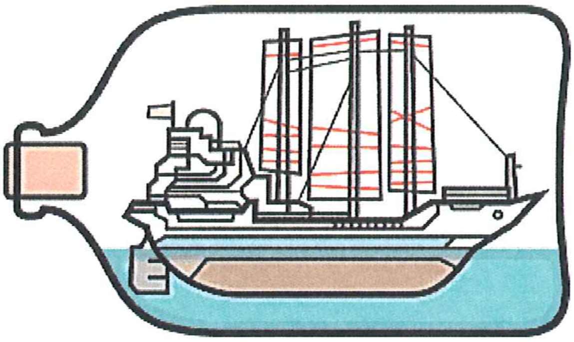
A Survey of Global Finance

"A cruel sea of capital"

The Economist, May 1st 2003

Global financial integration is supposed to lift countries up. Sometimes it sinks them. A guide to safer sailing, by Clive Crook



THOSE who believe that globalisation throttles democracy, gouges the poor and fouls the environment are bound to regard today's mostly open markets for international capital as evil. However, this does not prove that unimpeded flows of capital are a good thing. The capital market has vindicated its critics and embarrassed its would-be defenders too often of late. It has been responsible for, or at least deeply implicated in, some very costly economic breakdowns. Perhaps the anti-globalists are on to something.

Rapid globalisation has done nothing to undermine the confidence liberals have always placed in trade. No serious economist questions the case for international integration through flows of goods and services, though there is a lively argument over how integration through trade can best be brought about. Trade is good. But even the most enthusiastic advocate of economic integration may be starting to wonder whether unimpeded flows of capital are quite such a blessing.

Economic principles suggest that they should be. Economics relies heavily on the idea that wider opportunities make people better off—or at least that they do not make them worse off. Whatever else trade does, it widens opportunities. When trade barriers come down, people on each side have an opportunity lacking in a closed economy. They can decide to consume goods that they have not produced, and pay for them by producing goods they do not wish to consume. If they believe they are better off as a result, that is what they will do. Otherwise, they will carry on as before.

Essentially the same logic applies to international finance. Just as a closed economy can consume only what it produces, it can invest only what it saves—no more, no less. Trade in capital makes it possible for countries to separate their saving and investment choices. They can invest more than they save by borrowing the difference from abroad; or they can invest less than they save by lending out the surplus. Changes in the price of capital will ensure that global supply and demand match up, just as changes in the prices of goods bring exports and imports into global balance.

Just as nothing forces a country to trade when the economy opens up, nothing forces a country to become a net importer or exporter of capital if its firms and individuals prefer to lend and borrow as they did before. International capital widens choices in just the same way as international trade.

So how can you be worse off if you are given choices you did not have before, without being obliged to take them up? The answer is that you may make choices you come to regret. Experience suggests that even within the borders of a single economy, trade in capital is far more prone to mistakes than trade in goods or services—though why this should be so is not immediately obvious. And if domestic trade in capital is more error-prone than domestic trade in goods, then international trade in capital is even worse. This perhaps is easier to understand: take the mistakes that get made in a domestic context, then multiply them by ignorance due to distance and exchange-rate risk.

The result is plain enough: recurring financial calamity; sovereign debt default; capital flight; currency crisis; bank failure; stockmarket crash. And the harm is by no means confined to the people who made the mistakes, or to the finance industry at large. Financial collapses have an unmatched capacity for projecting their effects right across the domestic economy, and in the worst cases far beyond that, across the region and even across the world.

Even if there were no doubt that the gains from trade in capital are large—on a par with the gains from trade in goods and services—the costs incurred in recent financial emergencies would still give one pause. Financial crises of the sort that hit Latin America in the 1980s, Mexico in 1994 or East Asia in 1997-98 cause recessions equivalent to years of growth forgone. The 1980s were aptly called Latin America's "lost decade". Argentina and Brazil, to name but two, are even now struggling, respectively, with an exceptionally severe recession and the threat of a new financial collapse. Financial distress is a salient ingredient in Japan's endless economic difficulties, in Europe's current slowdown, in the fragility of America's economic recovery. And if things grow suddenly worse in any of these places, finance will spread the damage far and wide.

So trade in capital is different from trade in goods and services in two main ways: in the scope for getting things wrong, and in the punishment that follows. The first is great and the second is fearsome. It is enough to make a good liberal stop and think.

We all make mistakes

What makes finance so prone to error? Financial markets are asset markets: that is, they are markets for streams of payments spread out over time. (Many goods and some services have an extended time dimension too. By definition, the more this is true, the more such goods and services behave like assets. That is why the market for houses behaves a lot like the market for corporate bonds and not much like the market for biscuits.) When you buy an asset you are gambling on the future. Small changes in beliefs about the future can have a surprisingly large effect on the value of the assets concerned.

The numbers can seem outlandish, but it is only a matter of the arithmetical relationship between present value, compound interest and future value. Pricing a company share, for instance, involves several variables, but on plausible assumptions an improvement of just one percentage point in the expected growth of a company's earnings could easily justify a rise of 25% in its share price.

In other words, because asset prices are bets on a distant and uncertain future, they are inherently volatile. Moreover, investors tend to deal with uncertainty in ways that aggravate the problem. If information about underlying value is absent

or obscure, they are likely to become preoccupied with the views of other investors. Sometimes, maybe usually, this is a process that uncovers new information and disperses it. Now and then, however, it degenerates into crowd hysteria.
In extreme cases, the views of other investors are taken seriously even when flatly contradicted by such facts as may be available. That was certainly true during the later stages of the dotcom bubble of the 1990s, and there are countless other examples. From time to time, such mental aberrations are even dignified by being presented as "schools of thought": from "momentum investing" and "greater fool theory" to "the new economy".

Now add to this the possibility of leverage. Thanks to capital markets, investors can place their bets on this distant and uncertain future using borrowed money. Without debt, the most you can lose is everything you have. If you can borrow, on the other hand, there is really no limit to what you can lose, because leverage allows you to punt other people's money as well as your own. Financial markets attract talented and ingenious people. A great deal of effort, it is said, goes into finding ways of pooling and reducing risk. Evidently, however, a good deal also goes into finding ever more complicated ways of building leverage on leverage, and then leveraging some more.

It has been widely noticed that going bankrupt for a few million dollars is no more painful than going bankrupt for a few thousand. This is apt to discourage prudence, and the imprudent, however talented and ingenious, make mistakes. Debts are also a main reason why mistakes in financial markets, when they happen, can have bigger consequences than errors in an economy's less excitable parts. Losses may cascade across a series of lenders, many of which may not even have realised that they were exposed to the risk. A surprise that is big enough and bad enough may perturb the mood of self-justifying expectations that had up to then been propping valuations across an entire class of investments, and at worst across the economy as a whole.

A particular risk is that a bank may be threatened with failure as a result of its losses. Banks are intrinsically fragile entities, which is why, historically, they have invested so much in the pretence of security and solidity. They promise to give depositors all their money back on demand. As soon as depositors ask a bank to make good on that pledge, the bank (which retains only a fraction of its deposits in ready cash) goes bust. Depositors at other banks may then want their money back too. And because banks provide the infrastructure of payments services in a modern economy, that comes under threat as well.

Financial volatility need not in itself be such a bad thing. Even if it causes volatility in GDP, and hence in incomes, that is not necessarily disastrous either. People have ways of protecting themselves against ups and down in their incomes. Financial markets, of course, can help them in this. Governments can help as well, with safety-nets of one sort or another and with policies that mitigate the highs and lows of the economic cycle. Unfortunately, the evidence suggests that financial volatility not only causes bigger ups and downs in output and incomes, it also leads to lower average incomes over time. Latin America's lost decade really was lost.

