

## FINANCIAL MARKET STABILITY AND MONETARY POLICY

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### 1. INTRODUCTION

There are three central questions that I want to address today. The first is, what is the first role of the monetary policy on economic performance and stability especially in response to a crisis. I am going to argue<sup>1</sup> that the use of monetary policy in response to the Asian financial crisis was worse than ineffective: it worsened the economic downturn and, worse still, contributed to global economic instability.

I want to go from this description of *what was wrong with the policies and economic analysis underlying them* to the question of *why were these economic policies pursued*. This is part of what is called the political economy of the crisis, trying to understand the behaviour of the institutions responsible for formulating the policies. I would argue that we have spent too little time thinking about the behaviour of the international economic and financial institutions, given the important role that they play today in the global economy.

I am going to argue that the International Monetary Fund (IMF) changed the mandate from Keynes' original conception. Keynes was one of the conceptual founders of the IMF. He believed, or at least hoped, that such an institution would contribute to global stability, not to global instability. What I am going to argue is that it had changed its mandate from focusing on global financial stability and to providing liquidity to countries facing economic downturns, in order to sustain their economies at as close to full employment as possible, to pursuing an agenda that reflected the special interests of the financial community, in its worst manifestation to becoming if not the bill collector of the advanced industrial countries, an institution at least to enhance the likelihood that the creditors will be repaid. How do we explain this change of mandate? I want to suggest that it has to do with the governing structure of the institution.

The final question, which I shall have time to touch on only briefly is, what reforms should be undertaken, to make it more likely that the IMF returns to its original mission. (I should say that I believe that there *is* at least a potential

<sup>1</sup> Here I am in agreement with Professor Ho (who stated in his Presidential address that, 'if only we take advantage of what we have learnt in economics, we can avoid major policy mistakes'). But I do not share Professor Ho's optimism: policy makers may not have learned as much as they should from the experiences in the post-Keynesian era. Consider the IMF response to what Professor Mundell (in his speech) called the IMF Crisis in Asia. Performance would have been much better had they just gone back to simple basic economic principles.

role for an international institution directed at maintaining global stability, through the provision of liquidity to less developed countries facing a serious economic downturn.)

## 2. TWO FACTS

Let me begin with two basic facts.

### 2.1. *More frequent and deeper crises*

The first is that financial economic crises have become deeper and more frequent over the past 25 years. This may be surprising given what we have learned about economic management. In the United States, economic downturns have become less frequent, shallower and shorter. But that is not the picture around the world. If you look around the world it is almost more unusual not to have had a crisis than to have had a crisis. Almost a hundred countries have had some crises in the last 25 years. From this perspective, what set East Asia apart was not that it had a crisis in 1997; what was unusual was that the countries in the region managed for so long not to have a crisis.

#### A. *Caused by capital market liberalisation*

There is now a widening agreement that capital market liberalisation has played a critical role in this phenomenon, the increased frequency and depth of crisis – and it is now also recognised that liberalisation was the underlying source of the problems that gave rise to the East Asia crisis. The cost of these crises has also been absolutely enormous, not only in terms of the budgetary cost to the government but also in terms of the economic cost.

### 2.2. *Ineffectiveness of high interest rates in stabilising exchange rates*

The second basic fact is that the high interest rate policies in response to the East Asia crisis did not work, even combined with all the other ingredients of the packages that were part of the IMF programmes. They did not work in the sense that they did not succeed in their objective, which was to stabilise exchange rates. They were perverse in the effect they had on the economy. If you look at the economic data you can see the downward march of exchange rates and simply no evidence that the IMF packages worked at all.

### 2.3. *Monetary policy as the central point of contention*

The reason I want to spend today talking about monetary policy is that it has become the central point remaining in contention about the appropriateness of the IMF response to the crisis. The IMF now concedes that the magnitude of the downturn was originally underestimated. It now concedes that its fiscal policy was excessively contractionary. It now concedes that the financial

restructuring was, in at least several cases, mismanaged, as in the case of Indonesia. It now concedes that there was insufficient recognition given to trade inter-dependencies among the countries in the region. But it continues to defend the role of monetary policies that were used in the crisis. That is why I think it is really important that we have a discussion about the structure of those monetary policies.

Understanding the important role of the monetary policies is important because there will be more crises. One may be moving towards us now in Argentina. Turkey is already having one. There is absolutely no doubt that there will be further crises. Unfortunately I think there is high chance that these crises will be mismanaged. We must realise that how crises are managed affects the incentives and therefore the likelihood of future crises. I will argue that the way that the IMF has managed crises actually creates incentives that may lead to more crises in the future.

### 3. PREMISES UNDERLYING IMF MONETARY POLICY

To analyse the issue, let me try to describe what I see as the underlying premises of the IMF policies. As I see it, one of the central reasons for the failure of the IMF policies was that throughout the crisis in 1997/1998, the IMF employed an outdated economic model.

That model has three premises. The first premise was that it was important to prevent further deterioration in exchange rate, the second premise was that raising interest rates can do this, and the third was that the benefits of maintaining the exchange rate (i.e. through raising interest rate) outweigh the costs.

