

The Search for a New Financial Order

By Donald Greenlees

In the wake of the 1997 Asian financial crisis, there were loud calls for a new global financial architecture, but nothing concrete emerged. With the current crisis, however, a new opportunity presents itself to reshape the world's financial system, and Asia will play a big role, writes veteran Australian journalist Donald Greenlees.

WHEN INTERNATIONAL FINANCE OFFICIALS gathered for the annual meetings of the World Bank and International Monetary Fund on October 10, there were muffled admissions that the Washington Consensus, the resolute mission of global free-market liberalization these institutions had set for themselves, was dead. World Bank and IMF officials privately conceded that the consensus had expired at the time the administration of George W. Bush decided on the unprecedented \$700 billion intervention to rescue the US banking system.

The Washington Consensus had, in fact, been in terminal decline long before the global financial crisis put a final nail in its coffin. Four years earlier, economists, including Joseph Stiglitz, the Nobel Prize-winning former chief economist of the World Bank, were writing of a “post-Washington Consensus consensus.”

In East Asia, the Washington Consensus will not be missed. Here it evokes particularly bad memories of the financial meltdown of 1997-1998, intervention by the IMF and “rescue” plans that many governments and scholars blamed for exacerbating the crisis. The doctrine of downsizing government, trade and capital market liberalization, privatization and cutting government regulation of markets was imposed, many critics believe, without regard for local conditions or national sovereignty. Moreover, the ideological faith in light-handed regulation was one of the proximate causes of Wall Street’s excesses and the current crisis.

The IMF’s insistence during the Asian financial crisis that emergency financial aid would only be

offered if stringently applied market opening reforms were undertaken still leaves a bitter taste in the mouths of officials in countries such as Thailand, Indonesia and South Korea that were given that medicine in return for IMF funds. South Koreans commonly refer to the events of 1997 as the “IMF crisis.”

“At least in East Asia, the IMF has not regained its credibility because it has so far refused to engage in frank and constructive dialogue with Asian stakeholders,” Yung Chul Park, a professor of finance at Seoul National University, observed in a book of essays on the current crisis rushed out in time for a meeting of the leaders of the Group of 20 (G-20) countries in Washington on November 14 and 15.

It has been common in Asia since 1997 to hear criticism of how international financial institutions operate. But the region’s complaints about the global financial architecture have as much to do with how it is constituted as they do with what is prescribed. The fact that the US and Europe dominate many of the key institutions, a reflection of the post-World War II realities at the time the foundations of the modern financial system were laid, heightens concerns about national sovereignty.

One of the enduring images of the economic crisis in Indonesia in 1997, captured in a now famous news photo, was IMF managing director Michel Camdessus with his arms crossed looking like a stern schoolmaster over the shoulder of a beleaguered president Suharto as he signed on to a list of IMF-mandated reforms as a condition of financial aid. Camdessus did not mean any disrespect, but the image was an affront to many Indonesians, including those who were not sympathizers of the kleptocratic Suharto regime. The content of the IMF program, and the way it was implemented, played an important role in Suharto’s downfall the following year.

In the current crisis, it is the developing world’s turn to look smug. The crisis, having prompted emergency meetings of leaders from the developed and developing worlds and inspired promises of a new global financial architecture, would appear to offer an unprecedented opportunity for long-overdue reforms of governance and policy prescriptions of international financial institutions

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that take account of the greater economic weight of developing countries.

For East Asia, it is potentially a historic moment as the presumption that economic success could translate into increased global leadership is put to the test. The long period of export-driven economic growth, healthy national balance sheets and high savings rates in most East Asian countries not only gives them more flexibility to respond to tough economic times, but also puts them in a unique position to contribute to minimizing the pain of the worldwide crisis and to creating a new economic and financial landscape in the years ahead.

It remains to be seen whether Asian governments, enjoying a moral victory by avoiding the worst of the crisis, will be able to seize the opportunity. In the short-term, they need to fashion the right balance of domestic policies to maintain strong growth. In the longer-term, they will want to ensure that the future financial system, its institutions of governance and the policy orthodoxy that drive them offer more stability and are better suited to their needs and status as growing centers of economic power.

The reforms already placed on the table address some old grievances such as insufficient representation and transparency in international financial institutions, what is sometimes referred to as the “democratic deficit” of organizations like the IMF and World Bank.