All this, to be sure, could perfectly well be true of a closed economy. But an economy with financial links to the outside world may, according to circumstances, face much bigger risks. The problems of uncertainty are worse, for the reason already mentioned: distance, measured not just in miles but also in differences in language, business culture and legal environment. This increases the tendency to rely on other investors' judgments rather than one's own. It also increases the scope for risk that is disguised, accidentally or otherwise, and hence the danger that investors will be taken by surprise. And trading capital across borders usually involves an additional financial market that is especially susceptible to all of the above: the market for foreign exchange. Most if not all of the big financial crises of recent decades have involved banking crises, currency crises or both. In these ways, the global capital market appears to take a big problem—the economic instability that would anyway be caused by purely domestic finance—and make it worse.

If the scope for error in capital markets is so great and the subsequent punishment so brutal, do the benefits of unimpeded global finance, substantial as they may be, justify the risk? The answer, as this survey will argue, is yes—but for many economies it is a close thing. Much depends, as well, on exactly what is meant by "unimpeded".

A close-run thing

Trade in goods and services is simple: what governments need to do, through the World Trade Organisation, through this or that regional trade agreement, or best of all unilaterally, is abolish their barriers. When it comes to finance, there is no such straightforward advice. "Let capital flow where it may" is bad policy. Finance must be intelligently regulated, at home as well as internationally, in ways that ordinary commerce does not require. When capital flows are liberalised, it needs to be done cautiously and within prudent limits. To that extent, global finance must indeed be impeded.

Governments and their advisers are a long way from understanding how this should ideally be done, let alone from putting any such understanding into practice. There is no detailed consensus on the right approach to international financial regulation, any more than there is on the domestic sort: there is plenty of activity, but for the most part it is co-operation without conviction.

The risks of international finance need to be frankly acknowledged, and then reduced so far as possible. That means weighing the costs and benefits of different kinds of capital mobility, and setting policies accordingly. It means abandoning certain orthodoxies of international economic policy. The danger cannot be eliminated altogether, but the remaining risk is worth taking because the potential gains from international capital flows are large, especially for the world's poor countries.

To ignore that potential would be an even greater mistake than to liberalise recklessly. The global capital market is a treacherous aid to economic growth, but in the end, above all for the poor, an indispensable one.

"Catching the tide",

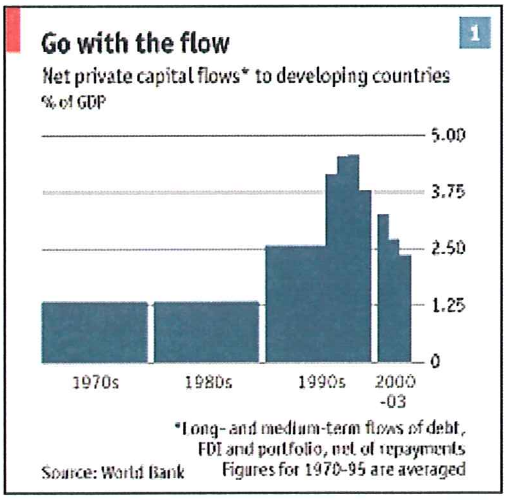
The Economist, May 1st 2003

Why does so little capital flow from rich countries to poor?

SUPPOSE capital were bottled up in individual countries, not free to flow from one to another. Rich economies would have lots of it. Too much, in a way: the law of diminishing returns would have set in. Poor economies, in contrast, would have less capital than they can put to good use: returns to extra capital there would be higher. Both kinds of country, and the world as a whole, would be better off if people were free to move capital from the one to the other—or so it would seem. The poor-country capital importers would invest more and produce more. The rich-country capital exporters would invest less, but the income they lost this way would be more than outweighed by the additional income they received from investments abroad offering high returns.

This is the simple theory of international capital flows. Sometimes it works. For sustained periods during the past century or two, capital went where it was supposed to, and made a great difference to the pattern of economic development. In the last quarter of the 19th century, British capital equivalent to 5% of host-country GDP and more flowed out each year to the United States, Canada, Australia and Argentina. France and Germany were big exporters of capital too, though not quite on that scale. The flows paid for a large part of the investment undertaken in the capital-importing countries.

This golden age of financial globalisation ended in 1914. Global financial connections were cut by the first world war, and only briefly repaired in the immediate aftermath. Then, for nearly half a century, from the Depression until the 1970s, international flows of private capital dwindled to almost nothing. In the 1970s, net flows of private capital to the world's poor countries amounted to a little over 1% of host-country GDP. This trickle was sufficient to finance a miserly one-twentieth of what many poor countries spend on investment (and an even smaller share of what they should be spending).



By the end of the 1970s, those meagre figures were increasing, though they still fell far short of the 19th-century boom. And the resurgence, such as it was, ended badly, in the debt crises of the 1980s. By the end of the 1990s, flows had recovered from that setback and endured two more—the Mexican devaluation of 1994 and the East Asian debacle of 1997-98. Taking one decade with another, flows in the 1980s were about equal to flows in the 1970s; during the 1990s, they were substantially larger. By the end of the 1990s, annual flows as a proportion of developing-country GDP were some three times bigger than in the 1970s (see chart 1).

Nonetheless, measured against the apparent opportunities for productive investment in the developing countries, as well as against the flows a century earlier, they were still small. At the end of 2001 (the latest year for which figures are available) the worldwide stock of cross-border bank loans and deposits was $9 trillion. Of that, only around $700 billion was attributable to developing-country borrowers. The stock of global cross-border investment in securities was some $12 trillion, of which developing-country borrowers accounted for just $600 billion. As in the 19th century, moreover, most of the capital exported by rich countries to poor countries still travels to just a handful of recipients.

Anti-gravity

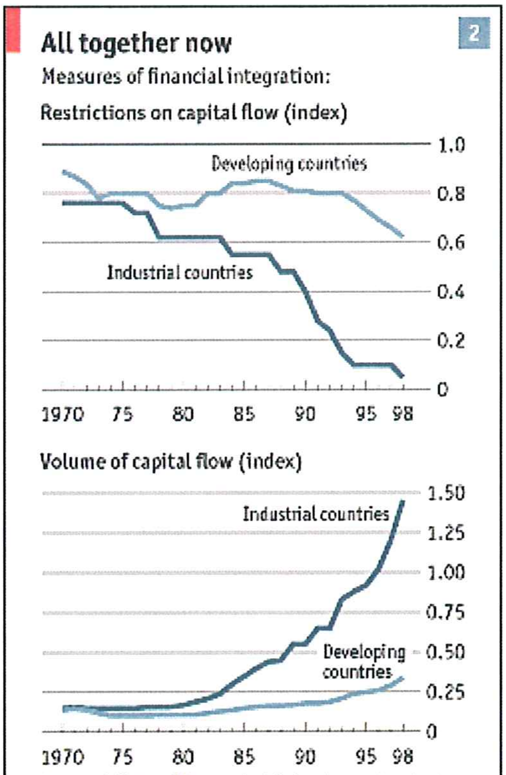
These figures belie the idea of a steady tide of capital running from rich countries to poor. On average, it is true, creditor countries are richer than debtor countries; in this sense, at least, capital does flow downwards. But there are some notable exceptions even to this broad pattern. Despite its economic slowdown, the United States continues to invest a lot while saving next to nothing: its economy draws in huge amounts of capital from abroad, and its net foreign liabilities currently stand at more than 20% of GDP.

All this raises a question. The most successful developing countries of an earlier era showed that foreign capital can make an enormous difference to their prospects for rapid development. Financial crises notwithstanding, rich-country investors profited too. Why, in that case, does capital today not flow in much larger quantities from rich parts of the world to poor?