Let us look at each of those premises. Is it desirable to prevent the further deterioration of the exchange rate? Is it true that raising interest rates can do that? Is it true that benefits of maintaining exchange rates exceed the cost of high interest rate policy?

#### 3.1. *The value of preventing exchange rate devaluation*

First, is it desirable to prevent the deterioration of the exchange rate *through government action*? To suggest this is the case is to say that the market-determined exchange rate is not desirable.

##### A. *Intellectual incoherence*

There is a real irony here. IMF is an institution that often talks about markets and believes in markets. But for some reason when it comes to exchange rates it does not believe in markets.

This is something that I saw all the time when I was in the Council of Economic Advisors. Everybody believes in two principles *for every other sector except their own*. The first is that 'there should not be subsidies; subsidies are bad. But for our sector, you have to understand the special circumstances!'. The second one is competition. 'Competition is wonderful! However, in our

sector it is destructive!’ Following this mold, while the IMF says it is a bad thing to have government intervention, it also says not only that the government coming in to stabilise the exchange rate market is a good thing, but also that it is willing to provide billions of dollars to enable governments to intervene in the foreign exchange market (to be sure, the money is only lent, and the ultimate cost of the intervention is borne by taxpayers within the country). International bureaucrats sitting in 19th Street in Washington believe they can do a better job setting the exchange rates than the markets – when they constantly argue that *in virtually all other areas* markets do far better than government bureaucrats. What’s so special about exchange rates to justify intervention?

Interestingly, the IMF has not come forward with a coherent analytic framework that would justify intervention *in this one market*. They sometimes note that there is a seeming market failure – an overshooting of exchange rates; but excess volatility characterises asset markets more generally<sup>2</sup>. Presumably, the *consequences* of this market failure are larger (although stock market instability and the instability of real estate prices are major sources of macro-instability, which imposes enormous costs on society).

### B. *Inflation*

The adverse consequence that is most often referred to is the inflationary effects of exchange rate depreciation. But of course changes in other prices – such as the price of oil – also can have, and have had, inflationary impacts. Thus, if inflation can justify government intervention in exchange rates, it could also justify government intervention in oil prices – something that the IMF typically vehemently opposes.<sup>3</sup>

People worry about inflation having adverse effects on economic growth and real income. But there is no real evidence that this is the case, so long as inflation remains moderate.<sup>4</sup> More importantly, depreciation did not have a major inflationary effect in Brazil or East Asia, while devaluation was actually the basis of growth and recovery in Brazil and in Russia.

It seems clear that, by and large, the adverse effects on growth of overvalued exchange rates are far greater than the adverse effects on growth of the inflation, which devaluation induces.

To be sure, once the growth starts the IMF is inclined to say (as it did in Russia and Brazil), ‘That proves our policies worked!’ when in effect it was

<sup>2</sup> See Robert Shiller (1981) ‘Do Stock Prices Move Too Much to Be Justified by Subsequent Changes in Dividends?’, *American Economic Review* 71, 421–36.

<sup>3</sup> One reason, of course, could be that the costs of intervention in oil (or other commodities) could be high relative to the benefits. We consider the costs of intervention more extensively below.

<sup>4</sup> See Michael Bruno and William Easterly (1996), ‘Inflation’s Children: Tales of Crises that Beget Reforms,’ *American Economic Review* 86, 213–8.

because of the devaluation they fought and spent billions and billions of dollars trying to stop, that the economy has recovered.

### C. *Contagion*

There is a second argument: unless the depreciation is halted there will be contagion, and the contagion will lead to a disruption of global financial markets. Again, each part of the underlying chain of reasoning can be questioned. *Will a devaluation of one currency lead to contagion?* Neither theory nor evidence provide convincing support for the proposition that it will. Brazil's massive depreciation showed clearly that the answer was: not necessarily. Why should a fall in Russia's exchange rate lead to a change in the exchange rate in some other country with which it trades little? There is no *information* about, say, Columbia conveyed by Russia's devaluation. There are, to be sure, linkages (e.g. through trade) and in any general equilibrium system, changes in one price *should* lead to changes in others; but this is just the normal part of the equilibrating process of the economic system. The argument that contagion provides a basis for intervention must thus be based on the premise of a *market failure*; the adjustments in other markets are, in some sense, not equilibrating adjustments. But if that is the case it means that, more generally, anything that causes a disturbance in the exchange rate in one country has *externalities* on others; and interventions are required not just for the consequences but earlier, on the causes; in particular, the capital flows that give rise to exchange rate fluctuations. Here again, we see an inconsistency in policy stance: the IMF has (until recently) not only adamantly opposed such interventions, it has also tried to expand its mission to embrace capital market liberalisation.

