This is the text of the Charles Rostov Lecture delivered by Paul A. Volcker on April 9, 1988 at the Paul H. Nitze School of Advanced International Studies, John Hopkins University. Mr. Volcker is a former Chairman of Council of Economic Advisors to the US President.

EMERGING ECONOMIES IN A SEA OF GLOBAL FINANCE

Paul A. Volcker

What has been the 'Asian financial crisis' has by now come to be broadly and rightly recognized as only the latest, and most dramatic, episode in a series of events that raise some basic questions about global finance and its implications for economic development.

Financial crises, national and international, have, of course, been a recurrent part of capitalism. But somehow they seem to be coming more frequently and with greater force these days, at least as they impact emerging economies. Not much more than a decade after the start of the severe Latin American debt crisis of the 1980s Mexico found itself in renewed financial turmoil with reverberations through South America. The international community, led by the United States and the International Monetary Fund, felt it necessary to respond with official credits that dwarfed amounts that had been lent, or even imagined only a few years earlier.

Last year, what appeared at first to be a limited exchange rate problem in Thailand touched off a major financial crisis throughout Southeast Asia and then Korea. Massive new IMF programs could not stem the contagion, and the entire region — with its vaunted Tiger economies— is suffering a severe economic set-back. Almost over looked in the midst of all that upset, the economically tiny Czech republic, widely thought to be among the most promising of the transition economies, experienced its own financial crisis. Russia, chronically unsettled, narrowly escaped a new financial breakdown at the end of last year.

In searching for common ground in all this, one interesting point stands out. With the exception of Russia, the crisis countries had been characterized by exceptionally good economic growth and good progress toward price stability. Domestic savings were high, substantial progress had been made toward more open markets for both goods and capital, and investment had flourished. Virtually, on the eve of some of those countries being engulfed by financial turmoil, no lesser authorities than the World Bank and the IMF had acknowledged the effectiveness of their macro-economic policies.

Structual Defects

As this crisis spread, much attention centered on perceived structural defects in Asian emerging economies. Weak banking systems, governmental subsidies and favoritism. and crony capitalism. These are, of course, matters that have persisted over many years of remarkably rapid growth. At best, change will be uneven and slow and will bring uncertainties of its own.

Quite obviously, something has been lacking in our analyses and in our response. Emerging nations making good progress toward liberal policies and reforms have been hit hard. The problem is not regional but international. And there is every indication that it is systemic— systemic in the literal sense that it arises not from some *deus ex machina*, but from within the ordinary workings of the international financial system itself.

Conceptually and practically, open international capital markets should offer huge potential benefits in speeding and sustaining the economic growth of emerging and transitional economies. There are clear examples of those benefits in Asia and elsewhere. At the same time the recurrent volatility of those global markets can impact with devastating force on inherently small and poorly-developed national markets and institutions.

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Clearly, a great deal is at stake in coming to some common understanding of that dilemma and how to deal with it. For that reason, I welcome the calls we are beginning to hear from both inside and outside official circles for a new look at the workings of the international financial system and its main institutions. But it is also my sense that we are still a long way from achieving a good understanding of, much less implementing, convincing new approaches.

In emphasizing so strongly the systemic nature of the financial problems I do not want to be misunderstood. I believe, over time. "crony capitalism", state ownership, and official industrial policies are all inherently less efficient than open competitive markets.

I have always favoured strong banks, well-supervised and with experienced and prudent management. I have for many years fought against indiscriminately mingling banking with commerce in this country, and believe it is generally bad policy.

And I agree more information, widely disseminated must almost always be better than less—and in any case will be required in a modem democracy.

In varying degrees, all the countries caught up in the present financial crisis—certainly those in Asia—have had marked weaknesses in these respects. Over time, basic reforms will be needed to support sustained growth. In some cases, a strong political commitment to basic reform-reforms extending beyond the economic—has become necessary to restore confidence in government, and surely helpful in restoring financial stability. In that respect, both Korea and Thailand are fortunate in having in place new governments eager to embrace reform.

