A Perspective on Financial Crises

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I think my role is supposed to be to provide perspective. When I listen to this discussion, I am struck by how little things have changed. I also confess, as age advances, to a little skepticism and last night, and again today, George Willis has kept coming to mind. He was a wonderful senior civil servant in the U.S. Treasury Department when I arrived there as a callow youth in the 1960s and early 1970s. George Willis was in charge of the international finance area; he was the last survivor, at least in the U.S. Treasury, of Bretton Woods, so he dated back to real monetary negotiations. He used to carry Mr. White's bags, I guess, at the Bretton Woods Conference, and he was a very dominant influence at Treasury. Not many people in the U.S. Treasury knew anything about international finance in those days.

Willis was a rather skeptical fellow. You may recall that in 1971 a sizable international crisis occurred, right at the heart of the international monetary system. In fact, I thought it was the biggest crisis in 50 years. (One of the characteristics of the international system is that about every 10 years, we have the biggest crisis in 50 years, which tells us that something is amiss.) But we had a big international negotiation then, the C-20, where Robert Solomon was one of the leaders, and where we debated all these arcane issues of international finance. I had to lead the American delegation, and we used to have conferences in my office and consider this alternative and that alternative. Eventually the discussion would get around to George. "What do you think, George?" And George would say, "It won't work!" Finally, you got frustrated about this, so you

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started out with George, and asked, “George, what will work?” And the answer came back, “Nothing!”

I want to explain to you why that response is still relevant today. I might add first that two concrete results of that old C-20 were the Interim Committee (this was 25 years ago, but it is still called the Interim Committee) and the Development Committee (you still need some development, I guess). Anyway, let me make a few points.

As Jerry Corrigan has already said, if you expect the results of all these efforts to be the end of international financial crises, you are wrong. International financial crises, I might even say domestic financial crises, are built into the human genome. When we map the whole thing, we will find something there called greed and something called fear and something called hubris. That is all you need to produce international financial crises in the future. I have not seen anything to raise any doubts about that.

Now, let me explain why I am skeptical about some of the answers that have been presented in the name of architecture. If I were to confess, I think that I have more respect for architecture than Jerry Corrigan, but I do think most of these proposed changes belong in the area of interior decoration rather than architecture.

The outline for this conference stated that “misguided national policies produce harmful spillovers.” That statement could have just as appropriately read, “national policies produce harmful spillovers,” because good national policies can also produce harmful spillovers. The better a national policy is perceived to be in the emerging countries, obviously the more capital they will attract. The increased capital they attract will be an endorsement of the fact that the policies are good, so the country will attract still more capital until you get a bubble of the kind we are interested in. Then it all unravels, and everybody looking back says you must have had bad policies.

I made the mistake of accepting an invitation to go to Indonesia in the middle of that crisis, when the IMF was on its first iteration of repairing its first program. For the first time I read the IMF and World Bank appraisals of Indonesia, which were then about nine months old, issued shortly before the Thai crisis. I also read their program for Indonesia, incorporated in the letter of intent. I tell you, no red-blooded American investor reading either the Thai report or the Indonesian report or the World Bank or the IMF material would not have wanted to invest in both of those countries in June of 1997. Those countries had had 8 percent rates of growth for 20 years, they had price stability, they had budgetary discipline. That was all the first and second paragraphs of these reports said.

Now, to be fair, if you read on the reports also said, well, maybe there are some structural weaknesses in the banking system and a few problems here and there. I must say I was also struck by all the people advising Thailand who were so confident that the Thai exchange rate was overvalued by 15 percent. When I asked them about the dollar/yen rate they said, "I do not have the vaguest idea what the exchange rate is." How can we be so sure about the Thai rate, and yet have no opinion at all about our own exchange rate?

I do not think that just following good policies will solve the problems, at least for the interim. I think the problems go beyond that. What about strong banks, strong supervision? Bob Eisenbeis and Jerry Corrigan already referred to this. What happened in the United States? The United States has the image of strong banks and strong supervision. I have been a supervisor in the United States for more of my life than I would like to remember, and I tell you the state of Texas keeps coming to mind.

The state of Texas in 1980 undoubtedly had the strongest collection of the most profitable banks in the United States, in the best part of the country. Five or six years later, they were all bust, all of them except one that had been bought by another American bank. Something went on there. It was in the early 1990s that the biggest bank in the United States was, I would judge, within three months of federal intervention, before the situation fortunately turned around. If it had not been for substantial supervisory oversight and action by management, the bank probably would not have remained an independent institution. That is in this decade!

There is an inherent problem here. I hear discussion goes on in Basle about letting banks judge their own credits and capital requirements. But we have seen the dangers of the banks setting their own capital requirements. We have a dilemma. If you go in and set a tough capital requirement in this day and age, the U.S. banking system is no longer the principal financial market. The market will go elsewhere. Recently, the U.S. government and others demanded that emerging countries toughen banking standards, insist on transparency, and limit bailouts. Then, right at home, we found it necessary to conduct an official sponsorship of the bailout of the most unsupervised, unregulated, non-transparent, financial organization in the United States, because of concern that its failure was going to bring down the whole of the supervised, open, American banking system.

