Introduction

A wide consensus had emerged among economists. Capital account liberalization – allowing capital to flow freely in and out of countries without restrictions – was unambiguously good. Good for the debtor countries, good for the world economy. The two-fold case for capital mobility is relatively straightforward: First, capital mobility creates superior insurance opportunities and promotes an efficient allocation of investment and consumption. Capital mobility allows households and firms to insure against country-specific shocks in worldwide markets; households can thereby smooth their consumption and firms better manage their risks. Business cycles are dampened, improved liquidity management boosts investment and promotes growth. Second, besides insurance, capital mobility also permits the transfer of savings from low- to high-return countries. This transfer raises worldwide growth and further gives a chance to the labor force of low-income countries to live better. In these two respects, the increase in the flow of private capital from industrial to developing countries from $174 billion in the 1980s to $1.3 trillion during the 1990s1 should be considered good news.

That consensus has been shattered lately. A number of capital account liberalizations have been followed by

1 Summers (2000).
spectacular foreign exchange and banking crises. The past twenty years have witnessed large scale crises such as those in Latin America (early 1980s), Scandinavia (early 1990s), Mexico (1994), Thailand, Indonesia, and South Korea (1997), Russia (1998), Brazil (1998–9) and Argentina (2001), as well as many smaller episodes. The crises have imposed substantial welfare losses on hundreds of millions of people in those countries.

Economists, as we will discuss later, still strongly favor some form of capital mobility but are currently widely divided about the interpretation of the crises and especially their implications for capital controls and the governance of the international financial system. Are such crises just an undesirable, but unavoidable by-product of an otherwise desirable full capital account liberalization? Should the world evolve either to the corporate model where workouts are a regular non-crisis event or to the municipal bond model where defaults are rare? Would a better sequencing (e.g., liberalization of foreign direct and portfolio investments and the building of stronger institutions for the prudential supervision of financial intermediaries before the liberalization of short-term capital flows) have prevented these episodes? Should temporary or permanent restrictions on short-term capital flows be imposed? How does this all fit with the choice of an exchange rate regime? Were the crises handled properly? And, should our international financial institutions be reformed?

This book was prompted by a questioning of my own understanding of its subject. Several times over recent years I have been swayed by a well-expounded and coherent proposal only to discover, with striking naivety,

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\[ ^2 \text{131 of the 181 IMF member countries have experienced banking problems between 1980 and 1995 (IMF 1996).} \]
that I later found an equally eloquent, but inconsistent, argument just as persuasive. While this probably reflected lazy thinking on my part, I also came to wonder how it is that economists whom I respect very highly could agree broadly on the facts and yet disagree strongly on their implications.

I also realized that I was missing a “broad picture”. An epitome for this lack of perspective relates to international institutions. I have never had a clear view of what, leaving aside the fight against poverty, the International Monetary Fund (IMF) and other international financial institutions (IFIs) were trying to achieve: avoid financial crises, resolve them in an orderly manner, economize on taxpayers’ money, protect foreign investors, respect national sovereignty, limit output volatility, prevent contagion, facilitate a country’s access to funds, promote long-term growth, force structural reforms – not to mention the IMF’s traditional current account, international reserves and inflation objectives. 3

This book is to some extent an attempt to go back to first principles and to identify a specific form of market failure, that will guide our thinking about crisis prevention and institutional design. Needless to say, I will be focusing on a particular take on the international financial system, which need not exclude other and complementary approaches. I believe, though, that the specific angle taken here may prove useful in clarifying the issues.

The book is organized as follows. Chapter 1 is a concise overview of recent crises and institutional moves for the reader with limited familiarity with the

3 For example, the Meltzer Commission, or more precisely the International Financial Institution Advisory Commission, chaired by Alan Meltzer and reporting to the US Congress (2000), views the role of the IMF as limiting the incidence of crises, reducing their severity, duration and spillovers.
topic. Chapter 2 summarizes and offers a critique of economists’ views on the subject. Chapter 3 provides a roadmap for our main argument. Basically, I suggest that international financing is similar to standard corporate financing except in two crucial respects, which I name the “dual-agency problem” and the “common-agency problem”. Chapter 4 therefore provides the reader with a concise review of those key insights of corporate finance that are relevant for international finance. Chapter 5 describes the market failure. Chapter 6 draws its implications for crisis prevention and management. Chapter 7 investigates the lessons of the analysis for the design of international financial institutions. Finally, Chapter 8 summarizes and discusses routes for future research.