IMF managing director Michel Camdessus watches Indonesian President Suharto sign an accord with the IMF in 1997.

But while many critics have long argued the interests of the developing world require a far-reaching overhaul of the global financial system, the likelihood is that the promised shake-up of the system will result in tinkering to make it somewhat fairer rather than a tectonic shift in influence.

The G-20 summit in mid-November evoked bold comparisons with the Bretton Woods conference in 1944 where finance ministers laid down the post-war financial structure. Instead, the signs are that negotiations will be long and arduous and that neither developed nor developing countries have the appetite to push for or reach agreement on anything too radical.

In the developing world, all eyes have been on China. Yet President Hu Jintao, despite bringing

about 100 officials with him to Washington, has espoused prudence. The Chinese delegation for the G-20 talks was notably low-key. Hu maintained that one of the greatest contributions China could make to international financial stability was “steady and relatively fast economic development in China.”

“Caution, caution, caution,” is how Charles Freeman, a former Bush administration trade official and Freeman Chair of China Studies at the Center for Strategic and International Studies in Washington D.C., has characterized the Chinese position. Still, Freeman argued that when it comes to the outcome of what will be a long process of negotiation over financial system reform, “China will have a significant say in what that looks like at the end of the day.”

One reason China should have considerable muscle in the negotiations is the approximately \$2 trillion it is sitting on in foreign exchange reserves. The enormous size of those reserves has increased expectations that China will make a large contribution to the cost of global financial reforms, such as augmenting the IMF's \$250 billion in lending capacity, which is widely viewed as woefully inadequate for anything other than assisting a handful of developing countries in distress.

China is not alone in having amassed proportionally large foreign exchange reserves in recent years. Many Asian countries learned the hard way after 1997 to avoid foreign-currency debt and ensure sufficient foreign exchange reserves to cover an ever-greater share of short-term debt and longer periods of imports.

Foreign exchange reserves started growing sharply in all developing countries as a share of GDP from the early 1990s, but ballooned in East Asia after the 1997 economic crisis. From an average of less than four months of imports during the 1970s and 1980s, reserves of Asian countries rose to an average of almost 10 months by 2004, according to an analysis by Dani Rodrik, an economist at Harvard University's John F. Kennedy School of Government. Several economies in the region, including South Korea, Malaysia, Thailand, Taiwan, Hong Kong and Singapore have each built war chests of \$100 billion or more.

Those reserves are providing a useful buffer today. It is an important factor in the resilience of the region in the face of the credit crunch and financial market meltdown in rich countries that quickly spilled over into the real economy. While emerging economies are not immune, forecasters say most countries in East Asia will avoid recession, and certainly will not experience anything like the downturn anticipated in the United States and Europe. The World Bank in December predicted that Asia would have growth in 2009 of a respectable 5.3 percent.

The accumulation of huge foreign exchange reserves by Asian governments has been a useful, if expensive, insurance policy. But it also offers an insight into the region's thinking. The experience of capital flight during the 1997 crisis and tough

At the heart of the current crisis has been the imbalance between Asia's saving — its huge current account surpluses and foreign reserves — and Western consumption.

Washington Consensus tutelage was a sharp wake-up call for many regional governments.

As Rodrik pointed out in a 2006 paper, "Social Cost of Foreign Exchange Reserves," for the US National Bureau of Economic Research, developing countries have realized they "cannot rely on the International Monetary Fund or reforms in the international financial architecture to protect themselves" from crisis.

Rodrik and others note the considerable cost of maintaining such high reserves. In his paper, Rodrik argued that the spread in yields between liquid, short-term securities such as US Treasury bonds, where central banks hold most of their reserves at small rates of return, and the external borrowings of developing countries can "amount to around one percent of GDP annually." That is roughly equal to the expected benefits from a successful conclusion to the Doha round of trade negotiations.

"Developing nations are paying a very high price to play by the rules of financial globalization," Rodrik argued.

It ought to be ample incentive for them to seek a better functioning, more stable system in which they can have more confidence. Hu Jintao set China that goal at the G-20 summit, where he said reform of the international financial system should aim to create a "new financial order" that was "fair, just, inclusive and orderly."

But, rhetoric aside, there has been little sign from Beijing or other Asian capitals of fresh ideas

on what a fairer financial order would be like or even of a desire for a radical re-engineering of the current system. In the early reaction to the crisis, new policy ideas came overwhelmingly from universities, think tanks and government policy units in the United States and Europe.

