GLOBALIZATION AND THE INTERNATIONAL FINANCIAL SYSTEM

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AT A DINNER HONORING THE 72ND BIRTHDAY OF

HIS MAJESTY KING BHUMIBOL ADULYADEJ

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To be asked to address this audience in celebration of your King's birthday is a signal honor for me.

I know something of His Majesty's extraordinary role in guiding Thailand through a turbulent period of rapid change. The enormous respect in which he is held reflects a truly remarkable record of selfless service to his nation, a record that has provided a solid foundation of civility and stability.

The invitation has also provided my first opportunity to visit Thailand and Bangkok for any length of time. Beyond that personal pleasure, I am greatly challenged to explore the implications of the globalization of financial markets.

For the past three years, Thailand has, in effect, been placed under a microscope by economic and financial doctors from all over the world. With or without official invitation, with or without the ability to offer concrete assistance or money at stake, visitors have analyzed your economic performance, your institutions, and your political life.

That's understandable in the light of the fact that the East Asian economic crisis, which for a time seemed to threaten financial turmoil more broadly, started quite unexpectedly right here, in a country that for a long time seemed to be doing very well.

Quite obviously, there are lessons to be learned. But those lessons surely extend well beyond the specifics of Thailand, and you may be relieved to know that I do not intend this to be a lecture on the particular policies of your country.

What I would rather do is address a more general question. Do the events of 1997 and beyond raise more fundamental challenges for the international financial system than have yet been generally recognized? Specifically, can smaller emerging economies live comfortably with the volatility inherent in global finance?

Consider where we are almost three years after the devaluation of the baht and at the start of a new decade.

The decade of the 1990's started with an event of surpassing significance - the victory, ideologically and economically, of democratic capitalism. The competing vision of a socialist and centrally controlled society seemed to vanish almost overnight.

The virtues of a liberal and open trading order became more widely accepted in the developing world. Even more striking was the rapid abandonment of controls on international capital movements, not just among economically more advanced countries but in the emerging world as well.

The remarkable economic growth and stability in the 1990's of the United States - the leading advocate of open markets - has seemed to provide concrete evidence of the value of these policies. Exuberant growth in much of East Asia - prior to the Thai crisis - could also be, and was, interpreted as confirmation of the potential of free markets. Growth rates of six to eight percent a year - even higher in China - seemed to be becoming the norm in this part of the world.

There were, and are, good and fundamental reasons why the Asian emerging economies could become exemplars of growth and highly attractive to capital. Low costs, a large and energetic work force, increasing education, typically substantial natural resources, receptivity to new technology, and increasingly disciplined macro-economic policies - all these had been reflected in good growth before the 1990's. But there couldn't be much doubt that the relative openness of world markets, the rapid expansion of international trade, and substantial inflows of capital as barriers were eased or dropped supported an even more dynamic process of economic expansion.

Thailand, for good reasons, was among the leaders in both growth and attracting foreign investment. Then, quite suddenly, it all seemed to go into reverse. What could be considered in the larger scheme of the world economy a small event - the devaluation of the baht - touched off a financial fire storm that extended even well beyond Asia.

Here in Thailand, I understand, recovery is clearly underway, with growth picking up to 3 1/2 percent or so in 1999, with further acceleration to 4-5 percent a reasonable expectation for this year. That kind of rebound, together with restoration of much greater stability in both domestic prices and the exchange rate, is reassuring. To greater or lesser degree, a similar pattern has developed in other emerging economies in Asia and Latin America which were hit so hard by the crisis.

So, there is a sense that the immediate crisis has been contained, and we can begin to look ahead more positively. But, there are concerns that won't go away - difficult systemic questions about the prospects and policies for small and open economies in a world of global finance.

The importance of the issue is underscored by the fact that economic activity in Thailand is still well below the level reached in 1997. Among the crisis affected Asian countries, only the more fully developed old "tigers" - Korea, Taiwan and Singapore - have approached their old growth pattern, and even they are below the trend line established in the 1980's and early 1990's.

