technology revolution as I previously pointed out, and the capital flow that is driven by such liquidity.

Second, I agree with Dr. Walter about how we must cope with the foreign exchange rate regime. Right now, recommendations given to emerging countries swing widely. Many people call it the two corner solution which means that recommendations swing from a floating rate system to implementing a currency board. Sometimes, even the currency board is not enough and the recommendation goes as far as dollarisation. We must have serious discussions as to whether it is wise to swing from one extreme to another in this manner.

Third, it is impossible to avoid globalization from developing in its present form, in which case it will be necessary to have some kind of an institution, perhaps not a central bank, but an organization that will serve as the lender of last resort. Of course if there are going to be some measures to regulate the flow of capital that will make a difference, but they will certainly have a very negative impact. We must cope with these fundamental issues: capital flow, exchange rate regime, and the lender of last resort.

We are having extensive debates on how to cope with these issues. I am afraid that perhaps Dr. Lipsky's assessment is correct when he says that it is unlikely that we will get results, or at any rate results in the short term.

The global economy in 1999, I believe, is still in a state of crisis. For example, the crises in Russia and Brazil are not solved. On the situation in Asia, I have a very different assessment from Dr. Walter. I believe that the economies of Japan and some other Asian countries will bottom out during the year. But I am afraid the recovery after bottoming out will not be very strong. Dr. Virabongsa predicted that it will still take some more time for the Thai economy to bottom out. I believe that whether it is Thailand, Malaysia, South Korea or Japan, their economies will bottom out, at the earliest, by middle of this year, and even after that, growth will not be very powerful.

I also think that we have a potential problem when the U.S. economy is too strong.

There is a strong possibility that at some point it will plunge drastically, and we do have to consider the risks involved in that possibility during 1999.

European economic growth is also likely to slow down. Unless the US economy grows at the rate of 3% or 4% and the Dow in New York continues to rise, I do not see any engine that will pull the world economy. I believe this is the honest assessment of the global economic situation in 1999.

I am also concerned that even if the US economy continues to serve as the engine of the global economy, or if the Dow does not drop drastically, the protectionist tendency in the United States is bound to strengthen. That will invite intense trade friction between the US and Europe, and between the US and Japan. We are already witnessing the tendencies. There is already a banana war going on between the US and Europe, and I do not think the war will end with just the bananas. Steel is the issue between the US and Japan, but here again I do not think steel will be an isolated issue. So I predict 1999 will be a year when there will be some weak economies within the global economy and it will be hit by some turbulence from time to time, with trade friction and political problems growing more and more serious.

I am sorry to be so pessimistic, but one optimistic thing I can say is about the Japanese economy. The financial crisis in Japan has subsided, or is approaching an end. I believe the next one or two weeks will be the peak. The presidents of the major Japanese banks seem to be meeting the Monetary Supervisory Agency. If in the next two weeks or so, there are agreements for more restructuring and capital infusion by the Financial Reconstruction Commission, we can say that the Japanese financial crisis is over.

Panel Discussion

Gyohten: Well, ladies and gentlemen, we have concluded the first round of initial presentations by five distinguished panelists. Frankly speaking, I would have expected somewhat a more positive view from those panelists about the near term future of the world economy, but I think we have to face the reality.

Now, I think those five panelists raised several very intriguing issues which have global implications. I'm afraid we cannot cover all those interesting issues during this very short period of time, but one thing I would like to put on the table, is that, as Mr. Virabongsa stressed, probably the most serious problem all those economies in crisis or in difficulties are faced with, is the problem of under-capitalization of banks and also of industrial firms.

So the problem is how this under-capitalization will be addressed. From a very common sense view, there are only three major sources.

One is for those banks and firms to raise new capital, in private market, either in domestic market or in international market. Second, the government will have to provide money to be injected into those undercapitalized institutions. Third is to depend on foreigners, either they could be public institutions like World bank, IMF or "Asian Fund", or whatever, or foreign private investors. I think any banks or firms that are suffering from this problem of undercapitalization must choose where to go. And I gathered from what Mr. Virabongsa feels that the first two alternatives are not very easy, so the only possible approach is to ask for international public investors to inject necessary capital.

I wonder what other panelists would have their own views on that. Is the international public investor the only possible provider of those needed funds or are there any ways those banks and industrial firms can explore or tap the needed capital to strengthen their positions? Because, I think unless we can solve this problem in an effective way, the present global uncertainty or lack of confidence for the future cannot be dispelled.