One reason is that capital is not the only thing which is lacking in most developing countries. Labour may be plentiful, but workers in poor countries are mostly less well educated and have less training in industrial skills than their rich-country counterparts. In many countries, property rights are insecure and the rule of law is unreliable. The economic infrastructure necessary to get the most out of new investment may not be there. Political risk may be a problem. For these and other reasons, switching capital from countries where there is plenty to countries where there appears to be a shortage yields smaller profits than one would suppose. (America's overwhelming advantages in all these respects help to explain why it attracts so much new capital, despite seeming to have more than it needs.)

Second, most developing countries do not let capital come and go freely. Blanket restrictions on the movement of capital are much rarer than they used to be, but assorted official or unofficial obstacles are still often put in the way of foreign investors. Despite measures to liberalise the capital markets in recent years, they are still far less open to cross-border finance than the typical developed economy (see chart 2).

So where the flow of international capital could do most good—in the developing countries—there is precious little of it. Does that matter? If you take the view that capital flows are more of a curse than a blessing, probably not. Yet history suggests that the most successful developing countries, at least up until the first world war, benefited enormously from foreign capital. And everybody agrees that the flow of capital from one rich country to another is wholly beneficial for both sides. Is anybody suggesting capital controls for the United States? Not even those who consider America's present rate of capital inflow worryingly high. The benefits of access to global capital markets are called into question only for poor countries.



Source: "Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence", by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose. IMF, March 2003

To get an idea of what is at stake, it would be useful to have a rough estimate of the developing countries' gains from capital flows. Unfortunately, no generally agreed estimates exist. The 19th century seems too remote a guide. Careful analysis of the more recent connection, if any, between capital flows and growth in developing countries is still surprisingly sparse, though interest in the subject has been mounting lately. As yet there are relatively few studies, far fewer than of the links between growth and trade, and the results have not settled down to anything resembling a consensus. This is partly because the expansion of rich-to-poor capital flows to significant size is, as noted earlier, a comparatively recent event.

Guessing the benefits

Two other things frustrate efforts to estimate the gains. One is that the main effects of openness to capital can be expected to push in opposing directions: access to capital ought to spur investment and growth, but at the same time it will expose an economy to additional economic turbulence which may slow it down. The net result will be difficult to uncover among all the other factors contending for influence.

Also, "capital flows" is a broad term. It includes quite different kinds of financial transaction: bank lending, short- and long-term; investment in public or private bonds; investment in equities; direct investment in productive capacity. Each has different implications for growth on one hand and exposure to capital-market risk on the other. The gains from capital inflows are going to depend on exactly what kind of capital is flowing. Again, statistical evidence may struggle to provide answers.

Still, one may hazard a guess. According to one recent review of the literature, by Wendy Dobson of the University of Toronto and Gary Hufbauer of the Institute for International Economics, developing countries may have gained roughly as much, overall, from access to global capital markets as from access to trade in goods and services. The authors say it is plausible to suppose that by 2000 developing countries were gaining around $350 billion a year in additional GDP thanks to access to the global market in goods and services. As a result, developing-country GDP was about 5% higher than it would otherwise have been. Drawing on research that aims to separate the effects of different kinds of capital, they calculate that the gain up to now from even the limited access to international capital these countries have enjoyed might be about the same.

If the gains from (incomplete) capital-market integration really are as big as that, they would be worth the price of a financial crisis or two. Over the past few decades, admittedly, the world has suffered more than a few. When it did the sums in 1999, the IMF counted 64 banking crises and 79 currency crises since 1970. (That includes some double-counting, because many countries had both kinds of crisis simultaneously.) Most of these were small affairs, national rather than international in character. Over time, however, the role of international capital in spreading financial breakdown across borders has been growing. And when financial crises happen, the toll on incomes is heavy.

Ms Dobson and Mr Hufbauer have gathered estimates of the cost in lost GDP of 24 banking crises and 36 currency crises during the 1980s and 1990s. Research suggests that the calamities of the 1980s cost Latin America an average of 2.2% of GDP a year over the decade. In the 1990s East Asia's financial traumas cost the region 1.4% of GDP a year. Within these regional averages, of course, some countries suffered much more than others. Indonesia's output, for example, fell by 14% in 1998 alone, against an earlier trend of 7% annual growth: a one-year GDP shortfall of more than 20%. Overall, though, the cost of financial crises for all emerging-market economies worked out at around 0.6% of GDP a year for the 1980s and 0.7% of GDP a year for the 1990s (see table 3). Set beside Ms Dobson's and Mr Hufbauer's estimated capital-market benefits of 5% of GDP a year, that does not seem too bad.

However, many critics of financial globalisation would challenge these numbers, especially so far as the benefits are concerned. And they have a surprising new ally. A new review of the empirical literature by economists at the IMF, traditionally devoted to the cause of open capital markets, finds no consensus that financial integration yields any net benefits in growth at all (even though, the Fund insists, in theory it ought to). Of 14 papers reviewed, only three find that financial integration has a positive effect; another four find that the effects are mixed; and the rest find no effect one way or the other. The IMF's review also looks at the relationship between other measures of economic well-being and different measures of economic openness. Trade improves economic welfare, according to this research. Financial integration has no significant effect.

The absence of a clear conclusion suggests two possibilities. One is that financial integration is indeed a mixed blessing: it has costs as well as benefits, making net benefits (if any) hard to spot. Second, unlike free trade, financial integration may be good for economies only if certain conditions are met. If countries meet these requirements, they gain; if not, they lose. On balance, the effects tend to cancel out. These theories are not mutually exclusive.

Downside 3

GDP losses from banking and currency crises

	1980s	1990s
GDP loss from financial crises in emerging markets, $bn	249	419
Asia	13	260
Latin America	207	123
Africa	15	18
Europe	na	11
Middle East	14	7
Average annual GDP loss in emerging markets, %	0.6	0.7
Asia	0.1	1.4
Latin America	2.2	0.7
Africa	0.5	0.6
Europe	na	0.1
Middle East	0.3	0.1

Source: "World Capital Markets: Challenge to the G10", by Wendy Dobson and Gary Clyde Hufbauer. Institute for International Economics

Split the difference

Even so, for some countries, at least, access to global capital is likely to bring advantages as well as drawbacks. And there is no need to come to an all-or-nothing judgment about capital flows. The choice is not between completely unfettered flows and financial isolation. According to circumstances, a middle way may be best. The aim should be to reduce the costs of financial integration without casting aside such benefits as there may be.

Seeking the benefits of financial integration while suffering fewer costs is a difficult task, as the rest of this survey will explain, but by no means a hopeless one. There is little prospect of ever eliminating the risk of financial crisis, short of eliminating finance itself. But the terms of the trade-off between higher incomes (because of broadened economic opportunities) and higher risk (because of exposure to financial hazards) can be improved.

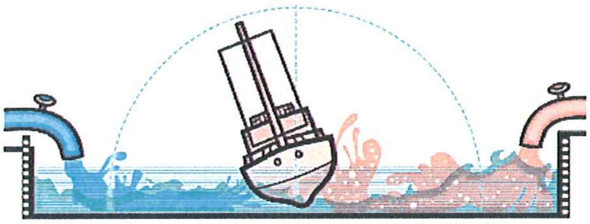
Unfortunately, developing countries face particular difficulties in striking the right balance. The combination of malfunctioning domestic finance, weak regulation and erratic economic policy is perfectly designed to get the worst out of financial openness. In countries where those failures are severe and cannot be corrected, an incautious opening of the economy to foreign capital is likely to do much more harm than good.