Surely, the basic economic potential of which I spoke of Thailand and most of the other emerging economies remains substantially intact. Economic conditions in the developed world are now more favorable. Despite the financial setbacks in the recent past, direct investment has been remarkably well sustained and a number of the newer emerging economies are again attracting portfolio and venture capital.

So what needs to be done to provide better assurance that all that bright promise can again be reflected in sustained performance, minimizing the threat of another setback?

The first answers - embodied in the self - styled Washington consensus among American and international policy-makers and economists - have been stated and restated. The premise is that the crisis basically reflected institutional and policy shortcomings in the emerging world itself, complicated by the inability or unwillingness of international money managers to assess risk properly. There is emphasis on familiar policy fundamentals - the old story of the importance of responsible budgetary and monetary policies. Beyond that, attention has been focused on institutional reforms, particularly in the financial system, that historically have received little emphasis. As never before - at least in my memory - questions of adequate bank capital, of banking supervision, of accounting and auditing standards, and of "transparency" have been placed front and center on the policy agenda.

As one concerned with banking supervision and the structure of financial markets for many years in my own country, I welcome that emphasis. The often expressed concerns about the importance of open and fair business practices, of respect for the rule of law and open competition are at least as relevant.

In that connection, I can't refrain from expressing a point that seems to me crucially important for any market - oriented economy. It is a particularly critical point for nations without a long and strong tradition of financial stability.

A strong central bank, well insulated from partisan politics, professional in its staffing and fiercely protective of its integrity, is an invaluable national resource. With nationally and internationally recognized leadership and an established record of continuity, a strong central bank will command respect for its policies and enhance confidence in a nation's currency, invaluable assets at a time of crisis.

That may seem a rather parochial point by an old central banker. But it is a lesson that has been taken to heart in recent years by most countries, large and small, right around the world. A world of convertible paper currencies, a world that has long since abandoned the discipline of gold, and a world in which money can move so freely, necessarily requires high confidence in its basic monetary institutions. My sense is that both Minister Tarrin and Governor Sonakul have fully recognized that need. I congratulate them on their work to restore and nurture a strong Thai central bank. I trust those efforts will continue to command wide support.

Appropriate and desirable as all these efforts are, my sense is that they do not, and cannot, adequately deal with the systemic problem facing smaller new economies, individually and collectively, in this world of global finance. My sense is that the crisis has raised some broad questions that neither the official nor the academic communities have been willing to recognize and face squarely.

We can, I think, safely start from the proposition that volatility is inherent in financial capitalism. It is, at its roots, a part of human nature: the recurring urge to take large risks to get ahead, and - equally - to be consumed by doubts and fears when hopes and expectations are punctured. And we are all inclined to take courage in our hopes and solace in our fears by being part of a crowd; the herd instinct in financial markets remains strong.

Modern technology has made it possible to move money even faster at less expense. That same technology has made it infinitely easier to be well informed - or at least to think one is well informed - about almost anything with a few clicks of a computer mouse. Access to information and world markets is no longer confined to a few institutions and experts.

In combination, those developments have spawned an explosion in international borrowing and lending. And it's all gotten more impersonal, with shorter trading horizons rather than a sense of more permanent commitments.

Those are changes of degree. What has in my judgment contributed much to the severity of recent crises is the disparity in the size of the participants in international markets.

Thailand is not small in population, resources, or economic potential. But the aggregate size of its banking system is less than 150 billion dollars. Indonesia, The Philippines, Malaysia, Argentina, and the other smaller Latin American and Eastern European countries have banking systems of similar or smaller size. Even the largest of the individual banks are of a size that, in the United States, would be considered community or small regional institutions, with operations confined to their immediate areas, with little or no participation in international markets.

Contrast that with the size and diversity of the world's largest banks - individually ranging close to a trillion dollars. Investment firms in the United States or Europe may manage hundreds of billions of dollars. The hedge funds that have received so much attention are typically much smaller, but they are, of course, inclined to move that money quickly as they perceive changes in circumstances.

My point in making these comparisons is that even relatively marginal shifts in funds by the big international players - marginal from their point of view - can overwhelm the capacity of relatively small economies and banking systems to employ inflows of funds prudently or to meet sudden withdrawals.

