Proceed with care in reforming global financial system, Aizenman urges

In the wake of the 1990s' experience with economic and financial crises, there has been considerable debate about the reforms needed to make the global financial system more stable. A key area of contention is the role played by financial liberalization. In a February 23 seminar at the IMF Institute, Joshua Aizenman, professor of economics at the University of California at Santa Cruz, examined the complex trade-off between liberalization's adverse intermediate effects and its more arguable long-run benefits. He cautioned that successful reforms will need to factor in market imperfections.

On balance, is financial liberalization good or bad? In truth, we may not yet have the tools to do a definitive cost-benefit analysis, Aizenman suggested. There is "solid evidence," he said, that the fragility induced by financial opening increases the chance of a financial crisis. The proof that there is a positive correlation between financial opening and long-run growth—as Ross Levine and others have argued—was more tenuous, although financial opening could lead to higher growth, in part by encouraging a more efficient allocation of investment. Moreover, empirical studies provide little guidance on how to weigh potential costs against potential benefits. Any estimate of this balance would depend critically on an appropriate time horizon and an evaluation of the counterfactual. For example, what would have happened to the Korean economy had the country not liberalized financial flows during the 1990s?

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—Joshua Aizenman

Improving the trade-off

The key challenge for policymakers is to figure out how to supplement financial opening with policies that could diminish short-term volatility without undercutting prospects for higher growth over the long term, Aizenman said. Numerous reforms have been proposed to reduce the incidence or alleviate the costs of financial crises. Among those that have focused on crisis prevention, Aizenman cited the Meltzer Commission recommendation that the IMF limit its lending to those countries that have been pursuing "appropriate" policies and have satisfied predetermined criteria; the Basel II Accord, which strengthens capital adequacy standards; Chilean-style capital controls (taxes on short-term inflows); varied efforts to design "crisis insurance"; incentives to move from debt financing to equity financing; and attempts to design a crisis warning system based on statistical indicators of vulnerability. Among the reforms that seek to strengthen crisis management and mitigate its costs, Aizenman mentioned proposals to develop international bankruptcy-style procedures or work-out mechanisms and the addition of collective action clauses and/or rollover options to loan agreements.

Beware of unintended consequences

Which types of proposals hold the most promise? According to Aizenman, reforms must address the fundamental forces that lead to excessive exposure and crisis. He warned that changes in policies can affect incentives and budget constraints facing debtors and creditors, altering the nature of economic relationships—in effect, what has come to be called the Lucas critique (based on a seminal 1976 work by Robert Lucas, who first pointed out that new policies alter the behavior of agents, thereby modifying observed correlations). Unless reforms are designed with these potential effects in mind, Aizenman said, they "may lead to disappointing results at best, and welfare reduction at worst."

A good example of how the Lucas critique could come into play is in the area of transparency. While acknowledging that a minimum level of transparency is needed for financial market operations, Aizenman cautioned that stiffer transparency requirements may lead to more creative accounting rather than fewer crises. Verification that standards are being met is "costly and fuzzy," and, "frequently, it takes a major crisis to force the 'real books' to open." A vicious cycle could be induced, whereby enhanced standards lead to more creative accounting, a crisis exposes new loopholes, standards are changed accordingly, and so on.

Such a dynamic could undermine proposals that rely on improved transparency, such as those that restrict crisis lending to countries that have satisfied certain predetermined criteria (notably the Meltzer Commission recommendation and efforts to develop crisis insurance). It may also lead to a new form of moral hazard in which countries that perform well according to preset indicators are expected to be safer, as they would be bailed out in the event of a crisis. Indeed, Aizenman asked, "what should be done in the case where, in the aftermath of a crisis, we learn that some of the criteria were met only superficially?"

There is also reason to be wary about an increased focus on vulnerability indicators as this could lead to incentives to distort them, Aizenman said. And there is no assurance that tracked indicators, which reflect experience with past crises, will perform adequately in future under changed policy environments.

Aizenman suggested that effective reforms will also need to be time-consistent. Consider the case where crisis lending is prohibited unless certain pre-crisis conditions have been met. In the throes of an actual crisis, is a prohibition against lending credible if conditions were not satisfied but contagion is a key concern?

And, Aizenman added, there are inevitably political economy ramifications. For example, experience has indicated that a low ratio of international reserves to short-term debt has been associated with a higher incidence of crises in recent years. The instinctive reaction would be to advise countries to increase this ratio to lower their risk of crisis. Yet in countries where there is political instability—for example, where there is a risk that opportunistic administrations might "loot" the treasury to favor narrow interest groups—the optimal amount of international reserves should actually be lower than in countries not subject to such instability. In this instance, targeting a higher ratio of reserves to debt could actually reduce welfare rather than increase it.

More prudent measures

"There are good reasons to support both more effective crisis management and more prudent ex ante allocation of credit," Aizenman concluded. But given market imperfections, such as costly verification, incomplete insurance markets, and political economy factors, no solution is likely to be "first best." In his view, a mix of "second-" or "third-best" solutions will be required. More prudent regulations may reduce the incidence of insolvency but cannot eliminate liquidity crises. And crisis management proposals, which may include postcrisis lending, will not eliminate incentives to undertake excessive risk.

In terms of preventing crises, institutions have a key role to play in creating the rule of law and in ensuring a low level of corruption and good contract enforcement. A number of studies examining financial liberalization have shown that countries with weak institutions are more vulnerable to crisis, while countries with strong institutions are more likely to enjoy higher growth. Both findings suggest, he said, that in financial liberalization the sequencing of reforms matters.

There are other unilateral steps that countries can take to lower the risk of crises, reduce their severity, and speed recovery. Developing countries would do well to adopt more flexible exchange rate regimes, although there may not be "any smart choice that will avoid a crisis" and factors deeper than exchange rate rigidity may be at play. Countries should also strengthen financial systems and fiscal policy, beware of overborrowing, and reduce external overexposure by moving from debt financing to equity financing when feasible.

Aizenman: Given market imperfections, the search for better crisis prevention and management tools is likely to yield a mix of second- or third-best solutions.

In the developed countries, Aizenman saw merit in exploring deeper insurance markets as a way to deal with terms of trade volatility; encouraging the use of collective action clauses; and adopting improved minimum capital requirements. In Aizenman's view, international financial institutions could also do more to enhance country efforts. And, while being mindful of the dangers of "transparency creep," they should continue to improve transparency standards for macroeconomic policies and for financial and corporate sectors.

In closing, however, Aizenman said he was not convinced that "all crises are bad." In some cases, a crisis has been the catalytic event that spurred reforms and ultimately led to dramatic improvements in economic performance and social welfare. Typically, these were reforms that had not been implemented earlier owing to political constraints. Indeed, many countries that have experienced occasional crises have grown faster, on average, than countries that have had smoother credit conditions. ■

Patricia Reynolds
IMF External Relations Department

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