What I do not believe is that the timing, nature, and force of the Asian financial crisis (or for instance, those in Mexico or the Czech Republic) can be explained in terms of those structural factors, important as they may be over time. None of them are new. None of them have been unknown nor, to the best of my knowledge, have they suddenly gotten worse.

There are basic reasons why growth among the Asian Tigers, old and new has been sustained for decades at unprecedented rates.

There is a good supply of energetic and intelligent workers. A strong entrepreneurial spirit appears alive and well. There is willingness to a adopt and adapt to new technology and to maintain high rates of saving. All that means low cost and rapidly rising productivity even in the face of what appear, by Western standards flawed and weak institutional structures. That potential remains intact today. But clearly something has abruptly happened to disrupt that process. And, it seems to me that something lies more in the financial area than in the structural flaws that have been at the center of so much attention.

Flows of funds and their valuation in free financial markets are influenced as much by perceptions as by objective reality—or perhaps more precisely, the perception is the reality. The herd instinct is strong. Only in hindsight do episodes of strong—or "undershooting"— become evident, and the reversals are typically sudden.

All that has always been true. The resulting volatility can ordinarily be accepted as a small price to pay for the immense benefits that broad and active financial markets can bring. That is certainly true for large and well-diversified economies with sturdy financial structures. They typically have the resiliency to ride out the storm with limited and temporary damage.

Emerging Economies

The situation is more difficult for emerging economies. By definition, their economies and their financial institutions are tiny relative to the size of international markets to put that in perspective the entire banking systems of Indonesia or Thailand or Malaysia are comparable to one good-sized regional bank in the United States. Their entire Gross National Products are smaller that the funds controlled by our largest financial institutions, including large mutual fund families and other investors caught up in intense competition to put-perform their competitions. One result has been a capacity and willingness to reach out for more exotic high-yielding investments. The private sectors of emerging economies, with their strong growth potential, have become prime targets.

Those countries have in recent years become converts to the basic philosophy that more open markets for capital, as well as for goods, will bolster growth. One manifestation is their greater willingness to accept direct investment. Its longer-term orientation and technological and managerial components have been mutually beneficial. But there have been strong incentives to accept and encourage portfolio capital as well, where the benefits to the economy are more indirect and the potential risks greater. And much of that investment can be moved on very short notice-at least until a crisis shuts down the market.

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The process for a time is self-reinforcing. The inflow of foreign money helps to spur investment to strengthen directly export capabilities, and to sustain high rates of economic growth. By supporting a strong exchange rate, inflation is contained and a sense of stability reinforced. Profit opportunities for local banks and other financial institutions blossom as they intermediate the flow of funds. And the apparent success of the early investors encourages more to join allocating amounts that from their individual perspectives may be marginal.

The difficulty is that what may by marginal to the increasing numbers of investment institutions with mobile money, can, in its totality, be overpowering to the small receiving country. The possibility of simply sterilizing the inflows is expensive and self-limiting. With money so freely available from abroad, banks will lend aggressively. Sooner or later investment is likely to run ahead of needs and be misallocate by governments or private investors. In the circumstances, a real estate boom will be almost inevitable, and, whatever the particular exchange rate regime, the real exchange rate will appreciate, undercutting trade competitiveness.

Sooner or later, some event internal or external, political or economic, will raise questions about the sustainability of it all. The capital inflows will slow or stop. The exchange rate will come under pressure, inducing capital flight. Reserves are depleted, the exchange rate sinks way below what was thought to be reasonable, inflationary forces rise, interest rates double and re-double, and the crisis is at hand.

Global Financial System

In one sense the pattern is all too familiar. But there is a large difference from most earlier experience when the source of the crisis could be traced to irresponsible macro-economic policies— loose budgets, excessive monetary expansion, an escalating wage/price spiral—the kind of thing towards which IMF rescue programs have been typically and effectively directed in the past. The present situation is more complicated. It involves deep-seated questions about the operation of the global financial system, as well as macro-economic discipline. And it has become increasingly clear that simply providing escalating amounts of short-term financial resources cannot provide a satisfactory approach—certainly not without providing creditors with a degree of assurance that would raise large questions of moral hazard.