Reaching a modest minimum competence in regulation and economic policy is crucial for the emerging-market economies. And there is a lot of work for governments elsewhere too—very much in their own interests, not just for the sake of spurring development in the poor countries. Rich-country suppliers of finance, rich-country regulators and the international financial institutions directed by rich-country governments all need to do better if the full mutual benefits of financial globalisation are to be achieved.

"Hot and cold running money",

The Economist, May 1st 2003

One way of increasing the benefits of global capital while reducing the costs is to alter the mix



ARE some kinds of capital inflow better than others? On the face of it, yes. Borrowing from a bank, for example, is relatively risky. If, for example, the borrower's income falls, for whatever reason, he has no choice but to service the debt just as before, even though his capacity to do so may be less. A bank loan taken out at a floating interest rate, or denominated in foreign currency, exposes the borrower to additional risks beyond his control. Banks may call in loans, or refuse to roll over short-term credits.

At the other extreme, foreign direct investment (FDI) looks comparatively safe. In effect, the foreign investor is sharing much of the receiving country's risk. If profits should fall, so will the foreign investor's income from his investment: the cost of servicing the investment moves in step with the recipient's economic fortunes. Also, FDI is a lot more difficult to withdraw when times are hard. Investments may have to be sold at a loss, if they can be sold at all. Somewhere between bank loans and FDI in terms of risk-sharing are portfolio investments such as bonds and shares.

Again, however, there are trade-offs which make the choice more complicated than it seems. A key issue is cost: there is no something for nothing in international finance. FDI may be a safer source of capital than borrowing from a bank, but in the long run it is likely to be more expensive. The reason is simple: in return for shouldering extra risk, investors require a bigger income. In the end, the share of profits to which FDI entitles them can be expected to pay a lot more than the interest payments due on a comparable bank loan.

FDI has other drawbacks. It is much more difficult to arrange. Banks specialise in bridging the gap between investors and borrowers, bringing them together even though one may know nothing about the other. FDI demotes the middle-man to an advisory role at most, so the principals have more to do. Direct investment requires a close long-term relationship between the investor and the company that is invested in.

This is an advantage in some ways. FDI often brings the recipient useful technical and managerial knowledge, and vital contacts in world markets, as well as money. But an FDI partnership requires a big investment of time and effort, especially on the investor's side. This will tend to narrow the scope of FDI to large projects in relatively large recipient countries (which can offer the investor a correspondingly big market for its output). Of all the companies or activities in developing countries that could make good use of foreign capital, comparatively few are currently in a position to attract FDI.

A pity, because the economic evidence, such as it is, seems to confirm that FDI is on balance the most desirable form of capital inflow. Recall the estimate quoted earlier for the developing countries' gains to date from openness to cross-border capital: an improvement of 5% in GDP, roughly on a par with the gains from trade. The studies which yield that number allow separate (albeit rough) estimates to be made for the respective gains from FDI, portfolio flows (bonds and equities) and bank loans. This research suggests that a rise of one percentage point in the ratio of the stock of FDI to GDP will raise GDP by 0.4%. In the decade to 2000, the ratio of FDI to GDP in the developing countries went up from 7% to 21%. That rise of 14 percentage points implies an improvement in GDP of 5.6%.

The evidence on whether portfolio investment affects growth is even more sparse than the evidence on FDI. However, the OECD's Marcelo Soto, whose work was used in deriving the FDI estimate, has looked at both. He found that, within the total of portfolio flows, equity flows have an even bigger positive effect on GDP than FDI, an admittedly strange result. Conversely, bond flows actually have a negative effect. Averaging the two, with a 60% weighting for bonds (to reflect the mix within the portfolio-flows total), suggests an improvement of 0.2% in GDP for each one- point rise in the ratio of portfolio capital to GDP. Between 1990 and 2000, the ratio of portfolio capital to GDP in the developing countries rose from 8% to 14%, implying an improvement in GDP of 1.2%.

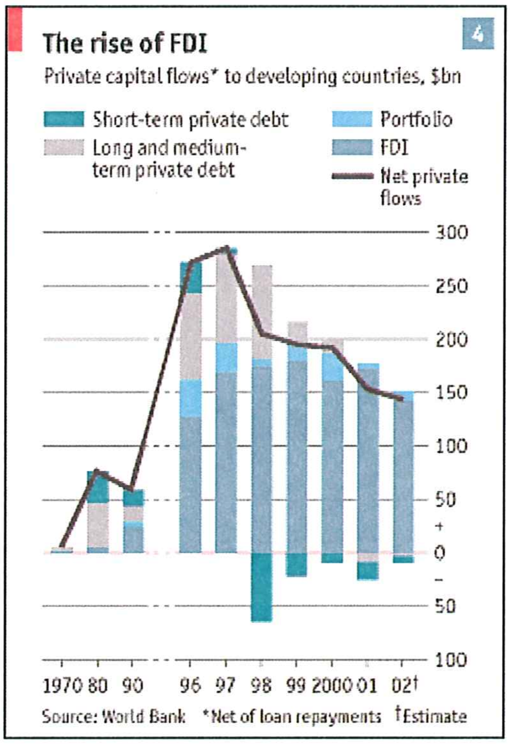
According to the same research, bank debt is the one to avoid. It is estimated to reduce GDP by between 0.2% (Mr Soto's figure for loans) and 0.4% (trade-related credits) for every rise of one point in the ratio of bank debt to GDP. The developing countries' stock of foreign bank loans and trade credits increased from 30% of GDP in 1990 to 37% in 2000. That implies a fall in GDP of around 2%.

It just so happens

At best, these figures should be regarded as only a rough guide to orders of magnitude. Nonetheless, they seem to support a preference for FDI over portfolio flows, and a strong preference for either of these over bank-debt flows. Recent years have seen a dramatic shift in the composition of capital flows to the emerging-market economies. In light of the evidence on the advantages of different kinds of capital, the change looks like one for the better. Bank lending has fallen sharply. Portfolio investment (bonds and equities) has gone up. And FDI has soared, despite the difficulties in expanding it as quickly as many countries would wish.

In 1980, flows of short-term debt to emerging-market economies amounted to $30 billion, net of repayments. In 1990, the figure was $15 billion. From 1998, flows of short-term debt turned negative; that is, repayments and interest exceeded new loans. FDI inflows moved sharply in the opposite direction: from $5 billion in 1980 to $24 billion in 1990 and $160 billion in 2000. Net portfolio investment has increased too, from about zero in 1980 to $26 billion in 2000 (see chart 4).

A variety of factors lie behind this changing pattern. Bitter experience, culminating in the East Asian debacle, has curbed the banks' own appetite for conventional cross-border lending, though perhaps only temporarily. Attitudes have also changed in many of the developing countries. In some of them, financial liberalisation has opened domestic securities markets to foreigners for the first time. In others, access may not yet be free but is at least easier than before. And attitudes to inward direct investment have undergone a transformation. Even countries such as India, which for decades set its face against foreign ownership of local assets, are vying with each other to draw foreign investors in. China's remarkable growth during recent years, fuelled in part by its success in attracting FDI, has not gone unnoticed.



Even if economic policy in industrial and emerging-market countries did nothing further to alter the mix, the trend towards greater flows of FDI and equity finance seems likely to continue. This is not because the lessons from the financial crises of the 1990s have been taken to heart: financial markets have short memories. It is because economic development itself seems to favour this kind of finance.