But there are further objections to the *contagion justification*. First, it is not clear why interventions should stop contagion. If Mexico needs a multi-billion dollar bail-out to stabilise its exchange rate, why should that stabilise Argentina? Isn't it just as likely that the realisation that huge bailouts are required but that Argentina is not going to get a bail-out will lead to a worsening of Argentina's position?<sup>5</sup>

Second, it is clear that some of the actions taken by the IMF did have adverse effects on neighbouring countries – the attempts to prevent a devaluation through contraction monetary and fiscal policy led to a reduction in incomes, a reduction in imports, which, by definition, *constituted trading partners exports*, and therefore had adverse spill-overs: contagion in other words. This form of contagion, indeed, was perfectly analogous to that resulting from the beggar-thy-neighbour policies of the 1930s, which had formed part of the motivation for the establishment of the international

<sup>5</sup> See Stiglitz, 'Whither Reform? Ten Years of the Transition' Proceedings of the Annual Bank Conference on Development Economics 1999 (ABCDE) World Bank. (Originally presented on April 30, 1999. Published in *Transition Economics* 3(12) June 18, 1999) and the discussion in the section below.

economic institutions; the major difference is that, while both result in making neighbours worse off, the contractionary monetary and fiscal policies result in making the country itself worse off – which is why I refer to such policies as *beggar-thy-self* policies.<sup>6</sup> (I will discuss these policies at greater length later on in this talk.)

Thus, while the interventions designed to prevent contagion resulting from exchange rate depreciation may not have been necessary – there might not have been significant contagion in any case – and may not have been effective – any contagion that might have occurred without the intervention could have occurred with the intervention – the interventions themselves did have adverse effects on trading partners, leading to a round-robin of implosions of the economies in the region. And if the IMF really believed seriously in the importance of contagion, it should have taken a wider range of *preventive actions*, including actions to stabilise capital flows. Interestingly, *in retrospect*, even the IMF now agrees that it underestimated the significance of these linkages.

In short, there seems little support for the first premise of the IMF monetary strategy; the objective of trying to stop the further deterioration of exchange rates is, at best, questionable.

### 3.2. *Will raising interest rates stop depreciation?*

We now come to the next question. Will raising interest rates stop the depreciation of a sliding currency? One might have thought, given the cost to the economy, to the society more broadly, if the huge increases in interest rates were so large, that there would be a wealth of econometric and statistical evidence to support this premise.

What is remarkable is how few studies there are that support the view that raising interest rates will sustain exchange rates. There just isn't much evidence.<sup>7</sup> The reason is simply that it isn't true. Yes it is true that many governments raise interest rates. But the fact that the governments do it does not mean it works. And we now have a wealth of evidence and experiments to see if it works. There is little evidence that such a policy has a high likelihood of success. You might ask, given that the evidence is so weak what is the theory?

Professor Mundell talked about bad textbook economics, and this is another example. (There are some good textbooks around, by the way!) The basic idea is a very simple one: if you raise interest rates it looks more attractive to put more money into the country. If money flows into the country it supports the exchange rate and stops the devaluation. All this makes perfect sense except for one thing: when you have private sector debt there is always a probability that

<sup>6</sup> For a more extensive discussion, see Joseph Stiglitz (1997), 'Dumping on Free Trade: The US Import Trade Laws,' *Southern Economic Journal* 64, 402–24.

<sup>7</sup> See Jason Furman and Joseph Stiglitz 'Economic Crises: Evidence and Insights from East Asia', *Brookings Papers on Economic Activity*. Presented at Brookings Panel on Economic Activity. Washington D.C. September 3, 1998. Volume 2, pp. 1–11, and the studies cited there.

debt is not going to be repaid. People do not just care about the interest rate, they also care about getting their money back. If the bankruptcy probability, the default probability, goes up, and if it goes up enough, it becomes less attractive, not more attractive, to put money into the country. It becomes more attractive for people in the country to take their money out, to put their money in a safe haven like the United States. The implication is clear: causing a recession or a depression will result in money leaving the country. The irony here is that worries about default were at the heart of the Asian crisis from the beginning. What caused the crisis in Korea? It was that the banks refused to roll over their loans. Why? Not because the interest rate was abnormally low, but because they thought there was a high probability that they were not going to be repaid. It was the default probability that was of concern. So default was at the heart of the crisis. The IMF repeatedly talked about the role of weak financial institutions in causing the crisis? But what does one mean when one says 'weak financial institutions'? A weak financial institution is one with a high level of non-performing loans. What does one mean by 'non-performing loans'? Default! So everybody was talking about default, even the IMF, and yet the critical variable was left out of the model! The IMF repeatedly talked about the high leverage (e.g. in Korea). What did they mean? That meant that the Korean firms had high levels of short-term debt. But what did that imply? It means that raising interest rates would quickly lead such firms into bankruptcy or distress.