The IMF and the official community have clearly been faced with difficult circumstances beyond the well-trodden approach of macro discipline and the provision of short-term credit. In the circumstances one can empathize with the urge to deal aggressively with all those matters of internal reform to which I referred earlier. But there are limits and dangers to that approach as well perceptual and political as well as economic.

...small and open economies are inherently vulnerable to the volatility of global capital markets.

One is the extreme difficulty of changing ingrained habits of government and business rooted in deep-seated cultural patterns. Ordinarily, it will be slow process, and there can't be any assurance that radical change imposed in a crisis won't exacerbate uncertainty and dislocation; the contagious runs that followed the sudden closing of some Indonesian banks is one case in point. To the extent that "reforms" are, or appear to be, imposed from abroad, the risk of a counter-productive backlash is increased.

The easy advice we give others about quick reform of their banking systems, I might point out, stands in stark contrast to our inability in the United States to pass legislation rationalizing competition among out banks and competing financial institutions-an impasse that has lasted for more than 15 years amid entrenched private interests. It is ironic that one of the matters at issue in our Congress is the political pressure brought to bear to weaken our traditional barriers to combinations of commerce and banking, precisely the practice in Asia and elsewhere that we rail against as a major source of institutional weakness.

More important in the present context, we have to deal with the simple fact that countries with strong banks, honest and democratic governments, relatively transparent accounting systems, and experienced regulators have not been immune to banking crises. The list is long, and it includes the United States.

The Case of Texas

Others have aptly pointed to the situation in Texas to make the point. Once itself an independent country, Texas has economic mass—a GNP about the size of Korea's and a large multiple of any of the smaller Asian economies. At the start of the 1980s it had among the most strongly-capitalized and profitable banks in the United States, and they were fiercely resistant to permitting any "foreign" ownership—foreign defined as New York or other out-of-state banks. No doubt there is and was a certain amount of cronyism among Texans, and we later learned there was a good deal of corruption among poorly-supervised thrifts. But as one of the responsible commercial bank regulators at the time, I'd like to think that supervision was state-of-the-art. Certainly the bankers were experienced, accounting as in the hands of the Big Six applying GAAP standards, and SEC 10K reports and financial prospectuses were reviewed by the highest-analytic talent in the world. But none of that institutional strength insulated Texas financial institutions and the Texas economy from the financial excesses that accompanied the energy and real estate booms of the early 1980's.

Texas did and does have enormous advantages relative to a small emerging economy. It was part of the world's largest common currency area—the United States. As such, there could be no loss of confidence in its currency and no inflationary impetus from depreciation. Its interest rates were those of the United States-and they tended to fall rather than rise. Large companies were typically part of dispersed national and international operations. There was an effective lender of last resort and credible deposit insurance-and a certain amount of regulatory forbearance.

Well, Indonesia and Thailand, Mexico and the Czech Republic are not Texas. But I think there are lessons to be learned from all this experience.

The first and most important is that small and open economies are inherently vulnerable to the volatility of global capital markets. The visual imagery of a vast sea of liquid capital strikes me as apt— the big and inevitable storms through which a great liner like the U.S.S. United States of America can safely sail will surely capsize even the sturdiest South Pacific canoe.

The natural defense is to seek the shelter of larger, inherently more diversified and stable ships. Texas is a case in point; by the end of the 1980's, every major bank in Texas with the encouragement and support of the Federal Government, had become part of a much larger national banking organization. With heroic effort Argentina has effectively adopted the dollar as a parallel currency and only one sizable private bank remains without substantial foreign ownership and interest. In Mexico, where resistance to foreign ownership of banks was a major issue only a few years ago in the NAFTA negotiations, four of the five largest banks today have important foreign capital. Thailand, strongly protective of its banks and finance companies before the crisis broke, now eagerly seeks foreign participation. On the other side of the world, in Eastern Europe, foreign ownership of banks is becoming commonplace.

In the non-financial world, there can't be much doubt that similar forces are at work. Distressed industrial and commercial firms will naturally look more favourably on injectors of capital from abroad, whether by means of joint ventures or outright sale. Without doubt, to large and diversified international companies, this is a buying opportunity.