There is a familiar pattern. An emerging economy is doing well, is perceived to have responsible macro-policies, and is thought to have a strong growth potential - Mexico in the early 1990's, Thailand and much of East Asia even after the Mexican crisis are obvious recent examples. Foreign money flows in, the currency is strong, investment is stimulated, and imports help hold down inflation. So more money flows in. The whole atmosphere is conducive to more spending, easy credit, more lending.

In that environment, with all going so well, it is very difficult to maintain bank capital ratios or to strengthen supervision and regulation, even with a strong central bank. There are few bad loans to report. A rising current account deficit - the counterpart to the capital inflow - is easy to finance. So insidiously, the risk of a financial bubble arises, with severe consequences when perceptions change.

Experience amply demonstrates that even the largest and most advanced countries are not immune. We in the United States not so long ago experienced a crisis that effectively destroyed half of our large savings institutions. Much of our commercial banking system was threatened twice within the past 20 years. The banking systems of Scandinavian countries effectively had to be nationalized. The Japanese banks have been severely compromised by non-performing loans.

None of those economically developed countries escaped adverse economic repercussions. All have experienced so-called "credit crunches". To protect their financial stability all felt it necessary to effectively guarantee bank depositors and creditors, sometimes at heavy budgetary cost. To some degree, all experienced recessionary pressures. But none of them experienced anything like the degree of economic shock and budgetary pressure common in the emerging economies.

I don't think that's a matter of sheer coincidence. Nor can it be accounted for by superior foresight, by wiser macro-policies, or by relative speed or ease of taking corrective measures.

I am acutely conscious of the fact that American banking regulation and supervision, U.S. auditing, and the disclosure standards in which we take pride did not forestall severe strains. I am also conscious of the fact that it was only last year, after almost two decades of effort, that the Congress finally passed legislation to provide an up-to-date legal framework for banking and other financial services. What has been so typical is that measures to increase bank capital and to strengthen bank supervision have followed crises, not anticipated them.

Rather than concentrating so exclusively on institutional and policy shortcomings in the emerging world, I want to emphasize an inherent difference between large and well developed national financial systems and those of small emerging economies. These differences are things we take for granted; they have been little discussed in the wake of the Asian crisis. But the simple fact is that sheer economic and financial mass is important when it comes to dealing with, and diffusing, crises.

Large economies are, generally speaking, diversified economies. Their main financial institutions are also large, and tend to be highly diversified, nationally and internationally. Diversification and size provide a certain "built in" stability. Large, diversified countries and companies have less relative exposure to international trade and finance, and therefore to the impact of exchange rate fluctuations. Less tangibly but equally important, the developed economies generally have a stronger sense of institutional and political continuity. That provides a certain resistance to contagion, a resistance that is hard to match for newer economies.

All of that, it seems to me, goes a long ways toward explaining how, what first appeared to be a small blip in the world of finance - the small devaluation of the Thai baht - could have had so devastating an impact on Thai financial institutions and on your economy. The defense against a reversal of market psychology and an outflow of funds were inherently limited. The depreciation of the exchange rate was self-reinforcing as confidence gave way. And it was not so surprising that the contagious effects were strong, with the crisis spreading through East Asia to Latin America.

The fact is, the East Asian economies, for all their enormously favorable growth prospects, were financially too small, too exposed, and too young to withstand stormy financial seas.

One approach to that circumstance would be to turn back the clock, to reverse the rapid liberalization of the past decade and so reduce financial exposure. I think it is interesting and significant, despite all the recent difficulties, that only one country - Malaysia - decided to adopt comprehensive controls. Even there, as markets have stabilized, that approach has been relaxed.

Given the enormous advantages of participating in world markets and receiving longer-term direct investment, comprehensive exchange controls would exact a heavy cost. I share the doubts they could be equitably and effectively maintained at all. In retrospect, there are arguments that a more gradual removal of controls may have been reasonable. China, a much larger and more self-sufficient economy, has had some success with that approach. I join the now rather common view that some restraints on the inflow of short-term capital by small exposed economies may be useful, particularly if they succeed in encouraging longer-term commitments. But in and of themselves, controls are not likely to be effective in preventing crises without undercutting the benefit of participating in global markets.