The belief that raising interest rates would lead to a stronger exchange rate was thus based on bad economic analysis, ignoring the consequences on default probability – what should have been a first order effect was simply left out of the analysis because it was left out of the outdated, oversimplistic models.<sup>8</sup>

There is something further wrong with the analysis. The theory of intervention holds that by raising the interest rates temporarily one would lead to a change in sentiment in some way that would allow for a permanently higher exchange rate. The argument was that a temporary intervention would lead to a higher *equilibrium* exchange rate. There is some implied assertion here, a rather mysterious one to an economist. All economics students learn in the first course not to confuse a movement along the demand curve with a shift of the demand curve. But IMF economics is asserting that a movement along the demand curve (raising interest rate was

<sup>8</sup> To be sure, many older macro-textbooks do a poor job of incorporating finance, and, like the IMF, seemed to ignore the importance of bankruptcy and default. The financial market is reflected only in a money demand equation. But one of the major advances in economics of the past quarter century has been the incorporation of finance, and one of the major advances in finance has been an understanding of the importance of bankruptcy and default. For an example of a simple macro-economic model incorporating both written before the crisis, see B. Greenwald and J. E. Stiglitz, 'Financial Market Imperfections and Business Cycles', *Quarterly Journal of Economics*, 108(1), February 1993, pp. 77–114. For an extension of that model, as an interpretation of the crisis, see Greenwald, 'Aggregate Devaluation Impacts in Economies with Imperfect Financial Markets', 1999 World Bank ABCDE Conference.

a movement along the demand curve), would somehow lead to a permanent shift in the demand curve. Maybe, but what is the process in which it would occur?

While the IMF never clarified what their underlying model was, there are two theories that have been put forward. One entails notions of ‘confidence’, the other involves ‘signalling’. I argue that both of these are questionable.<sup>9</sup>

#### A. *Confidence*

The first is that raising interest rates restores confidence. I put this in the realm not of economics but of psycho-babble. It always seems to me that economists who talk about ‘confidence’ have chosen the wrong profession: they seem to be trying to be armchair psychologists, trying to figure out the psychology of the market. Nothing in the standard training of economists would seem to prepare them for this task and, judging by performance, their ability to judge market psychology would not have received high marks.

In some respects the task is, even in the best of times, a difficult one. As Keynes emphasised, one of the principal tasks of those who are actively engaged in the market is to gauge, and anticipate, market psychology; but few of the international bureaucrats who decided to raise interest rates ever actually participated in the market. Their judgements, at best, were based on what they could glean from talking to others. When they do talk to the market, which market do they talk to? Almost undoubtedly they were more in touch with, and more in tune with, Wall Street and the City, than Jakarta or Bangkok. And there could well be a very different psychology in London, in Jakarta and in Bangkok. Policies that *might* have led investors in the West to put more money into the country might at the same time have led businessmen in the country to pull their money out. It is simply bad economics not to be attuned to these differences, to assume that there is such a thing as ‘the market’. And it is the height of arrogance for an international bureaucrat to try to pretend that he knows how ‘the market’ will respond to any particular action, to know what will restore ‘market confidence’. But there is a more serious criticism: to put it mildly, it is very hard to restore confidence, at least in anybody that I have talked to, in a country that is going into depression. It is very hard to restore confidence when the economy is going into social and political turmoil. If you have riots in the streets, it is very hard to restore confidence. Moreover, if the economy is going into recession, and real wage is going down by 20, 30 percent, unemployment going up by a factor of ten, and amidst that you cut out food subsidies to the poor, it is predictable that you get riots. If you do a regression one can identify the circumstances

<sup>9</sup> There are other theories, e.g. multiple equilibria models, in which the intervention is designed to move the economy from one equilibrium to another. See Stiglitz (1999) and the papers cited there.

that are *more likely* to lead to political and social turmoil. There have been what are sometimes called IMF food riots in many parts of the world. We can also predict that when you have the economic preconditions described above, and in addition you have ethnic fragmentation,<sup>10</sup> the probability of riots following the elimination of food subsidies is increased. In this particular case not only was the turmoil predictable, but it was predicted. Months before the riots occurred in Jakarta in May 1998, I warned (in a speech delivered in December 1997, to a meeting of the G-20 finance ministers in Kuala Lumpur, reflecting widespread sentiment within the World Bank, a meeting attended by the managing director of the IMF) that if the policies of austerity were continued, there would be a high likelihood of political and social turmoil. The IMF chose to ignore these warnings; its managing director simply reiterated the longstanding position that the country must feel the pain if it were to recover!

In short, the recessions and depressions brought on by IMF policies, including the high interest rates, induced capital flight and did not restore confidence. This hurt the country and the exchange rate. No wonder the high interest rates did not have the hoped-for effects.

### B. *Signalling*

An alternative way that a temporary change in the interest rate could have a permanent effect on the demand curve is through signalling. The claim is that high interest rates could provide a signal to the market that the country was being well managed, a signal that would permanently shift the demand curve. The IMF claimed that such a signal could be provided, through high interest rates, at low cost, because the interest rate would only need to be maintained for a very short time. When things calm down they could lower the interest rate so the damage could be very low.