Logic of Global Capital

To put the point more generally, the *economic* logic of living in a world of global capital markets is much more integration with the crisis. The obvious counterpoint is a growing lack of autonomy in economic management, easily perceived as an affront to sovereignty. That potential for *political* resistance will be all the greater if the changes seem to be forced not by economic logic and national decision but by external forces with their own agenda.

One thing is sure. If a country wants to participate in open markets for goods and other services, it can't feasibly opt out of world financial markets. The fact is finance is intertwined with trade and Investment. There are so many ways for funds to flow, and so many incentives to circumvent controls, that effective insulation cannot be achieved without stifling growth.

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So what can we do to better balance the opportunities and risks of global financial markets?

For one thing, justified skepticism about the efficacy of controls doesn't mean we need to frown on more limited efforts to restrain inflows of potentially "hot money". Some countries with Chile the leading case in point have developed techniques to restrain those flows that are broadly consistent with the basic desirability of encouraging prudence in banking practices. I am encouraged that the leading officials of the IMP have expressed some sympathy to that approach. I trust that in its zeal to incorporate freedom of capital movement in its basic charter, the Fund visualizes the prospect of maintaining surveillance over such measures rather than assuming they are, ipso facto, objectionable. Ideological purity rigidly applied is hardly appropriate to present circumstances.

A much more fundamental and difficult matter is exchange rate management. It is, it seems to me, an area of intellectual confusion. Not so long ago, there was considerable sympathy for the use of a stable exchange rate for smaller, inflation-prone countries as a key policy objective and an anchor for expectations. In the aftermath of crises, criticism has mounted that exchange rates have been managed too rigidly, that something much closer to free floating would have helped protect against volatile capital flows. The irony is that some of the fiercest critics of Thai or Indonesian exchange rate policy have also been among the most vociferous of those urging that the tiny economic area of Hong Kong and emerging China must, above all else, dedicate themselves to maintaining a strict peg against the dollar lest a new and devastating round of financial volatility break out in Asia.

Somehow we seem to be setting out a menu of exchange rate choices *a la carte* without much sense of how those choices can mould together. The reality is that left to the market, exchange rates of small and open economies are likely to be prone to wide and disturbing fluctuations. That is why the natural instinct is to seek shelter by maintaining a stable relationship with close trading partners of one of the major world currencies. In the industrialized world, the ultimate expression of that instinct is the drive toward a common currency in Europe. Another manifestation is the new interest in currency boards, accepting the loss of monetary sovereignty. Much more common are compromise approaches formally or informally setting a range of values around a reference currency or a basket of currencies. Quite a few countries have managed such arrangements for considerable periods. There will, of course, be strains in the face of volatile capital markets and all the pressures and uncertainties in real economies. That is all the more true in Asia where trading and financial patterns are so widely dispersed among North America, Japan and Europe. The choice of an appropriate anchor currency is not obvious.

Those difficulties are compounded when the major world currencies are themselves highly volatile. One precipitating factor in Asia was the large depreciation of the yen. With its currency loosely linked to the dollar, Thailand's competitive position was sharply and unexpectedly undercut. But the solution is not so clear.

With fluctuations in the yen/dollar rate in a range of 50 percent or more over the space of a year or two, Thailand, or any similarly situated country, faces an insoluble dilemma. Both Japan and the United States are important markets and sources of finance. But stability against one currency is volatility against the other. Attempts to split the difference, even if practically feasible, can't escape competitive distortions.

I count it as one of the few constructive by-products of the Asian crisis that, finally, questions are again being asked about the design-or, more accurately, the absence of design-of the exchange rate system. For years, the 'Big Three" (Germany, Japan and the United States) have been reassuring each other that the recurrent volatility among their exchange rates would settle down-or if not, it didn't really matter much any way. Today, that air of insouciance is harder to maintain.

New Approaches

It's a frustrating time, analytically as well ad practically, in dealing with the unprecedented problems of emerging Asia. Criticism and unhappiness about the role of the IMF and the other major players in international finance has been inevitable. What is encouraging is that the Fund itself appears to recognize the need for stepping back and for assessing with a fresh mind both the challenges posed by the new world of global finance. The fact is, new approaches are needed.