The communiqué from the G-20 summit, which was supposed to chart a way through the crisis, offered some concessions to longstanding complaints that international financial institutions did not take into account the interests of developing countries. It pledged to reform governance and membership of institutions so that “emerging market economies and developing countries have greater voice and representation.” The G-20 leaders agreed to convene again before April 30 and, in the meantime, allow their finance ministers to oversee work by officials on an action plan.

But the meeting was for the most part a triumph for what Bush has termed “democratic capitalism,” with restated commitments to “free market principles,” including the maintenance of open trade and investment, competitive markets and “efficient, effectively-regulated financial systems.”

Leaders wisely pledged not to repeat the pernicious cycle of trade protectionism that followed the stock market crash of 1929, and which helped precipitate the Great Depression that followed. The G-20 agreed to “reject protectionism,” to strive to reach an agreement by the end of 2008 on means that would lead to an early conclusion of the Doha round of trade negotiations and to refrain from imposing any new investment or trade barriers for 12 months.

The work of finance ministers and officials in the coming months will largely focus on improving the functioning of financial regulations, such as efforts to align global accounting standards and strengthen transparency in global derivatives markets.

It is hard to see this exercise leading to anything other than a renovation and renewal of a system that has largely suited rich countries.

The decision to base the initial crisis summitry on the G-20 was itself hailed as evidence of changing global economic reality. The nine-year-old G-20 brings China, India, Brazil, Mexico and Indonesia together with the major industrial powers and the European Union. The convening

Tim Geithner: An Asia Hand at the US Till

Incoming US presidents have often been criticized in Asia for being too slow to acknowledge the importance of the region. At a time of global economic crisis, when America’s fortunes appear more deeply tied than ever to Asia, it is not a mistake that President-elect Barack Obama appears likely to make.

In late November, when Obama announced his economic team, his choice for US Treasury Secretary was a well-respected economic bureaucrat with a long history of dealings with Asia, including in times of crisis.

Tim Geithner, the 47-year-old president of the Federal Reserve Bank of New York, rose to prominence in recent months amid the bailouts, takeovers and collapses that have changed the face of Wall Street.

But to many finance officials in Asia, Geithner was already well known. In 1997, he was one of Washington’s point men in dealing with the region’s economic crisis as under-secretary of the Treasury for international affairs in the administration of President Bill Clinton.

Geithner’s experience in coping with crises was clearly one of the parts of his resume that appealed to Obama — at Treasury he helped manage the US response to the 1995 Mexican peso

collapse and the 1998 meltdown of the Russian ruble.

Obama was also attracted to Geithner's other international credentials: in his youth, he lived in Thailand, India and Zimbabwe. He studied Chinese at

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Dartmouth College, and spent a summer in China. He received a master's degree in international economics and East Asian studies at John's Hopkins School of Advanced International Studies.

"Tim's extensive international experience makes him uniquely suited for this work," Obama said when introducing his economic team in Chicago on Nov. 24.

"Growing up partly in Africa and having lived in Asia and worked throughout Asia; having served as under-secretary of the treasury for international affairs, one of many roles in the international arena; and having studied both Chinese and Japanese, Tim understands the language of today's international markets in more ways than one."

When Geithner takes over from current Treasury Secretary Henry Paulson on Jan. 20, he will be well aware of the grievances Asian countries have with the global financial system — he served in the key post of director of the policy development and review department of the International Monetary Fund.

Geithner will also be conscious of Asia's potential to help the world emerge from the economic crisis; he will likely take to heart instructions from Obama to "reach out to the countries around the world and craft a global response."

Geithner has delivered tough messages to Asia before, telling the Chinese in 1997 not to devalue the yuan — something Chinese officials, ironically, were not inclined to do anyway, and for which they have subsequently been praised by other Asian countries afflicted by the financial crisis at the time.

During the annual strategic economic dialogue between the United States and China in early December of this year, Paulson was forced to listen as his Chinese counterparts told him to get his economic house in order. It was a reversal of roles for Paulson, who was usually the one dispensing economic advice.

It was one of the many ignominies Paulson has had to suffer in recent times. Geithner should be much more at ease in hearing the hard messages from Asia, but also delivering some of his own.

