Reforming the Global Economic Architecture: Lessons from Recent Crises

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The author reviews the underlying causes of the financial crises that have occurred with increasing frequency in the past quarter century. He suggests measures that countries can take to protect themselves from such crises and argues that an international lender of last resort is neither necessary nor sufficient to prevent future crises and, moreover, unlikely to be effective.

The recent financial crisis in East Asia has raised the question of whether current international financial arrangements are adequate to protect the world from future crises. During the past 25 years, financial crises have occurred with increasing frequency, affecting 80–100 countries, with negative impacts on growth rates and unemployment.

Economic theory and empirical research agree that capital market liberalization can result in greater vulnerability to crisis. Opening a country's capital account encourages short-term capital flows and increases potential instability. In East Asia, huge short-term capital inflows after the opening of capital accounts were followed by even more rapid outflows. Other forms of financial liberalization can lead to an increase in risky lending by banks; in Thailand, investments in speculative real estate grew dramatically after liberalization.

Stiglitz argues that reliance on prudential regulation is insufficient to safeguard against increased risks of financial-sector liberalization, especially in countries with poor information and limited transparency. In fact, relying on minimum capital adequacy can

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reinforce instability: When the economy turns down and bankruptcies begin, banks that fall below minimum capital requirements may curtail their lending, leading to increases in nonperforming loans and bankruptcies.

Financial market liberalization may discourage economic growth because it is related to increased instability, which goes far beyond the immediate actors—the borrowers and lenders. The instability can affect people throughout the country and spread to other countries. Because of these externalities, developing comprehensive programs of institutional strengthening and interventions within countries is important.

Stiglitz outlines four areas for reform. First, government distortions that encourage, even indirectly, short-term capital flows should be eliminated. For example, Thailand directly facilitated short-term flows, and South Korea had restrictions on long-term flows. Second, financial institutions need to be strengthened through improved prudential regulations and supervision, greater transparency, and limitations on lending. Third, direct interventions may be necessary to control financial flows outside the banking system, such as the corporate borrowing that occurred in Indonesia.

These reforms may still be insufficient, as witnessed by recent financial crises in the United States, Scandinavia, and Japan, so Stiglitz suggests that in some countries it might also be prudent to impose additional limitations, such as limitations on lending for investments in real estate, the use of derivatives by financial institutions, and the rate at which overall lending can increase.

Lastly, Stiglitz argues for reforms in bankruptcy laws to distinguish between individual company failure and systemic bankruptcy. For the latter, he recommends a “super chapter 11,” in which existing company management would continue in place, corporate reorganizations would be accelerated, and creditors’ claims would be rearranged. Reforms in bankruptcy along these lines would prevent the sort of downward spiral that occurred in East Asia, where nonperforming loans grew, credit contracted, and more companies became insolvent.

Regarding whether an international lender of last resort should be established, Stiglitz raises a number of issues. First, a lender of last resort is not sufficient to protect an economy from crisis; the Federal Reserve Bank in the United States was supposed to be the lender of last resort, but it did not prevent the Great Depression. Second, for countries with flexible exchange rates and adequate bankruptcy laws, a lender of last resort is not necessary. Third, Stiglitz notes that automatic access to funds would presumably be available only to countries that had acted in a reasonably prudent way. But if a judgment were made that a country did not "qualify" for access to funds, this judgment could signal that the country is a poor risk, which itself could set off a crisis and which would defeat the purpose of having a lender of last resort. Finally, Stiglitz doubts that countries would be willing to cede responsibility for financial supervision to an international agency that is not politically accountable to the country. Given the essential role that adequate supervision plays for a lender of last resort, he concludes that an international agency would be unlikely to play this role effectively.

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