There is another approach toward which many officials and informed analysts seem to be leaning. They are searching for means to discourage excessive inflows of "hot" money by increasing the perceived risk to the lenders. Specifically, the idea is to make more difficult - a few would eliminate entirely -the provision of official finance in a time of crisis. Instead, more weight would be placed on encouraging renegotiation of debts. The purpose would be to encourage lenders and borrowers alike to be more sensitive to the inherent risks in international lending, reducing the possibility of a financial bubble arising in the first place.

That approach is urged as philosophically consistent with the ideology of free markets. Risk, the argument goes, should not be subsidized by providing protection for foreign lenders. Advocates point to the massive $50 billion "bailout" of short-term Mexican lenders in 1995, suggesting that it contributed to undue confidence by those extending credit to Thailand and other emerging economies.

I do not deny that such "moral hazard" can become more than a theoretical possibility. But I would also note that, as things stand, many lenders and borrowers have experienced large losses. That was certainly true in the aftermath of the Latin American debt crisis of the 1980's. That experience didn't deter a lot of lending (mostly by different participants) a few years later.

My experience suggests strongly that the IMF and the governments of the leading countries, which decide upon official assistance, will be averse to letting a crisis run its course when their strong interest in the growth and stability of not only the emerging world but their own countries might be threatened. Indeed, many argue that earlier assistance, with less intrusive conditionality, may have nipped some incipient crises before they fully materialized.

What better example of such official reactions can be found than in the United States, when, during the summer of 1998, the Federal Reserve itself sponsored a rescue of Long Term Capital Management, a large hedge fund which, contrary to all our advice to other countries, operated within the United States unsupervised, with great secrecy, and exceedingly thin margin of capital.

I have said more than enough to suggest the great complexity of the problem we collectively face. I have come halfway around the world to report that I do not feel the authorities and the commentators for all their efforts have yet found a fully effective or satisfactory answer to the systemic risks facing emerging economies adrift in a sea of institutional or policy "fixes".

I do believe, however, that natural and effective economic defenses - defenses fully compatible with open markets - are emerging. These adjustments are, in fact, piece by piece being worked out within economies and markets without official direction or management.

What is at issue is whether those economically efficient approaches will also be acceptable and sustainable politically and culturally.

I have emphasized the vulnerability of open emerging economies with small and brittle financial structures. Obviously, within a small economy a bank or finance company cannot make itself big and diversified by international standards. What local banks and other financial institutions can do is join forces with larger and more stable partners. That kind of consolidation is, in fact, proceeding rapidly within the United States, within Europe, and even within Japan where the banks are very large to start with.

For an emerging economy, if strong and needed competition is to be preserved, that kind of consolidation means merging or some kind of partnership with a foreign institution, most likely with an internationally active institution headquartered in a mature economy. Under pressure, that is what is happening with remarkable speed. Following the 1995 "Tequila crisis", Argentina finds itself left with only one private bank of significant size without foreign ownership or substantial control. Mexico, far larger than most developing countries, now has four of its five largest banks with foreign control or sizable equity participation. (You may recall that only a few years ago, during the negotiation of the North American Free Trade Agreement, Mexican authorities were exceedingly reluctant to permit any foreign ownership of Mexican banks.) Korea, a more developed country that also long protected local banks, now is willing to more than contemplate that possibility. Surely, the ability of Hong Kong and Singapore to maintain financial equilibrium in the midst of the Asian crisis was related to the dominant presence of strong international banks. I need not emphasize that attitudes here in Thailand, under the pressure of events, have changed.

A similar process seems to be at work in the non-financial world. In America and Europe, the forces of global competition are spurring an urge to merge and consolidate among even large corporations. In the developing world, we have seen a strong level of direct investment maintained, even in the teeth of financial crisis. It is that investment, far more than short-term portfolio investment, that brings tangible benefits in terms of employment, management, technology, improved market access, and not least the financial strength to withstand crises. So far as portfolio capital is concerned, equity investment in emerging economies seems to be reviving faster than lending.