There should also be no doubt about what is at stake. If, a few years down the road as we get into the new millennium , the turbulence of markets persistently undercuts strong and consistent growth in emerging markets, then temptations to reject the ideology of open markets and multilateralism will increase. The kind of open, benign regionalism characteristic of much of today's trading world would turn malignantly inwards, with all that implies for political conflict as well as economic tension.

Plainly, the United States is the single most influential actor in all of this. We are not a helpless giant. To the contrary, the danger lies in a certain arrogance-a tendency in the Congress particularly to pull back from international economic leadership in the illusion we can be secure in our own strength lulled by the performance of our economy and booming financial markets.

I do not need to emphasize that even the United States is not, and cannot be, on economic or political island. The simple fact is we need to work within and through international organizations-organizations that we largely created-if we want our vision of open markets and political consensus to prevail. One need not agree with every policy and every decision of the IMF to realize that it is the only vehicle we have-and the appropriate vehicle-to bring consensus and legitimacy to reform of the financial system on a global scale.. To fail to support the proposal for additional IMF resources at this time, a proposal which burdens neither the budget nor the economy, could be interpreted as a kind of abdication of leadership in the midst of crisis.

There is another imperative. In our insistence that the beleaguered economies of Asia take tought steps to reform their own economies, we need to recognize the need to keep our markets open. That happens to be in our immediate economic interest helping to maintain price stability in the midst of vigorous growth. More fundamentally, we must not fail to demonstrate by our own actions that our advocacy of open trade is a lasting commitment for fair weather and foul.

The turbulence in world financial markets strikes me as a test—a test of our capacity to lead and also to work imaginatively and cooperatively with others. I don't underestimate the difficulty of the challenge. But happily, it comes at a time of great strength, and that strength can convert into opportunity. ■

The following editorial appeared in ***The Washington Post*** *on September12, 1998.*

RETHINK CAPITALISM

What is frightening about the world's current economic troubles is a sense that rules we thought we understood don't seem to apply now. Until a few months ago, we thought we new that a developing country had to do to join the ranks of the wealthy. We thought we knew how a Communist country could transform itself into a capitalist one. The general understanding was that as the world become more prosperous.

Now, with Russia and much of Asia having crashed, with Eastern Europe and Latin America imperiled and with much of Africa going backward, the certainties of only a year ago seem far from certain. Malaysia last week shut the door on the global economy, as its autocratic leader withdrew his currency from international circulation and fired the deputy prime minister who had pushed hardest for openness and liberalization. " The free market system has failed and failed disastrously" Prime Minister Mahathir bin Mohamad declared.

Russia edged toward nationalization of industry and more state control. Even Hong Kong, until now the world's most ardently free economy, spent billions of government dollars to prop up the local stock exchange-an intervention that free marketeer Milton Friedman bluntly labeled "insane."

Looking around Mr. Mahathir's stricken neighborhood, it is not hard to understand his retreat. But it is important at a time like this not to draw more lessons than the facts provide. Not everything we thought one year ago, in other words, now has been proved wrong.

Yes, this is a time for humility. Yes, the IMF's doctrinaire opposition to any controls on capital, even on short-term movements, may have been mistaken, and its initial efforts at Asian rescue may have been misguided in key respects. But much of what Asia did in the past 30 years-investing in health and primary education, welcoming outside investment, eradicating poverty-was correct, and it is still, quite likely, enduring. Much of what Eastern and Central Europe have accomplished in a few short years has been not only heroic but absolutely on track.

If the mistakes that have been made have a common thread, it was the emphasis of economic solutions over political ones. In Indonesia, it was believed that economic growth would, in its own time, overcome the obstacles of autocracy and corruption. In Russia, it was hoped that macroeconomic stability and privatization would foster the middle class that would in turn, insist on thee rule of law, contract sanctity and the rest. In both cases, the sequencing didn't work.

A lot of rethinking needs to be done. But many of the goals and principles were right, and they should not all be thrown overboard in a panic.

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