But there is no free lunch and no free signals. To put it another way, talk is cheap. Signals are credible only if it is costly to use them (and if the cost is lower for those who have good economic management). Raising interest rates thus conveys relevant information only if there is a significant cost associated with it. The irony of this is that in fact IMF policy over the last 15 years had actually reduced the credibility of the signal. Why is that? What has the IMF been pushing over the last 20 years? More independent central banks that are less accountable to democratic processes and are not only independent, but also not representative (i.e. have closer connections with the financial community than with other segments of the economy and society). Such a governance structure would naturally lead them to care more about their friends in the financial community than the welfare of workers. In such circumstance, the cost *to those who are in charge of setting interest rates* from setting a high

<sup>10</sup> See P. Collier for a discussion of the role of ethnic fragmentation in civil strife. Paul Collier, 'Economic Causes of Civil Conflict and their Implications for Policy,' a chapter forthcoming in *Managing Global Chaos* Chester A. Crocker & Fen Osler Hampson with Pamela Aall (eds.). Washington DC: US Institute of Peace.

interest rate (which leads to an economic slowdown) may be lower than if they were more directly democratically accountable, and so the effectiveness of the signal may actually have been lowered.

There are other problems. The theory does make some sense in Latin America with its lax monetary authorities. But that was not the problem in East Asia. That was not the problem in Korea where the inflation rate was only 4%. Hence, there was no need for the monetary authorities to signal that they were serious about inflation. If anything, to raise interest rates in an economy with no serious macroeconomic problems, when the raising of interest rates would lead to massive corporate distress and a huge economic downturn, could just as well have sent an adverse signal: this monetary authority clearly does not know how to design policies appropriate for its situation.

### C. *Hysteresis*

Ironically, there were long-run effects from even temporary increases in interest rates but they were not the long-run effects that the IMF anticipated. It believed (without evidence) that while there would be a permanent benefit in terms of confidence, there would not be any longer run adverse effects on the economy. In fact, there was no restoration of confidence but there was long-run damage. The higher interest rates pushed the highly leveraged firms into bankruptcy (and predictably so); lowering interest rates then would not unbankrupt them. More generally, there are long-run effects of the large negative effects on net worth, given the limitations on equity markets. (See Greenwald and Stiglitz, 1993). In effect, the high interest rates not only led to a reduction in aggregate demand, it also shifted the aggregate supply curve; and even if lowering the interest rate restored aggregate demand, it did not shift the aggregate supply curve back fully to where it was before.

### 3.3 *The trade-offs*

The next issue in the evaluation of monetary policy concerns trade-offs. The IMF said 'Well, yes, we recognise there is some cost with raising interest rates but the benefits of defending exchange rates exceed the cost.' In effect, they chose the damage from higher interest rates over the damage from lower exchange rates. But under the circumstances prevailing in East Asia, the high interest policy was a lose-lose policy. There was no trade-off. Higher interest rates damaged the economy, the small businesses, and eliminated jobs. The recession caused capital flight and worsened the exchange rates. The countries lost on both accounts: on exchange rates and on interest rates.

The IMF asserted that there would be a short-run pain for a long-run gain. But what the above analysis suggests is that it has short-run pain and huge long-run cost. I have not described the long run cost fully. Among the long run costs was bankruptcy and corporate distress. As we noted, in these countries with a high degree of leverage, high levels of short term debt, when they raised interest rates they forced many of the firms into bankruptcy. There is a lack of appreciation for irreversible changes. It is easy to destroy firms, it is easy to

destroy firms' net worth, it is easy to put firms into bankruptcy. But when you finally lowered the interest rates you do not recreate the firms you had destroyed. In Indonesia about 75% of the firms were forced effectively into bankruptcy. When they lowered the interest rates, they did not unbankrupt them. The problems will take years to undo.

A. *An alternative policy: standstills and chapter 11*

Let us assume, for purposes of argument, that there was a trade-off. What was the trade-off? First I want to point out that there were alternatives. There was an alternative policy that would have limited the damage of a decreasing exchange rate. That policy would have entailed either a standstill on debt repayment, or a 'superchapter 11' bankruptcy, which would have allowed the firms to have continued producing, might even have allowed them to have reentered capital markets.<sup>11,12</sup> When I discuss this alternative with people at the IMF, with, for instance, Stan Fischer, the first deputy managing director, they talked as if bankruptcy was an abrogation of the commitments in the credit contracts. They did not appreciate that an implicit part of every contract is bankruptcy. You could not have modern capitalism without a provision for bankruptcy. Equity markets are based on limited liability. Limited liability says that there is a risk of bankruptcy. When credit is extended to a private firm the possibility of bankruptcy must be recognised. Bankruptcy was something that should clearly have been on the agenda. In fact what should have been done was the strengthening of bankruptcy laws, to adapt them to deal with the kind of macroeconomic disturbance that faced East Asia, and coordination of bankruptcy through standstills rather than what was actually done. Indeed, it was only with the standstill that was eventually negotiated in March 1998 that Korea's exchange rate was finally stabilised.

B. *Another alternative: capital controls*

There was another way by which the terms of the trade-off could have been changed, even if one believed that capital flows were interest sensitive. One could have done what Malaysia eventually did, and that was to intervene in the capital market, either through taxes or controls. Such interventions enable the country to have lower interest rates without (as large) fears of depreciation. As a result of the interventions in the capital market, Malaysia's downturn was shorter and shallower than that of the other countries in the region and the legacy of debt with which it was left after the downturn was smaller than in the other countries in the region (partly because the lower interest rates meant that it did not have to face as significant costs in corporate and financial

<sup>11</sup> There might have been a debt for special lending facilities to have been created, to ensure an adequate flow of credit.