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Brazilian President Luiz Inacio Lula da Silva said the “G-20 had effectively replaced the G-8” at the center of international economic policy coordination. Indian Prime Minister Manmohan Singh shared the conviction that it demonstrated a fundamental power shift. “The Western world has at long last got to realize this reality,” Singh said.

The rhetoric is undoubtedly premature. What Raghuram Rajan, a professor of finance at the University of Chicago and former chief economist at the IMF, has termed the “dialogue of the deaf” over global economic policy is unlikely to change simply as a result of one or two summits of leaders of the G-20.

“Industrial countries stopped requiring financing long ago; they now believe they are responsible global citizens, and guard their policy independence carefully,” Rajan wrote in a recent paper on reforming global economic and financial governance. “It seems they view the primary role of multilateral institutions as correcting the policy mistakes and naked mercantilism of emerging markets, and, of course, providing aid to the very poor.”

The reforms put on the table at the G-20 did not exactly represent an epiphany by rich countries. Rather they are consistent with gradual initiatives that have been around for a couple of years to allow a handful of major emerging economies to creep up their influence in financial institutions.

At its Singapore meeting in September 2006, the IMF ceded more votes to China, South Korea, Mexico and Turkey. China’s vote increased to 3.6 percent, compared to 16 percent for the United States and around 5 percent each for Germany, France and Britain. But the United States still enjoys an effective veto at the IMF.

British Prime Minister Gordon Brown has been among those lobbying for reserve-rich countries including China and Middle Eastern oil producers to provide funds to expand the lending capacity of the IMF to enable it to respond to larger shocks. So far, these countries have not been drawn, and they are not about to inject more cash unless they get a bigger share of the vote and more say over guiding the institution’s direction.

Developing countries are also going to want a bigger say in an array of other international financial bodies. The Financial Stability Forum, which brings central bankers and national regulators together, has no developing country representatives. Others, like the Bank for International Settlements and the Basel Committee, which deals with international banking regulation, are dominated by industrial countries and are similarly short on developing country representatives.

Rajan, one of 20 economists to contribute to a book by the London-based Centre for Economic Policy Research entitled, *What G20 Leaders Must Do To Stabilize Our Economy and Fix the Financial System*, has laid out a scenario that would improve the developing world’s trust in the IMF and World Bank and ensure better international economic dialogue.

He argued that the G-20, with an amended membership, could be the basis for economic dialogue in place of the current “small and unrepresentative” gatherings of industrial countries. He has proposed giving European Union countries just one seat, which would free up four seats for others, presumably from the emerging economies.

Rajan would like to see a more independent and effective IMF operating as the secretariat for this expanded G-20. The new IMF could be self-financing, better financed and more transparent, with its agenda set by a more representative group of countries. The United States’ veto would go.

If Rajan’s proposed reforms were implemented, they would go some way to restoring confidence and legitimacy in the IMF that it has been lacking in Asia and elsewhere in the developing world in recent years.

But there is a bigger agenda ahead in the debate over the global economy. At the heart of the current crisis has been the imbalance between Asian saving — the region’s huge current account surpluses and foreign reserves — and Western consumption. The money that poured from Asia into the United States and Europe helped feed the asset bubble.

Economists have been sounding warnings about the risks of the imbalances in global payments for some years. The Nobel economist Stiglitz in 2006 argued that the use of the US dollar as the world’s reserve currency was a source of instability and potential crisis.

Stiglitz, who also presciently cited the “worrisome” problem of large variable-rate mortgages in the US, saw the solution in a new reserve system modeled on an old proposal by John Maynard Keynes for a global reserve currency. Countries would contribute to a global reserve fund, receive what Stiglitz termed “global greenbacks” in return, and be able to draw on funds in times of emergency such as banking failures.

Others, recognizing the difficulty in shifting away from the US dollar, have suggested using a basket of currencies such as the dollar, euro and yen.

Regardless of the mechanism, Rajan argued that the most important thing was to build the confidence of emerging economies in the global financial system by ensuring sufficient resources are

available to meet a crisis, without too many strings attached. He warned that if nothing were done to address the issue, the world would come out of the current crisis with “many countries attempting to build reserves through export-led strategies and managed exchange rates, aggravating the demand imbalances that are at the heart of the crisis.”

It will not be easy to wean Western consumers off their over consumption. And Asian countries, who have learned to be wary of global finance, are going to find it hard to give up their use of huge exports to fill vast pools of foreign reserves — if anything, the current crisis has shown how valuable they can be.

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