Stiglitz: I think one need to think separately about banks and corporations. In a context of corporations, I refer to my discussion of the importance of bankruptcy law, bankruptcy restructuring and the conversion of, for instance, debt into equity.

The financial reorganization reform does not necessarily require outside capital. One has to make a judgment about whether the firms need new injections of capital in order to grow. That's a quite separate question. But the conversion and the financial reorganization of the firm itself does not necessarily require outside funds.

Looking at the issue from the perspective of the overall economy, Asia has had a very high savings rate. Historically, the savings rate have been thirty to thirty-five percent, quite in contrast to that of the United States. If Asia continues to save at that level, they don't need outside money. They don't need outside funds. In aggregate, it's the question of re-deployment of funds or making sure that the funds somehow get into where they are going to be necessary in order to make the micro - economy work. And so it's the link between the macro and the micro. But it's not an overall source of funds that's the problem.

Now let me talk about the banking system because I think that is a rather different set of issues. There is often a confusion between the deficit that the borrowing that the government might have to undertake to recapitalize banks, and other forms of government borrowing. When the United States had to spend a couple of hundred billion dollars to recapitalize S&Ls, there was a lively debate about whether those expenditures should be even included as part of the deficit. And the reason for that is that it's basically a capital asset transaction. It is an investment, you can think about it as the government is giving funds to a bank and getting a return, a certain claim on the bank. It' s a capital asset transaction. If you have the right accounting framework, which no government does, you wouldn't even include it as a deficit. It would be part of a portfolio reallocation of the government.

It is completely conceivable to me that the second of the ways Mr. Gyohten described is a viable way recapitalizing the banks without having recourse to foreign sources. A number of countries have, in fact, engaged in a rather clever way of going about raising this, where the interest cost are even kept at a very low rate. What they do is that they actually borrowed money from the banks and then used some of the money that they borrowed from the banks to invest in the banks. And because of the multipliers associated, that does give the banks more liquidity with which they can lend to other firms. It is a way of meeting the capital requirement, the Basel capital adequacy requirement.

I think that the Miyazawa initiative is a very important vehicle for putting in new capital where it is needed. But I think the overall perspective that I 'd like to put forward is that actually foreign funds are really nonessential part of the recovery. They add their help but they aren't really that essential. And in the long run there are real questions about selling assets at fire sale prices and particularly given the context in which the problem has arisen where in many of these countries they first were told to raise interest rates which depressed capital asset prices.

First there were loans made by international banks. They were persuaded to take the loans. Then the money was withdrawn, and the interest rates would rise, and asset values go down and the foreigners buy the assets at fire sale prices. That particular configuration of sequence of events could obviously be interpreted by some people in political process in a way that would be very destabilizing.

Walter: Bad loans often result from interference of fiscal process (industrial policy) and the credit allocation process. In centrally planned economies that is a regular feature. In quite a number of mixed economies budget policies distort credit decisions, often with the best of intention. This holds true in Germany or France, in Japan or Korea and it is prevalent in quite a number of emerging countries. Therefore, to blame the insufficient credit allocation process alone for the large bad loan problem and the lack of transparency and accountancy principles is not appropriate.

I therefore suggest that what is badly needed is the separation of those two processes. It is not enough to recapitalize the institutions and then not let them soon to make the same mistakes.

Mr. Stiglitz is absolutely correct in reminding us that the savings rates are very high in Asia.

These savings could be used to recapitalize the Asian monetary institutions. So there is no specific need for funds from international investors. But on occasion, it is helpful for new concepts to develop faster to allow management know-how to be imported. In Europe, we had to learn that the hard way, after the Iron Curtain was lifted when quite a few countries in Eastern Europe not only had to be recapitalized but had to be equipped with management know-how in order to get off the ground. While there is agreement on this issue in principle, I fear that there are wildly inappropriate judgements on the manpower needed for this task. Just for the small case of Germany, the West German banks were sending eight thousand bank managers for five years into East Germany in order to help to develop the banking sector for fifteen million people.

This gives you an idea of what would be the needs for Indonesia: To establish Indonesia's financial sector 100,000 experts would have to go for half a decade to the islands in order to do a job comparable to the one in the former GDR. FDI in banking, however, could be construed as selling out the country at low prices: This may cause political opposition. But we have learned it the hard way: Those countries in Central Europe that were open-minded to the import of foreign capital and foreign management know-how are much better off today than those that pursued only good macroeconomic policies and were not allowing foreign capital and foreign management know-how to come in. The country I have in mind is Hungary, still not pursuing too good macroeconomic policies, but allowing the micro economy to improve through import of international capital and international management know-how, whereas the Czech Republic performed excellent macroeconomic policy through an excellent central bank, has not yet performed as good as Hungary, because it could not attract the interest of the international management and investors on a sustainable basis. This certainly should be a lesson for quite a number of Asian countries. If one wants to get out of the difficulties post, there is no alternative but to hire the experts who have for example served the savings and loans for your country.