Surely, these developments are a natural response to the globalization of the world economy. There can't be much doubt that they have greatly speeded up in response to the crises. And the result should be a strongly stabilizing force in times of financial pressure.

In the world of money - in the true architecture of the international financial system - something more surprising is taking place. Directly contrary to the widely accepted textbook models, more and more smaller countries - particularly in Latin America and Eastern Europe - have questioned the value of an independent currency. A number have already taken the major step of abandoning their own currency altogether, or approximating that approach by linking the local currency to a major international currency by means of a currency board.

In effect, those countries are saying that they are willing to forego the financial autonomy and flexibility afforded - at least conceptually - by a national currency. What they expect to get in return is the stability and integrity - and the relatively lower interest rates - inherent in use of an internationally strong currency, the dollar or the Euro.

I trust they are not misled in their thinking; use of an international currency cannot prevent speculative excesses and a banking or financial crisis in response to misguided policies. Budgetary discipline and effective control of costs will be essential. Circumstances can easily be envisaged - the text books are replete with them - in which the loss of monetary flexibility will be regretted.

However, the key point for countries with a long record of domestic inflation, weak institutions, and large external exposure is that the virtues of monetary autonomy may be largely illusory. What is gained by "dollarization" or "euroization" is protection against the extreme currency depreciation and volatility of interest rates that has so damaged the economies of East Asia, Latin America, and Eastern Europe. And, it seems to me a perfectly reasonable economic trade-off to be made.

I realize that, symbolically and politically, these approaches - more direct investment and loss of currency independence - run straight up against long held concerns about national sovereignty and local control. Those concerns are by no means confined to the developing world. It has taken Europe 40 years to face up to the monetary implications of its "single market" aspirations.

Now, in a new century, modern technology, free trade, and the globalization of finance have projected the image of a single market onto the world stage. But the political and cultural setting is quite different than within the confines of Europe. There is simply not the same economic and political incentive for most emerging countries to link their economic destinies so closely, with a perhaps distant economic power. And there can't be much doubt that, in the monetary arena, an effective common currency will require the kind of strong and stable anchor only a large economy can provide.

Moreover, there is a very large practical problem for an East Asian country with highly diversified trading partners. Without a dominant trading and financial partner, there is no obvious single monetary link. And when the exchange rates of the yen, the dollar, and the euro fluctuate so radically, without much reference to shifts in economic fundamentals, then the possibility of conducting any coherent foreign exchange policy - fixed, floating, or in between - is greatly impaired. In fact, the sharp appreciation of the dollar vis-a-vis the yen was surely an important, and typically overlooked, factor leading to the Thai crisis in 1997.

In my view, and it is a matter for another lecture, the main countries should accept the responsibility for working much more closely together, not to fix the precise value of their currencies, but to stabilize them within reasonable ranges. Success in that approach - and it seems to me technically feasible - would result in a much safer, a much more reasonable, world for emerging economies. I think that would be true for the major countries as well.

Demonstrably, as things stand leaders of the "big Three" countries have seen little incentive to move in that direction. With their large diversified economies relatively less dependent on international trade, even large exchange rate changes don't seem so disturbing. Policy-makers are sensitive to preserve their policy autonomy, to my mind exaggerating the constraints involved in more consistent efforts to stabilize their exchange rates.

My sense is that if we are to have a truly globalized economy, with free movement of goods, services and capital, a world currency makes sense. That would be a world in which the objectives of growth, economic efficiency, and stability can best be reconciled. Financial crises would not disappear, but neither should they be so destructive for smaller countries as during recent years.

That is not a world I will live to see. But I do think the underlying tendencies are in that direction. More likely for the medium term, the tendency toward large regional currency areas will be reinforced.

Surely, that would be a more desirable world than a retreat into economic isolationism - a retreat that in the end would be destructive of growth if it were feasible at all.

The cultural and political diversity of nations is a value to be treasured. It is a value symbolized so strongly here in Thailand by the justified pride you have in the presence and traditions of a unique monarchy.

I trust and believe that the valued elements of that cultural heritage - and that of other countries - will not, and should not, be lost as we step by step learn to live with the powerful forces of a global economy.