As the developing countries become more prosperous, their financial and legal systems will become more sophisticated. FDI opportunities will become easier to find and exploit, and domestic financial markets will converge on the standards of depth and organisation familiar in the rich West. As domestic banking systems mature, moreover, they will be able to meet more of the financial needs so far satisfied by bank borrowing across borders. With economic growth and intensifying globalisation, every kind of financial flow might well continue to expand. But the mix of capital types, left to itself, is likely to drift gradually in the right direction.

Faster, faster

Ought governments to be satisfied with that, or should they try to accelerate this recent trend? The answer is that they should hurry it up. Some suggestions follow as to how they might do it. But first a word of caution: intervention of this kind needs to be done rather carefully.

If different kinds of capital were a close substitute for one another, there would be little need to hesitate in trying to improve the mix. Policy could aim to reduce cross-border bank flows and increase FDI, say; the expanded FDI would meet all the needs satisfied up to now by cross-border bank finance; capital flows would be safer, and nobody (except the banks) would be any the worse off. The trouble is that different kinds of capital cannot stand in for each other in this way. Many of the borrowers in developing countries that could put foreign capital to good use lack access to FDI, or to equity finance for that matter, and will for the foreseeable future. A strong push against cross-border bank debt could leave most such borrowers stranded. Risky capital from banks may be the only kind they can get.

This danger will be especially great in the poorest, worst-governed countries. Recall that FDI and cross-border equity finance are safer for the borrowing country because the investor shoulders more of the financial risk. In backward countries, foreign investors may simply refuse to do that. Legal systems may offer little or no protection against breach of contract, expropriation or outright theft. Corruption too is often an issue. In such circumstances, a western company with a reputation to lose will think twice before entering into a close economic partnership. To be sure, bank lending to such countries is hardly to be recommended either—but it may be that or nothing. Ruling out bank lending altogether is going to make some worthy borrowers worse off.

All or nothing?

Another risk is that in trying too hard to discourage one kind of capital, governments may inadvertently discourage others too. Maybe cross-border bank finance goes hand in hand with cross-border equity finance and with FDI. Discourage the banks, and far from seeing FDI and equity finance rise, you may see them fall, again leaving the borrowing countries worse off.

On the whole, though, the evidence on these interconnections is encouraging. It certainly does not seem to rule out cautious efforts at reforms to improve the mix. Within domestic financial systems, different aspects of financial development tend to go forward together. Bank finance and stockmarket development, for instance, seem to be closely associated. But there is little sign that cross-border bank finance has any particular significance in this. Certainly, economic policy needs to nurture efficient domestic banking: for its own sake, and also because otherwise equity markets and other aspects of financial deepening may be held back. But so long as governments do not discourage cross-border bank finance in a way that also discourages domestic bank finance, the effects on FDI and securities markets are likely to be slight. So far as substitution of one kind of capital for another is concerned, the price to be paid for discouraging cross-border bank lending seems affordable. Other forms of capital are unlikely to expand to fill all of the gap, but they will expand to fill most of it—especially if the rules are drawn up to discourage only those forms of bank finance that are particularly hazardous for poor-country borrowers.

If the rules concentrate on discouraging short-term lending, for instance, the resulting gap can be filled not just by additional FDI and portfolio investment, but also by additional long-term loans—not as risky as short-term loans. In 1991 Chile imposed an implicit tax on inflows of short-term capital to reduce the aggregate inflow. In that, the policy failed: the overall flow was not much changed. But studies conclude that the tax did alter the pattern of inflows, shifting it away from short-term debt. That was a useful, albeit accidental, discovery.

Bear in mind, also, that in making the global capital market a safer place, the policy-reform agenda goes far beyond the extent to which developing countries should encourage or discourage particular sorts of inflow. It requires changes in a broader set of policies, aimed at promoting an efficient and well-balanced domestic financial system. That in itself will help speed the right kind of inflows; and without it, even the right kind of inflows would be little use.

Rich-country policies need to be looked at as well. The mistakes that led to the financial crises of the 1980s and 1990s were made by rich-country financial institutions under the supervision of rich-country regulators. And finally there is the multinational dimension: rich countries and poor countries alike need to examine the "architecture" of international finance, and see what kind of additional work—extensions, embellishments or strengthened foundations—may be needed. Are multinational bodies such as the IMF doing all they can to prevent crises or, if they happen, to manage them competently?

The financial upsets of the past two decades, and especially the East Asian crisis of the late 1990s, have yielded a mass of new information and spurred a great deal of activity under each of these headings. Under its own steam, the global capital market seems to have been moving lately to a safer and more productive mode of operation. Here and there, better policy can help to move that process along.

"Sudden storms",

The Economist, May 1st 2003

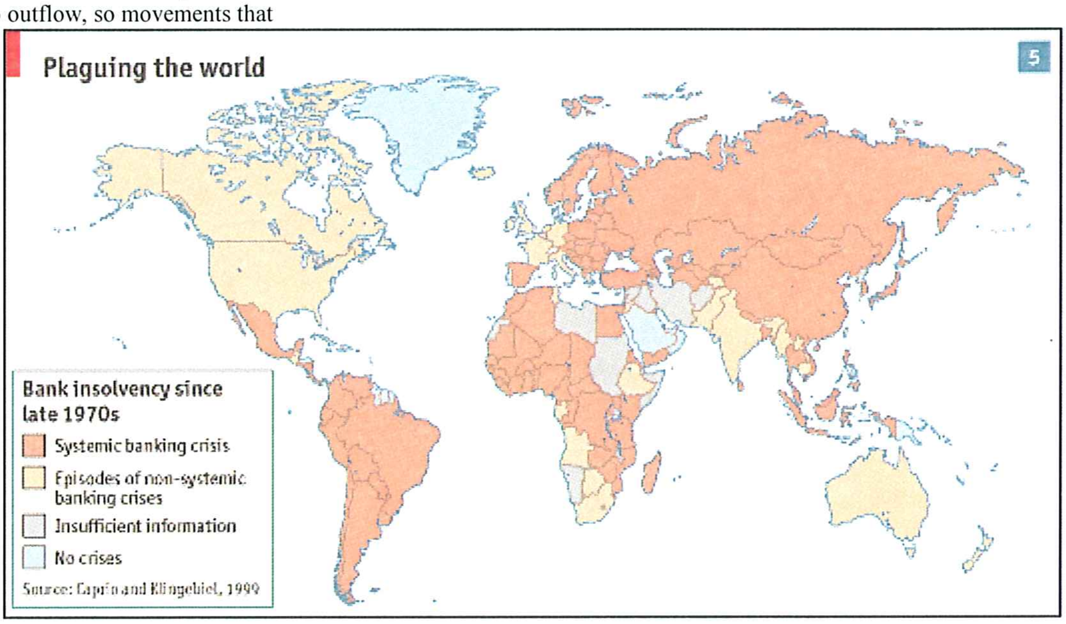
Financial crises don't come from nowhere. With effort and luck, some can be avoided

ONE way to improve the capital-flows trade-off—to combine more economic growth with less financial instability—would be to avoid at least some of the financial crises that might otherwise come along. But are they avoidable? They happen so often that it is natural to think that capital mobility and financial distress are inseparable: if a country wants the first, it will have to put up with the second. There is some truth in this. Access to more capital makes bigger crises feasible; every now and then, somewhere in the world, one is going to happen.

Is this because the same mistakes are made again and again, or is each crisis unique? The answer is yes to both: each crisis is unique, and the same mistakes are made again and again. However different the precise circumstances may be in each case, most of the scores of financial crisis seen in the past few decades do have certain central features in common. This is encouraging. Understanding these features and taking steps to deal with them could increase the safety of the global financial system without denying the developing countries the capital they need to grow quickly.