Lipsky: It brought sense. Both Dr. Stiglitz and Dr. Walter made their points. But I think there is one point that is worth keeping in mind in thinking especially about Asia but elsewhere. In every single sense, in every single case, in the crisis countries, the triggering event was domestic capital flight. And foreign capital followed after. And that suggests, and this is what makes the solution tricky, and means that there isn't going to be one solution for everywhere. Ultimately you have to restore domestic confidence and if you don't do that, it doesn't matter how much external capital you apply. If there is not domestic confidence, foreign investors will simply be financing capital flight. And it's just a reality and that means it's hard for these cases to be solved, hard to solve them quickly, hard to say that here is a magic solution that will solve the problem in every country.

Virabongsa: I would like to make it clear here. Dr. Stiglitz and our colleagues believe that the saving rate in Asia is very high. Actually, it is true, in the past and at the moment.

But do not forget that our investment rate was even higher. That caused the problem. For example in 1990-1996 our saving rate was 35 percent of GDP but the investment rate was 43 percent of GDP. That was also true in Malaysia, Indonesia and other countries in the region.

Therefore, traditionally countries in Asia, except for Singapore, are capital importing countries, including probably South Korea in the past also. Therefore the debt accumulated by capital importing during the decade is higher than GDP. This is evidence, this is quite obvious, that you know, now our banking system needs recapitalization of about 40 percent of GDP. And probably other corporation, non bank corporation need probably the same magnitude. Therefore, it is important for both domestic and international market to finance the equity, the capitalization that is needed there.

The direction recommended by the Fund or our friendly nations like the United States or others is that we should clean up ourselves, we should take a bath three times a day and so on, so that we will be attractive enough to bring in capitals.

The market, the international capital as well as money market in Asia has failed. Here's a failure that doesn't function properly. Therefore it gave some source of intervention internationally. That is the idea of proper international equity fund or whatever you may call it. The other alternative probably is to lower standard and forget about foreign investment, foreign fund or foreign capital that will come and bail you out from the crisis starting from where you were ten years ago and so on.

The direction that we are taking I think in the case of Thailand as well as probably Indonesia and Korea, is to use tax money to bail out our financial institutions. That will create a lot of problems in the future and that will never be enough for the need that occurred at the moment. The real sector has not been taken care of. Whatever you put in financial sector, and if the real sector is still weak and ailing, everything will be wiped out, sooner or later. Therefore this is a really serious question. I think the Bank and the Fund have to look into the situation seriously and try to find what is going on there, what is the magnitude and you have to think the things integrately, not separately from the issue.

Sakakibara: On Mr. Virabongsa's point, I am sure that investment rate has been very high in those Asian countries, but the question here is that they have overinvested during the course of last several years and it was probably one of the major causes of the crisis that we have experienced in this region. Another thing, you know, I think that John is right that Asian countries do have high savings ratio. But the current global sort of system is that Wall Street or the City sucks all the money from the rest of the world and then distribute them. So the fact that they have the highest saving ratio does mean that they do not need the importation of the foreign capital.

One thing which has been sort of proposed by one of the Asian countries was to create a deep and resilient debt market in Asian region so that Asian money could be at least recycled within this region. And that is one of the sort of proposals I think we could elaborate upon. There are lots of equity market but for many Asian countries, equity market has become somewhat speculative in nature. In the United States. Internet is now is like a lottery but lot of lotterist has accessed in Asian countries during the course of nineties.

Stiglitz: I agree that one wants to distinguish between the role of foreign capital and foreign management although they are typically linked and that there is a real value to bringing outside ideas. But I think quite often, this point is exaggerated.

I want to point out two points. First is that the region experienced thirty years of very rapid growth that took some kind of management. I mean you couldn't just convert it and that growth was real and there is some local talent that does know something about how to deploy resources in ways to make them productive.