<sup>12</sup> It is important to distinguish between the orderly resolution of financial distress associated with a corporate reorganisation under a super-chapter 11 provision, which would have allowed the continuation of existing management, with the chaotic situation resulting from the distress that resulted from the high interest rate policy. In the latter case there are no clear owners.

restructuring, partly because the lower interest rates meant that it could rejuvenate the economy with less reliance on fiscal policy (Rodrik, 2000). But the IMF ruled this alternative out of court and predicted that Malaysia would suffer dire consequences as a result of its resort to this policy. As repeatedly happened throughout the East Asia crisis, the IMF's predictions again turned out wrong: not only did the dire consequences not materialise (in spite of the adverse consequences of the IMF condemnation) but, as we have noted, it recovered more quickly.

### C. *Differing trade-offs across countries*

Assume, for purpose of argument, that neither of these alternatives were admissible and there were a trade-off; one had to choose among the two 'harms' – that of high interest rates or lower exchange rates. How should one think about these trade-offs? First, one has to recognise that the trade-off differed across the countries. The adverse effect of high interest rates is clearly greater where the short term leverage is the highest. The adverse effect is also greater where the banks have assets that are interest rate sensitive, such as real estate loans. When you raise interest rates, that decreases the value of the collateral and leads people not to repay their loans. All of this was well known *well before the crisis*. United States had a similar crisis and then a recession because Volker raised interest rates from 1979 to 1981. These lessons are part of standard economics that we have been teaching in the graduate schools, they should have been first order concerns brought into the decision making processes at the Fund. But they were not.

Similarly, within East Asia the adverse effects of the depreciation depend on a variety of conditions. For instance, the foreign exchange exposure in Malaysia was very low because the Malaysian Central Bank worked very hard to limit the degree of exposure of the corporations to which the banks lent money. That meant that in balancing the trade-off between the interest rate and exchange rate in Malaysia, the recommendation should have been for a lower interest rate policy than in other countries, where the adverse effects of sharp depreciation would have had far more adverse consequences. And yet a 'one size fits all' prescription was made, for Malaysia as for other countries in the region.

Thailand was actually one of the more interesting cases. One always needs to look at the microeconomics because macroeconomics does not tell the whole story. There were two groups of firms with exposure to dollar denominated debt. One of them was the real-estate firms. These firms and the banks that lent them money were already bankrupt, with the collapse of the real estate market. When you are dead it does not make much difference if you are dead. The additional damage from further depreciation was zero for them.

The other group was the exporters. But the exporters gained in the value of their exports just as they lost from the increased value of their liabilities. The net effect on them is relatively small.

What I have tried to argue so far is that in the East Asia crisis the use of a high interest rate policy to sustain exchange rates simply did not make sense.

Even if there were a trade-off, the balance of risks suggested allowing the exchange rate to fall.

D. *Distributional consequences*

So far we have argued that, at least for Thailand and Malaysia (and similar arguments could be put forward for Korea), the adverse impacts of high interest rates on the economy as a whole were far greater than the adverse effects of falling exchange rates.

The high interest rates also have huge distributional effects. Higher interest rates force fire sale of assets in order to pay back loans. When you raise interest rates that lowers the values of assets, debtors are forced to sell assets to foreigners at fire sale prices.

E. *Social consequences*

The distributional impacts, in turn, can have large social consequences, illustrated by Indonesia and Malaysia. An awareness of how these consequences might differ in different countries also called for policies to be adapted to the situation in each country.

Consider Malaysia. The problem of ethnic fractionalisation was as bad, perhaps even worse, than in Indonesia. Malaysia too had faced ethnic strife in the early days of its independence. Mahatir recognised that a major economic recession, which high interest rates and fiscal austerity would surely have led to, risked ethnic strife, and the country simply could not afford it; it would set back the development agenda by years, perhaps decades, as it did in Indonesia. But the IMF, in its policy advice, exhibited no sensitivity to these concerns.

F. *The moral hazard problem*

There was a further argument for not trying to sustain the exchange rate: doing so would produce a moral hazard problem. The knowledge that there will be intervention to sustain the exchange rate (either through spending reserves or raising interest rates) reduces the need for borrowers to buy insurance against devaluation; and the bail-outs reduce the necessity for lenders to exercise due diligence.

In defending devaluations the IMF has become an advocate for these lenders and borrowers. There is a moral issue here (not only a moral hazard issue). The IMF went in to save the people who deliberately decided not to buy insurance, but it did so at the expense of the innocent bystanders, the small businesses – they were just doing business normally, borrowing normal amounts of money as any business has to do. These innocent businesses were bankrupted in the name of helping out the speculators who had borrowed money in dollars – they had put the country's economy in jeopardy because they believed that by borrowing dollars they could save on interest payments, and by not buying insurance they would save on insurance premiums. Now the defenders of the IMF policies say that the companies should not be blamed – as always, it is the country that was at fault; the country was at fault because it had a fixed exchange rate (though, to be sure, many countries had been advised by the

IMF to have a fixed exchange rate, to provide a ‘nominal anchor’ to keep inflation under control). But there has never been a true fixed exchange rate system. We know that when exchange rates seldom change, they will change by a lot when they do. This is precisely the kind of risk that insurance is well designed to handle – small probability of events with large cost. If, in fact, the judgement that there would be no change in the exchange rate was widely shared, the price of the insurance would have been commensurately low. They should have insurance but they did not.