Banks are almost always deeply implicated when a financial crisis occurs—and banking crises are anything but rare (see map below). Given their role at the centre of any market-based financial system, it could hardly be otherwise. International bank flows, which declined so sharply during the 1990s, can still leave a country financially much more vulnerable than the figures suggest, because bank flows are so much more volatile than other kinds. Bank capital can switch quickly from inflow to outflow, so movements that seem small in absolute terms can exercise disproportionate influence.

Two kinds of banking weakness need to be distinguished: dangers specific to the borrowing country where the crisis starts, and risks that are due to capital moving across borders. As the crisis unfolds, these two interact. And the trouble often starts with financial liberalisation, a process that may aggravate both kinds of weakness. Talk about the perils of liberalisation makes some economic liberals uncomfortable, though financial economists, including many with strong pro-market leanings, have been pointing to the dangers of badly handled liberalisation for decades.



Falling standards

Every study of the East Asian crisis of the late 1990s has drawn attention to lax lending standards in the crisis countries. A lending boom preceded the breakdowns, and in each country most of the money went into risky assets such as property and equities rather than into productive investment. In Thailand, Indonesia and Malaysia the stock of lending for property accounted for as much as 40% of all lending before the crisis struck. Creditors were therefore unusually exposed to certain kinds of risk. Higher interest rates, for instance, would lower the value of the assets against which they had lent, at the same time as making some of their loans non-performing.

Government involvement in many of the regions' banking systems made matters worse. Ministries urged banks to lend to specific sectors or firms with little regard for creditworthiness. "Connected lending"—that is, lending to the banks' own proprietors or to affiliated businesses—was tolerated or even encouraged. Ordinary standards of prudent loan appraisal were set aside.

Banks often lacked the resources, human and technological, to apply such standards in the first place. Their lending officers and risk-management systems were stretched beyond the limit of their competence by the sheer volume of business. The same was true of the bank supervisors' resources, such as they were. Not only did the banking authorities lack the skills and the manpower to do an effective job, but they were also usually under the thumb of ministries that were reluctant to see lending curtailed.

"Forbearance" was the rule—meaning permission to keep lending until the problems went away, and to hide the evidence in the meantime. Bad loans were "evergreened": failing borrowers were allowed to service their debt with new loans. Accounting rules allowed such practices to be concealed. Nearly all of the crisis countries turned out to have had vastly greater volumes of non-performing loans on their financial institutions' books than the official figures admitted at the time. The official figure for South Korea's non-performing loans in 1996 was less than 1% of all loans—between one-tenth and one-twentieth of the true position.

In addition to weakly regulated banks, most of the crisis countries had, in effect, virtually unregulated quasi-banks operating alongside. Thailand's finance companies are the most notorious example. South Korea had its "merchant banks": owned by the country's conglomerates, and more or less unregulated, they were at the forefront of credit expansion and of borrowing abroad. Indeed, the government allowed these ex-finance companies to borrow abroad only if the debt was short-term.

All of this was familiar from earlier financial breakdowns, looking back to the 1960s and before. Paradoxically, one of the least familiar aspects of the East Asian crisis, which helps to explain both its severity and the shock it caused around the world, is that many other aspects of economic policy were being handled well, and that the countries concerned seemed in most respects to be thriving.

In fact, East Asia was an extraordinary success story. Investors had every reason to feel confident. Even fiscal policy was mostly under control, which in developing countries is unusual. In a perverted way, it added to the financial danger. Investors believed that if banks and finance companies should fail, governments would be there to sort things out. The record showed that they were competent, and suggested that they had untapped fiscal resources in reserve.

The countries' success added to the dangers in another way: foreign capital was all the more readily drawn in. The sheer volume of additional inflows compounded the difficulties of monitoring and supervision. It added to the mood of optimism, so standards were relaxed still further. And it introduced the exchange rate as a new and potentially destabilising factor. Foreign inflows, while they lasted, supported the local currencies and added to the feeling that all was well. Governments, moreover, had promised to peg their currencies against the dollar; again, the markets assumed that they meant it, and that they knew what they were doing.

This sort of activity is strongly self-sustaining. While a bubble is inflating, reckless lending seems merely bold, and appropriately well-rewarded. Deteriorating credit quality is easy to conceal so long as the price of property and other assets offered as collateral is going up. The growth in lending fuels demand, so economic growth stays high as well. That reinforces the government's reputation for competence, so the boom continues.

Overborrowing syndrome

It is easy to see how this cycle of excess gets out of hand, but what starts it in the first place? Any news that spurs a rush of optimism can get things going. One potential catalyst is financial liberalisation, the very thing that first opens the credit taps. This has been known for decades. A classic text on development finance, by Ronald McKinnon of Stanford University, spelled out the dangers exactly 30 years ago.

A later volume of Mr McKinnon's again drew attention to the risks. Published six years before the crisis of 1997-98, it recounted South Korea's previous experience with overborrowing in the mid-1960s. Starting in 1965, financial and trade liberalisation had stimulated South Korea's growth, prompting a fundamental reappraisal of the country's prospects by foreign investors (not long before, economists had compared South Korea's prospects unfavourably with the North's). Liberalisation allowed capital to rush in, but the surge was too great; it forced inflation up and left the country struggling with the problem until the early 1980s.

Having started, and grown bigger, why does the bubble eventually burst? All it takes is a shift in perceptions, reversing the one that started it all off. After a few years of overborrowing, balance sheets start to look stretched. At some point, borrowers begin to think enough is enough. Here and there, asset sales begin as firms try to restore financial ratios to something closer to normal. Prices stop rising and then start falling. Inflows of capital slow and the currency comes under pressure.

The central bank would like to defend the currency by raising interest rates, but finds it cannot because the weakness of the banks has suddenly become clear. All at once the abyss opens up, and there is a stampede to get away from it. Panic and forced selling accelerate the decline in property and equity prices into a crash. The government's reputation for competence tanks. As capital flees, pressures on the currency force it to give way. Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts.

In the middle phase, while the bubble is inflating, multiple layers of moral hazard are in play. Domestic lenders are not effectively supervised either by regulators or (thanks to explicit and implicit deposit protection) by the markets. Foreign lenders likewise perform their death-defying feats over a safety net extended by their home governments—with some additional assurance of protection from borrowing-country governments and, should things turn really bad, from the IMF.

What little discipline markets might supply under these circumstances is undone by lack of information. Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts. The promise to defend the currency creates a kind of moral hazard too: an exaggerated sense of safety, leading people to do things which they would otherwise regard as too risky or too costly.
Looking back at the beginning of the 1990s, with the East Asian debacle yet to come, Mr McKinnon put it like this:

> [We] know that in any purely private capital market each individual borrower faces an upward-sloping supply curve for finance. That is not really a distortion. The more that is borrowed, the riskier the loan gets at the margin. The upward-sloping supply curve imposed by private lenders accurately reflects the increasing riskiness of the private borrower as he increases his exposure.
> Consider instead the world of the 1970s and 1980s, where governments guarantee all credit flows. The host government in the borrowing country guarantees private foreign credits, either officially or unofficially. In the lending countries we have official export-import banks and deposit insurance for the commercial banks. Consequently, the normal upward-sloping supply curve for finance did not face individual private borrowers in the third world during these two decades of huge accumulation of external debts. Because of the government guarantees that were involved, they could borrow at a virtually flat rate of interest.

Exactly the same thing happened all over again in the 1990s, and not just in East Asia but in many other countries too. Nobody should suppose for a moment that, after East Asia, it cannot happen again. Turkey and Argentina, to name but two, already confirm otherwise.

Is it infectious?