And secondly the example that Dr. Walter gave about S&L experts, is exactly the kind of problem that I think is the danger of bringing in foreigners, because the difference between systemic crisis that I described, the financial market crisis, and S & L is very large Bringing the model that worked in S&L crisis to another country may not work at all. To give you just another aspect besides the difference between one being systemic and the other being a relatively small fraction of the US financial market. The Resolution Trust Corporation took in the bad assets of S&L. What were the bad assets? They were real estate. Not managing them very well didn't cause much of a problem. If the assets of S&Ls had been major loans to General Motors and RTC had wound up managing General Motors and Ford Motor Company, it would have been a very different picture and it would not have worked as effectively. My observation is, watching some of the people who had the experience in S& L brought to Asia, that they have compounded the problem rather than resolve them.

Open Question-and-Answer Session

Q.: To Mr. Stiglitz, it's an opportunity I've been waiting for since February 28th last year. You know why. For an institution that is so slow moving, the World Bank, you have been very very fast in criticizing the IMF. After all the IMF time frame is usually three years, but barely after three months into the Korean program you delivered in Chicago, sort of wide ranging criticism of the IMF recipes. Now fourteen months later it looks like the IMF recipes work when and if, and of course it's a big if, they are genuinely applied. So I'd like to have your assessment on where exactly Korea stands and if it's getting out of the recession much quicker than anybody expected. That is; if foreign capital is flowing in again, is it because of or despite the IMF remedies?

Stiglitz: Let me first begin by echoing the point that my colleague just here pointed out that there is a lot of confusion between the stability in the financial variables like exchange rates and interest rates, and the real recovery. It is still expected that unemployment will continue to increase in Korea and the pace of recovery is....there is still considerable uncertainty. The issue that I raised is in retrospect I think now generally agreed, that the IMF in its own report has pointed this out, that the policies were excessively restrictive, particularly on the fiscal side. The reason that I came to that judgment and I think most other people, many other people came to similar judgments, is that if you wrote down a standard macro economic forecasting model, you would have come to the following observation, that these economies faced a drastic drop in domestic aggregate demand as investment was going to drop away and consumption was going to be undermined. And for instance in the case of Thailand, we saw data coming in almost immediately after the crisis about car sales and consumption and the drops were just dramatic. Well, I mean I was putting myself a little bit in the position of the Chairman of the Council of Economic Advisors and if I'd seen numbers like that I think I would have committed suicide. They were just dramatic. When you see numbers like that, you say there's a problem and in general, there's the view that I still believe that a necessary condition for restoring confidence in economy, is that economy is functioning and that high levels of bankruptcy and high levels of domestic contraction are not consistent with restoring confidence. The only possible prospect to offset the dramatic reduction in domestic aggregate demand was an increase in exports.

At the time that the crisis for instance hit in Korea, it was already clear that there were reasons to expect pessimism about exports in terms of the weaknesses in the Japanese economy, weaknesses in the regional economy, beginning signs of falling declining terms of trade plus a well-known experience that when there is a financial crisis firms often have a difficulty getting credit, and the lack of credit and the lack of funds itself can be a restriction in the short run, exports. And in fact, the experience has been that exports have not done at anywhere near as well as you would have expected, given the magnitude of the devaluations, had these other effects not been there. So the overall perspective on that side that I brought was a straightforward experience of having been the Chairman of Council, how I would have looked at that, seeing where the economy was going and very concerned about the potential downward contractionary impact.

On the other side, one of the major advances that has occurred in the macro economics in the last twenty years is an attempt to integrate micro economics and macro economics and to integrate financial economics and micro and macro economics. Almost a quarter century ago I began writing articles in which I pointed out that raising interest rates have, in general, can lead to significant increases in the probability of bankruptcy and you can see that. I mean that's all in the published literatures. It is standard reading in graduate courses in economics even almost everywhere. It has actually, you know, led to a lot of rethinking on the nature of role of interest rates. More recently in about ten or fifteen years ago, I began doing research linking these bankruptcy effects to macro economics, taking it from the theory of the firm into the macro economic behavior.

Those theoretical works led very clearly to a concern, a concern that there would be these kinds of adverse effects in an economy in which there are high degrees of leverage as characterized in Korea, Thailand and in many other countries. Many of us had warned them against the high degrees of leverage. But the point was we were working not where they should have been but where they were. And given those high degrees of leverage on private debt, not on government debt, the adverse impact on the macro economy was quite predictable.

There are some very delicate issues that were debated and discussed about the alternative effects of devaluation and those also have to be taken into account and one has to balance the two. In the case of Thailand, for instance, data we have show that there were two categories of firms that had high exposure to foreign obligations. One of them were firms that were the real estate firms. There was a lot of foreign debt to the banks that have loaned to these commercial real estate. Those firms were debt and further devaluation would not have made them more debt. You're debt once and being debtor doesn't make a big deal of difference. And in any case, there would have been an end to the real estate boom. I mean that bubble had burst. On the other hand, the other major group of firms that had foreign exchange exposure were exporters, and while they would have lost on one side, they would have gained on the other. And so a risk analysis is what is required, and what I was really saying was one needs in evaluating any of these cases a very careful look at the micro foundations as you approach these macro problems especially when what is at a core is a private sector indebtedness.