#### G. *Feeding the speculative sharks*

Moreover, if you asked the questions: ‘what keeps the speculators in business? What keeps the Tiger Funds and the other speculative hedge funds in business?’ It was actually the IMF. They were providing the food for the sharks. The money game basically is a zero sum game. If you just have private sector participants, one gambling against another, somebody gains at the expense of the other. But now with the IMF, money from the public sector goes into the private sector’s coffers. Now you have greater incentive to speculate. By feeding speculation such policies actually contributed to global economic instability – reinforcing the problems these countries already faced from the policy of capital market liberalisation which the IMF foisted on the developing countries.

#### 4. EXPLAINING IMF POLICIES

The question that I want to turn to now is ‘how do we explain the policies?’ The IMF was originally created to encourage, and to provide the funds, the liquidity, for, expansionary policies for countries facing economic downturns. Recall the history: there was the Great Depression in the 1930s. World War II got the United States and other countries out of the Depression, but when the war came to an end there was a lot of worry about the world economy slumping back into depression. Keynes, and the other leaders of the victorious countries said, in effect, ‘we have to create an international institution to try to support those economies facing a downturn’. The irony is that during the last quarter of a century, there has been a systematic bias towards contractionary policies.

One might attribute *some* mistakes to forecast errors. But the mistakes have been systematic. They have not been just random. They have been systematically excessively contractionary. It wasn’t just an accident the way IMF treated the East Asian crisis.

One of the interesting things in the IMF’s post-mortem of the crisis and the failures is that they admitted that they were excessively contractionary. But there was no analysis of why the mistakes occurred. They did not go and say ‘let’s redo our models – there is something wrong in our conceptual framework.’ Rather, it was as if they were saying, ‘It’s just in *this* particular case we made a mistake!’ If one grants that there is a systematic bias, the next question is, why? My hypothesis is that the interest of the creditors has become

paramount. In other words, the analysis of the trade-offs in the previous section was not conducted for a simple reason. That analysis was predicated on the objective of maintaining the strength of the economy, keeping the economy at as close to full employment as possible. I described the trade-offs in terms of the risks to the country facing a crisis. I described the alternative policies that could have changed the nature of the trade-offs. But that was not the objective of the IMF. The purpose of the IMF had changed, from its original purpose of maintaining the economic strength of the countries affected by a crisis. The objectives seem to have become, not explicitly, but implicitly, enhancing the likelihood of the repayment of the creditors.

Consider, as an illustration, the subject of building up reserves. When you have a trade-induced crisis, reserves made some sense – you need reserves to finance the trade. But the crisis in East Asia was not basically trade crisis. Korea had no balance of trade problem at the time the crisis occurred. The crisis was induced by capital movement that was made possible by the capital market liberalisation recommended by the IMF.

Reserves are useful because they help the country repay the dollar loans. To build up the dollar reserves either you export more or import less. It would be very nice if you could export more, but who are you going to export to and how can you increase exports quickly? You can't do this unless you devalue. But the IMF was trying to stop the devaluation! The alternative is to import less. There are two ways of importing less. One is devaluation but that is off the agenda. The other is trade restrictions (tariffs), but that too is off the agenda; that is no longer allowed.<sup>13</sup> So what is one left with? Causing a recession. A lower income leads to fewer imports. That's what I called earlier, 'beggar-thyself' policies'. (It took a certain level of genius to think of something worse than 'beggar thy neighbour' policies, which had played such an important role in the global downturn of the Great Depression!)

Consider what this policy does. From the point view of your neighbour, what they observe is a cutback in exports – if you cut back your imports you cut back their exports. This effect on your neighbour is exactly the same as in the 'beggar-thy-neighbour' policies. The neighbours don't care why you are not buying their goods, whether it's tariff or recession; all they know is that you are buying less of their goods. You have exported your problems to them. But at least in the 'beggar-thy-neighbour' policies you strengthened your economies at the expense of others. With the 'beggar thy self' you weaken your economy as you hurt your neighbour.

While one of the ways to understand the IMF policies is to see them as pursuing an alternative objective – that of maximising the amount that creditors can recover – the irony is that, to a large extent, they failed even to achieve that objective. On the other hand the fire sale of assets, in which the prices were depressed by the high interest rates, which the IMF and the US Treasury

<sup>13</sup> Actually, it is allowed under the WTO trade rules, in the event of a crisis; but the IMF does not condone such policies and actually pushes countries to liberalise trade in the midst of a crisis.

repeatedly encouraged the countries to have, is in the interest of the creditors and the creditor countries. Had they had the fire sales, the high interest rates would have enabled the foreigners to pick up assets cheaply. Of course, this was not the argument put forward: the countries were told they needed foreign capital and needed to replace the management of their firms (which obviously had deficiencies, given the problems the country was facing) with good western management. But if you think about East Asia, the whole rhetoric did not make any sense. East Asia has this huge saving rate. What do they need funds from abroad for? The problem was that they were having trouble taking this savings and actively putting it into productive use. They didn't need other savings from the United States or other western countries. It clearly wasn't the capital they need from the United States. This argument did not make any sense.