This account of the forces that drive the cycle of optimism, overborrowing (especially from abroad), excessive risk-taking and crisis may seem plausible for any given individual economy—but one of the hallmarks of recent financial stress has been its multinational character. One country gets into financial difficulties, then another and another. This co-called contagion need not be confined to particular regions. The Russian financial crisis of 1998, itself a kind of aftershock from the East Asian crisis, put Brazil and other Latin American economies under pressure almost immediately.

Some economists insist that this apparent contagion is not real. They argue that countries make their own way into a position of financial weakness and vulnerability, essentially in the way just described. They object to the term contagion because it implies that the countries and governments concerned are not to blame. Bad news about a neighbouring or similar economy, they say, merely alerts investors to problems elsewhere the markets had been unaware of, or willing to ignore.

On this view, it is not so much the disease that spreads as awareness of the disease. Financial crises may tend to appear in clusters, but the sources of the problem are fundamentally national in character: that is, they spring from the mistakes of borrowers in, and lenders to, a particular country, not from some global propensity to system-wide breakdown.

It is true that contagion will not bring down a financial system which is strong, and that a crisis needs strictly domestic material to work with. Also, some of the economic shocks that trigger crises in more than one country are global or regional in their effects to begin with, such as a change in world interest rates, or a big movement in the dollar or yen, or a big change in the price of oil. If events of that kind start a cluster of crises, contagion is not to blame (any more than one would call it contagion when an earthquake causes neighbouring buildings to collapse).

The fact remains that even an economy which has been rendered vulnerable by weak supervision, excessive optimism and prolonged overborrowing is not necessarily doomed. If it is lucky, it might pass quietly through that period of danger and emerge on the other side with its vulnerabilities lessened, either by acts of policy or merely as a by-product of advancing economic development. If it is unlucky, it will be affected by bad news just when it is most susceptible. When this happens, it seems reasonable to call it contagion.
A crisis in a neighbouring or similar country might suffice to bring on financial difficulties in just the same way as a purely domestic reappraisal of economic prospects could do: bad news that forces a rethink. Often, cross-border financial flows also come into play, exerting their own direct and powerful influence on events. The evidence points clearly to a "common banker" effect: if two countries have borrowed from the same lender, when one gets into trouble the other can expect to face a squeeze as well, regardless of differences in underlying economic conditions.

There are other channels of contagion too. Equity markets have spells of moving in step, especially in downturns. Rich-country portfolio managers have a tendency to herd together when it comes to investing in emerging markets. When a bank or portfolio manager faces losses in one developing country, it may choose (or be forced by regulators) to sell assets in other markets to shore up its position. If one country devalues its currency, competing exporters come under pressure to do the same, regardless of the effect devaluation might have on corporate and financial balance sheets. All of these factors link economies together.

Because of technology, financial markets move faster than ever before. Partly for the same reason, financial institutions are bigger than ever. When a big rich-country bank changes its mind about the prospects of a particular emerging economy, the effect on asset prices in that economy can be dramatic; all the more so if other rich-country banks decide to join in.

In short, the possibility of contagion certainly adds to the risks of relying on foreign capital, shifting the balance of pros and cons away from openness to capital. For countries that nonetheless still seek access to foreign capital, it underlines the relative attractions of forms that will move only slowly when circumstances change, notably FDI. And it emphasises the dangers of the most mobile and volatile form of capital, short-term bank debt.

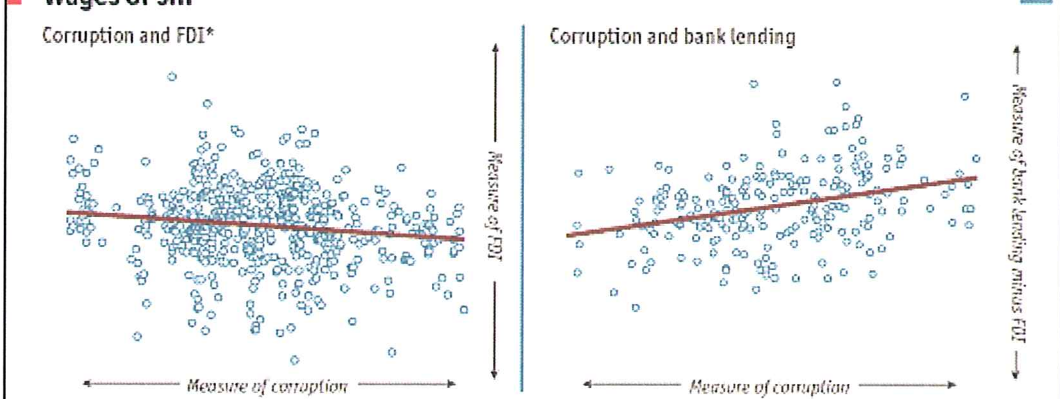
"Shipbuilding",

The Economist, May 1st 2003

Developing-country governments still have a lot of work to do if they want to attract the right sort of foreign capital

BETTER bank regulation is as much a task for rich-country as for poor-country governments. But in addition, the developing countries also need to implement many other financial reforms and improvements of their own. Few of them have the capacity to put imported capital safely to work. This capacity is something that governments can build, but a lot needs to be put right before openness to capital can be relied on to bring net benefits rather than net disappointment.

Reducing corruption would be high on the list even if economic efficiency were the only concern. Corruption particularly discourages inflows of FDI, the safest and most productive kind of capital inflow, so relatively speaking it favours bank lending, the riskiest kind of capital (see chart 8). Work on the connection between corruption and the mix of capital inflows has been reviewed in a paper just published by the IMF. However corruption is measured, the answer comes out the same: corruption discourages inward FDI. Indeed, it appears to discourage it even more than do high corporate taxes.



Wages of sin

*Bilateral foreign direct investment from 14 major source countries to 41 host countries, averaged over 1996-98. Index of host-country corruption is derived by combining the measures from the *Global Competitiveness Report* (World Economic Forum and Harvard University, 1997) and *World Development Report* (World Bank 1997).

Sources: Wei; IMF

Many developing-country governments, keen nowadays to attract FDI, try to appeal to investors by cutting corporate taxes or by offering subsidies. This often works, but the cost is quite heavy, and goes beyond the mere fiscal outlay or forgone revenue. Governments in most poor countries have to rely on a narrow tax base. They find it difficult to pay for social spending and economic infrastructure while keeping their own borrowing under control. Macroeconomic stability, as noted earlier, is an important contributor to financial safety. Special tax breaks for FDI may militate against such stability—and run a far greater risk, too, of distorting FDI decisions in favour of inefficient projects. In every respect, curbing corruption is a far better method of attracting FDI.

Reducing corruption is hard but not impossible. Measures include explicit restrictions on connected lending, better accounting standards and greater disclosure of financial information (and not just for the banks). In many countries, legal reforms will be needed as well. A constant theme of much of the recent research on finance and development is the importance of strong property rights. Without them, it is difficult, for instance, to offer collateral against a loan, or to resolve bankruptcies quickly and smoothly.

Faster and more accurate disclosure of information too is desirable in itself, for governments as well as for banks and private companies. A study by Gaston Gelos and Shang-Jin Wei, quoted in the IMF paper, looked at the investments of international equity funds between 1996 and 2000 to see if there was a connection with "transparency", measured in a number of different ways. It examined disclosure not just in the corporate sector but also in the release of official macroeconomic data and in the running of macroeconomic policy. All three aspects of transparency were found to be related to inward portfolio flows, even after allowing for the effect of many other factors (for example, incomes and market liquidity).

And these effects were big. For instance, on the macroeconomic-data measure, transparent countries received a share of global equity investment that was 48 percentage points higher than their market capitalisation (as a share of global market capitalisation) would suggest. Non-transparent countries received a share that was 25 percentage points lower than the same benchmark (see chart 9).