About transparency and auditing, all I will say is that in my entire experience as a bank supervisor, I have never seen a private bank audit that gave any warning whatsoever of a failing bank. Now, maybe some of you know of one, and I would be glad to hear from you afterward. Think about that audit report that the Penn Square Bank in Tulsa, Oklahoma, got some two months before the bank collapsed. You could not have a much worse bank than Penn Square, I will tell you. But they had a nice, clean, well-audited statement. Does anybody here really think that it is not possible to have a bubble in the U.S. stock exchange? I am not speaking about the current situation, of course, I am just talking theoretically.

With all the best accounting, disclosure, whatever, human emotions are involved. The problem is up here in the head, it is not what you read. The one piece of information everybody had about these emerging countries was that they did not have very much information. Did that stop anyone? And incidentally, marking to market, which Henry Kaufman already mentioned, can be a great recipe for accelerating crises.

Now in my view, all these arguments about what the IMF should do suggest a certain myopia. Are they lending too much? Are they lending too little? Are they providing too much surveillance? Too little surveillance? Are they too intrusive? Not intrusive enough? There are no good answers to those questions, in my view, except case by case, which has been suggested. The common theme I am trying to stress is that there is a broad systemic problem here that people have not been willing to face up to. The problem has been touched upon in these conversations, but I do not think we have faced it very squarely.

I think we are seeing a real crisis of global financial capitalism. It reflects the clash of two elements. One is globalization itself, all the technology you know about better than I. I cannot even get on the Internet. But a friend told me that he was in Heathrow Airport in these little booths where you make telephone calls, and an attractive young woman in the next one pulls in her laptop and does—whatever you do on a laptop—for 20 minutes! And he got curious as to how she was so busy on this thing for 20 minutes in Heathrow. Eventually, she got out and apparently she could not refrain from saying, with a little smile, "I just made $25,000." Now when you are operating on the Internet, making $25,000 between planes in Heathrow Airport, you know something of significance is going on.

The ability to move money around the world rapidly is well known. There has not been enough emphasis on the other element in the crisis. We live in an asymmetric world. As Jerry Corrigan mentioned, and Henry Kaufman mentioned earlier, we are dealing with very small economies. BankBoston, a $70 billion bank, just merged again because it apparently thinks it is too small. Yet it is bigger than most of the banking systems in these small economies. The more attractive they are, the more small countries are bound to be overwhelmed by free capital movements, no matter how strong they are to start with. You know, you put $30 billion of external capital into a total financial system of $100 billion, and you have a problem. A banking system that was strong to start with will not be strong after such an influx of capital.

The inherent vulnerability of smaller countries to this kind of capital flow is a real problem, no matter how good the economic policies, no matter how good their banking system, no matter how good their accounting system. What are we going to do about it?

Well, we can see a natural market response going on and it has very little to do with the debate here and elsewhere. Countries want to get bigger, they want to get more diversified. Obviously, a country faces certain constraints in that respect. But its economic system can in effect get bigger and more diversified by linking onto somebody else's. That is what has happened in Argentina. Argentina used to have its own banks; now almost all its big banks are owned and controlled by foreigners. The same thing is going on in lesser degree in Mexico. Korea has never felt good about opening to foreign banks, especially to Japan, but now they are beginning. It will be true in Thailand, it will be true in Indonesia, and soon people will have enough confidence in those countries to buy their banks, and the countries will be willing sellers. They are in a jam and they understand the only way they can get stability and strength is by joining to something that is big and diversified. The same thing is going on in the nonfinancial world. I think that is all fine, and economically it is correct, if we are going to have a good recovery from this crisis.

Let's consider what is at stake. These are countries that have been growing by 6 to 8 percent a year, as far back as my memory goes. They have only opened up their economies and particularly their financial systems in this decade. They opened up, and five years later they fell flat on their backs. Maybe it is all a temporary phenomenon; that is what we all hope. But we had better make it a temporary phenomenon or we are in real trouble, which brings me back to the exchange rate question and this talk of two-corner solutions.

I think there must be a third corner here someplace, but basically I am in favor of straight lines. I think the idea of a small country freely floating its exchange rate is unworkable. It does not happen in practice; they do not have the markets, they do not have the strong institutions, they do not have the size and depth. Then people say, "Well, it is a corner, but it is a modified corner. I know they have to manage it a little bit." In fact, the strong instinct is to fix.

The exchange rate is a multilateral phenomenon. There are a lot of sides to it. You cannot float and have other people fixed. We cannot fix and have other people float. There has to be some coherence in the system. I do not think there is any coherence in the system now, and these people in the Asian countries are not going to be able to pick a sensible exchange rate. Conceptually, it is easy to think of Mexico with a fixed dollar rate because so much of its trade is with the United States. But what do you do if you are in Thailand or Indonesia? A third of your trade is with Japan and 30 percent is with the United States and 25 percent is with Europe and 10 percent is with each other: You have nothing obvious to fix to. All in all, I believe we have a systemic problem with the exchange rate system, and that is where I disagree with my friend Jerry Corrigan and where I will conclude.