What about management? Well, they had 30 years of the fastest growth in the world. That was real growth. You can't manage to have that rate of growth without having some managerial abilities. So fire sales of assets and importing management skills also did not make much sense for most industries for East Asia. What did make sense is that American and Western firms wanted to buy up assets cheaply. That's why it was imperative to have the sales quickly, before prices recovered.

The financial sector, of course, always makes money out of transactions. They like turmoil. They made money when they helped firms conglomerate. Then, when it becomes clear that conglomeration makes no sense, that the large conglomerates are unable to manage their various parts, that firms need 'focus', the financial sector makes money again as they manage the process of dis-conglomeration so they make money again. Every 10 years they go through this process of aggregation and dis-aggregation. It's wonderful. But why impose that style on the rest of the world?

#### 4.1. *What led to the change in the IMF's mandate?*

##### A. *Governance*

The next question is: 'what led to a change in the IMF's mandate?' Keynes must be turning over in his grave when he sees that the institution he created to promote global stability has resulted in global instability. An institution that was supposed to promote expansionary policies has become an instrument for forcing contractionary policies. The basic argument that I would put forward is that it has to do with governance.

The great strength of economics is to look at incentives. The same principles apply to institutional analysis: you look at who runs the institution, what their incentives are and how this translates into institutional behaviour.

Who controls the IMF? It is controlled by the advanced industrial countries. One and only one country has the veto power in the IMF: the United States.

China has grown enormously in the last 20 years but its voting rights have not increased accordingly. There is no justifiable basis for the governing

structure of the IMF. But it is worse than that because the IMF is controlled not by the governments themselves but by the finance ministries and the central banks. Aren't finance ministries and central banks controlled by the countries? Anybody who studies political processes in their own country knows that this is not true. For the United States to turn over decision-making for domestic economic issues to the Treasury would be completely unacceptable because it is well recognised that they reflect the interests and perceptions of the financial community more than they do those of other economic groups (e.g. labour). We have a national economic council in the United States in which all the relevant parties are brought together, including the Justice Department because anti-trust policies are very important. For democracy to function well, you need to have everybody at the table. But somehow, when it comes to international economics, we bring only one group to the table, the financial community.

#### 5. REFORMING THE IMF

This brings me to the final question: what reforms should be undertaken, to make 'better' outcomes more likely? The most basic reform, the one that is most likely to have the most significant long-run effect, is the reform of governance. But that is not likely.

What is likely to be more possible is changes in processes, including those that lead to increases in transparency. The reason that increased transparency is important should itself be transparent: I think it is very important to have the exposure of hidden agenda that I have described. If the policies in East Asia had been exposed to the intense kind of scrutiny that is normally part of democratic processes, it is conceivable, even likely, that they might not have been undertaken. If the voice of workers and small businesses had been heard *before the policies were undertaken*, it is conceivable, even likely, that the policies would not have been undertaken. And even if these groups do not have a seat at the table (as they should, but will not unless fundamental governance reforms are undertaken), their voice can be heard through the media and other channels *provided information is made publicly available in a timely way*.

There are other types of reforms, for example in the scope of activity and the roles of the IMF. The IMF should be focusing completely on crisis lending, as every major independent commission reviewing the international financial system has recommended.

#### 6. CONCLUDING REMARKS

Let me conclude with some broad methodological remarks: bad economic models lead to bad policy. You need to incorporate finance into macroeconomics. When you incorporate finance it is not enough to incorporate money demand equations, especially when the money demand equation is 30 years old! You need to incorporate good microeconomics into macroeconomics.

There is little excuse for these failures. The models focusing on financing and bankruptcy were all formulated well before the crisis. The models that predict and explain the experiences of the East Asian crisis were already in the literature well before the crisis.

Most importantly, one cannot ignore political economy and political institutions. This is, by now, well recognised in the analysis of national economies. But this is a lesson that has been too often ignored at the international level. We need to view the International Monetary Fund as a political institution.

Focusing monetary policy on inflation and pushing policies that reflect the interests and ideology of the financial community (such as capital market liberalisation and macro-responses to crises that centre on enhancing the probability that creditors get repaid), does not contribute to global economic stability.

My discussion reinforces one of the basic conclusions in political economy – the importance of democratic accountability. This is probably the most important lesson to emerge from the crisis. If those affected by the policies had a stronger voice in the policies, different policies would have been pursued. That is why it is so important that all the affected parties have seats at the table when economic policy decisions are made. This has not been the case in the past. Hopefully, the recognition of the failures – which have proved so costly to those within the region – will lead to reforms that will enhance democratic accountability in the future.

#### REFERENCE

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