The same study found that herding among investors was substantially lower for countries with good disclosure than for the rest—presumably because greater transparency gives investors something more substantial to go on than what other investors are doing. Less herding is a good thing: when investors follow the crowd, they amplify the economic cycle, driving output and asset prices higher in booms and lower in slumps. Also, in the event of a financial crisis, capital flight seems to be less of a problem in countries with better transparency. Again, this may be because information equips investors to see beyond the short-term emergency to more reassuring long-term fundamentals. "Overall," the study concludes, "the data suggest that an improvement in transparency might very well reduce the so-called sudden-stop phenomenon of 'hot money', and hence increase the stability of the domestic financial market in a developing country."

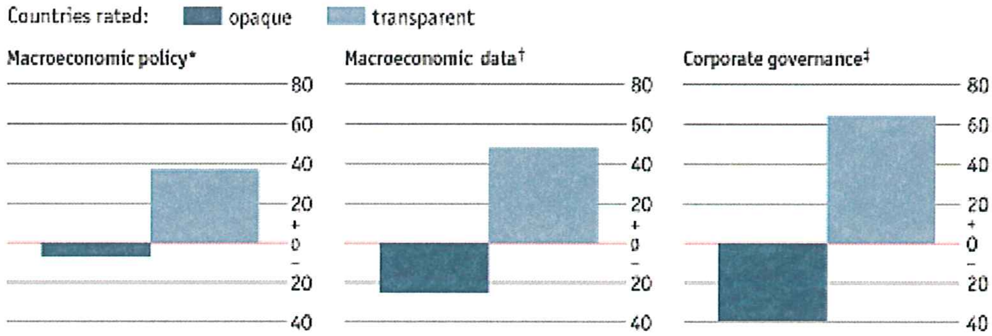
There is evidence that ownership of the banks and other financial institutions in developing countries matters a lot. Most governments restrict foreign ownership of banks. State ownership, on the other hand, is typically extensive. It would be far better the other way round.

Foreign ownership of banks is just a particular form of FDI. In many ways, therefore, the benefits to the host country of foreign-owned banks are simply the financial-sector equivalent of the broader benefits of FDI. These include not just the initial capital inflow itself but also the introduction of better technology and new management skills, not to mention greater competition for the existing domestic institutions. But in finance there are additional advantages as well. The task of financial regulators is easier if foreigners come into the market and establish new and higher standards. With a heavy presence of foreigners, the government is much less likely to bail out the banks en masse if they get into trouble. Uninsured depositors will accordingly feel that much less secure—which is all to the good, from the standpoint of discipline and monitoring.

action may seem advisable, especially since bank regulation is likely to remain far from ideal. But in systems that are neither clean nor well-run, and where governments would find it difficult to put this right by more direct means, narrower restrictions may be necessary. Two kinds of capital stand out: short-term debt, and debt denominated in foreign currency. Short-term foreign-currency debt, combining the hazards of both, is therefore a prime concern.

Transparently attractive 9

Foreign investment by mutual funds, actual % share of total minus expected share of total



*Conformity with prescribed standards and codes †Frequency and timeliness of official macroeconomic data ‡Level of financial disclosure and availability of information about business opportunities

Source: "Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence", by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose. IMF, March 2003

Banking-sector FDI also helps to fight corruption. Foreign-owned banks have their reputations at home and around the world to consider, not to mention their home-country regulators, so they will be less susceptible to corruption than incumbent domestic banks. They also have good reason to monitor what domestic banks are doing, and to expose corruption when they find it. From their point of view, improper conduct is a kind of unfair competition that puts them at a disadvantage.

Possibly most important of all, banking-sector FDI promotes diversification, which is a good way of reducing risk. The business of domestic banks in developing countries tends to be heavily concentrated at home. If the local economy turns down, all of their activities are exposed. Foreign banks have a far wider spread of risk, and can call on head office to help if need be.

For every advantage that banking FDI offers the emerging-market economy, state ownership brings with it a corresponding disadvantage. State-owned banks often institutionalise practices that would be called questionable or corrupt if undertaken by private banks. Connected lending, for instance, is not so much a consequence of state ownership as its very purpose: the whole idea is to make lending decisions on the basis of non-economic tests. This means state-owned banks must be expected to make losses, and will have to be sheltered from competition. Regulatory forbearance, in the same way, is not just likely, it is required. Monitoring by depositors and other creditors will be minimal: the promise of bail-out is as clear as it possibly can be. The evidence confirms that countries with the highest proportion of state-owned banks have the highest bank operating costs and the largest proportion of non-performing loans.

In addition to promoting access to information and curbing corruption—where greater foreign ownership can be of great help—developing-country governments need to weigh the case for explicit restrictions on certain kinds of financial activity. In systems that are otherwise clean and well-run, the need for further measures might be limited. Even then, some

Unpegged

Today the exchange-rate danger, at least, is smaller than before—not because currencies are more stable, but because the fragility of systems that merely appear to be stable is better understood. Fixed but adjustable exchange rates helped to worsen the plight of the East Asian economies and others in the late 1990s. The promise of a stable currency helped to draw in too much of the wrong sort of capital. Then, when events forced a devaluation, the economies concerned found themselves in trouble twice over—once for overborrowing in the first place, and then again because many of those debts had to be repaid in dollars or other hard currencies which had appreciated in the meantime.

The economic problem is even worse than this, because a heavy burden of foreign-currency debt makes it difficult for the government to cushion an economic slowdown in the orthodox way, by lowering interest rates. If it does that, it is likely to speed the flow of capital out of the country. This will drive the currency down further, increasing the burden of foreign debt yet again and dragging the economy into an even more ferocious recession.

Here, if nowhere else, lessons have been learned. All over the developing world, fixed but adjustable currencies have been replaced by more flexibly managed regimes (either pure floats or, more commonly, managed floats). Under floating-currency arrangements, the foreign investor comes in with a more realistic idea of the exchange-rate risk, and if the economy does get into trouble, the simple one-way bet of withdrawing capital before the currency peg gives way becomes more complicated. That is likely to encourage stability, both by tempering the inflow of capital during upswings of market sentiment and by encouraging long-term flows at the expense of short-term ones.

In other respects as well, international monetary arrangements are improving, albeit more slowly. The IMF, for instance, has a keener sense of the harm that can be done by letting investors believe that it will protect their investments come what may: moral hazard, yet again. A great deal of attention has concentrated lately on making sure that, once a crisis strikes, investors fully share in the losses—and that they will be well aware of this in advance.

But although understanding of the IMF's role has improved, policy for the most part has not. The main reason is that big financial crises are usually political crises as well. It is the way of the world that, at such times, economic principles are swiftly set aside. Generous IMF support, pushed through by powerful members (notably the United States), has often been granted for political rather than economic reasons, and will continue to be.

Also, as the Basel bank-regulation saga confirms, institutional reform that requires international consensus takes years, if it happens at all. Anne Krueger, the Fund's deputy managing director, has proposed a scheme for dealing with "sovereign bankruptcy", which among other things would allow investors' losses on loans to developing countries to be apportioned faster and more predictably. It is a good plan, and has won the support of many expert observers. But many governments, including America's, are not keen. At the moment, its prospects look poor.

Besides, the extraordinary attention paid to reforms of the "international architecture" over the past five years has been out of proportion to its real importance. As this survey has argued, it is the quality of national financial policy, in rich countries and poor countries alike, that decides the safety of the global capital market. If that policy is wrong, no reform of the IMF or changes to other aspects of the international architecture, however ingenious, is going to make cross-border capital safe and productive.