Gyohten: I'd like to listen to you more if you can delay the departure of your plane. But since it is impossible, I have to let you go.

Q.: As the title of today's symposium, the Prescriptions for the Recovery of the World Economy, indicates, the most serious concern of the world economy at present is, I think, whether the currency crisis can be stopped here; that is, whether we can make Brazil the last of the contagion of the currency crises. The prescriptions presented thus far on the crisis, especially those of the IMF, have often received many criticisms. I would be happy if any one of the panelists present here would give us the most important prescription to make the Brazil case the last of the chain reaction of the currency crises.

Lipsky: In answering that, I just would like to add one point. Joe Stiglitz gave a very sophisticated discussion of the considerations in constructing IMF programs as someone who doesn't have the familiarity with the Korean issue but did spend some time negotiating these kind of programs or participating in the IMF. I'd present just two practical considerations and then we'll talk about how that applies to Brazil.

First of all, often and especially in this case, these negotiations have taken place in a very uncertain, not to say chaotic, environment in which in many cases the authorities in the countries themselves, are unwilling to admit in public, therefore in the context of an IMF program, how bad things have become. Do you construct a program that claims it's based on stability in the real economy when everyone knows the right number is a very large drop in GDP and therefore construct a program that is entirely logically inconsistent but perhaps effective, or do you take the authorities at their word and build a program that is internally consistent but is bound to fail? I think that captures what goes on without saying there's no easy answer.

Criticisms of the IMF programs may in fact really represent criticisms of the crisis countries authorities unwillingness to admit in public how serious the situation has become. Now that may apply in the case of Brazil. It strikes me that in Brazil there were three problems. An excessive deterioration in the primary balance of the fiscal accounts; the primary deficit emerged. The need for structural reform in the public sector in state enterprises, and an overvalued currency. It seems logical that you will be successful by attacking all three of those problems. But the Fund program, at the insistence of the authorities, probably for perceived good reasons, was concentrated only on adjusting fiscal balance, and as a result the program simply lacked credibility and notably failed to convince the real people, the real targets of the program which were to restore domestic investor confidence. Simply we come back to the same thing we've learned again and again, that it is the loss of confidence in capital flight of domestic investors that causes and triggers the crisis. And without measures that successfully restore investor confidence domestically, the application of external funding is irrelevant to the solution and yet that seems to be a hard lesson to learn.

Final point. If the stability of our international system relies on the ability of five or six IMF staffers to arrive in the midst of a chaos and in a matter of two or three days construct an internally consistent program, a completely effective structural reform program, then I think that says to us that our system is fatally fraud. We have to design a system we all can agree. While maybe Joe will reject, we don't even have to argue on the benefits of open capital markets. Most people favor open capital markets as a solution, and if that's the case, we have to find an international system that makes market discipline effective rather than relying on systems of incentives and punishments doled out by the staffs of the IMF.

Sakakibara: I cannot comment on Brazil in any concrete terms because I shouldn't criticize IMF's Stanley Fischer who is trying to restore the stability in Brazil now. But one thing about Dr. Lipsky's comment. You know we've been playing what Paul Krugman has called confidence game: a game dominated with the market, dominated by the herd instinct. It is very difficult and you got to admit that this market is driven to a substantial degree by the herd instinct, which is necessary for objective analysis of the situation. So this is something the private sector people need to admit and the cooperation of the private sector in resolving those crises is extremely important. We call that private sector participation. Surely authorities of the countries in crisis and the IMF and the G7 are to be blamed, but the private sector had its herd instinct and their judgment before the crisis has erupted was something which needs to be analyzed as well.

Gyohten: I'm afraid time runs so fast and we have to end this exciting session. Although we couldn't produce during this past two and a half hours the clear answer to the world malaise. But nevertheless I think all of us probably can come out of this session with a better analysis of the situation, so that we can continue to work on the next step.

Address: 2-2, Nihombashi Hongokucho 1-chome, Chuo-ku. Tokyo,
103-0021, Japan
Telephone: 81-3-3245-6934
Facsimile: 81-3-3231-5422

e-mail: admin@iima.or.jp
URL: http://www.iima.or.jp/