In the past two years, major financial quakes have struck three geographically non-contiguous areas: East Asia in July 1997, Russia in August 1998, and Brazil in January 1999. If the sharp jolts in these economies were converted to seismographic readings, they would register at least 6.5 on the Richter scale, about the same as the Los Angeles earthquake in 1994.

In the Asian “crisis” countries—Thailand, Korea, Indonesia, and Malaysia—asset values plummeted by about 75 percent due to the combined effects of currency depreciations and deflated property and equity markets. Averaging over these countries, an asset worth $100 in June 1997 was worth only $25 a year later. In Russia and Brazil, the corresponding asset deflations were more than 70 percent and 50 percent, respectively. Assets worth $100 before the Russian and Brazilian crashes, were, respectively, worth only about $28 and $50 afterwards.

To place these tectonic crunches in another context, it’s worth recalling that, in the U.S. financial crises of 1929–1932, 1962, and 1987, the S&P index fell by 87 percent, 28 percent, and 34 percent, respectively.

Explanations for these jolts as well as prescriptions for mitigating them in the future fall into two camps. One ascribes principal blame

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to the miscarriages of “untrammelled” markets that inevitably result in “irrational exuberance,” financial “bubbles,” “contagion,” and “overshooting.” Protagonists, who might be labeled the “pro-intervention architects,” include George Soros, Eisuke Sakakibara, Mohamad Mahathir, Paul Krugman, and Stanley Fischer. They typically emphasize the errant behavior of unregulated capital markets, speculators, and hedge funds, and prescribe various types of new regulatory interventions applied especially to capital flows, as well as a new “international financial architecture” intended to deter future international financial crises, or to alleviate them if they occur. The IMF’s new Contingent Credit Line facility is the first major edifice of this financial architecture. Backed by a $90 billion replenishment of IMF resources, the CCL is intended to provide preventive loans to potentially vulnerable economies in order to forestall future financial crises.

The second camp, which might be called the “anti-intervention skeptics,” contends that financial crises in Asia, Russia, and Brazil were instead due to departures from the operation of free markets. Adherents include Milton Friedman, George Schultz, Alan Meltzer, Andrei Illarionov, and Marvin Krause. In Asia, for example, this camp contends that the financial meltdown, beginning with the collapse of the Thai baht in July 1997 and then rapidly extending to the other crisis countries in Asia, was in fact nurtured by non-market interventions and institutions (e.g., governments and multilateral agencies) that could be expected to come to the rescue if seriously adverse consequences ensued.

Hence, such actions as short-term borrowing (and lending) could be allowed to escalate, and interest-rate arbitraging could be promoted with what was thought to be minimal downstream risk. The result was pervasive encouragement of “moral hazard”: the usual precepts of “due diligence” were ignored in favor of what might be characterized as “undue negligence.” In the workings of “crony” or preferential capitalism in Asia, resources were not allocated according to fair assessments of market risk and realistic expectations of profit and loss, but according to the preferential status of particular sectors, firms, and individuals. The tacit assumption underlying these distortions reflected the prevalence of moral hazards: if seriously adverse consequences occurred, someone else would handle them.
Russia and Brazil displayed several variations on these themes. In Russia, the state's centrally-owned assets were distributed to the emerging “oligarchs” through government fiat, insider dealing, and outright fraud, rather than through open, competitive bidding. The ensuing massive flight of capital from Russia, lubricated by IMF bailout funding, depreciated the ruble by more than 60 percent, and sharply depressed stock market capital values.

Brazil’s departures from the market regimen included government pegging of the real at rates made increasingly unrealistic by large and mounting budget deficits. As a consequence, shorting the real and subsequent large-scale capital flight occurred, along with sharp depreciation of the currency—all of these representing predictable market responses to anti-market policies.

Instead of a “new financial architecture,” the anti-intervention skeptics concentrate on remedial measures designed to improve the functioning of markets, and to increase rather than diminish reliance on market forces and discipline. The skeptics are averse to the architectural proposals of the activists, professing worries that these remedies will have iatrogenic consequences: the side-effects will be worse than the symptoms they are supposed to relieve. For example, the IMF's CCL, although intended to forestall future financial crises, may instead engender them. The moral hazards created by the CCL will induce its prospective beneficiaries to “game” the credit line to obtain subsidized funding that existing capital markets would not provide, or would only provide at much higher rates.

At a more specific and operational level, the skeptics propose measures that would reinforce, rather than replace, market mechanisms. For example, one remedy would simply allow the homeostatic processes of market mechanisms to operate in the event of financial crises. Creditor institutions would bear collective responsibility for deciding whether to incur an actual default on debt owed to them, or instead to organize and share in providing roll-over financing subject to conditions levied on the debtors by the creditor consortium, rather than by governmental bodies. Free-rider temptations within the consortium could be avoided, or at least mitigated, by granting the consortium temporary exemption from antitrust liability, and allowing the consortium to develop its own means of maintaining compliance within the group.
Another device might be to adopt, while modifying, a suggestion made by one of the activists, George Soros, to set up a multilateral “International Credit Insurance Corporation,” to provide loan guarantees for emerging-market borrowing. The crucial modification, as well as improvement, in the original proposal would be to have the corporate financial community self-fund this insurance corporation through premium charges that would be performance-based. Such a premium schedule would ease, if not fully resolve, the moral hazard problem: risky behavior would, over time, be penalized by charging a higher premium for loss-prone buyers of the loan guarantees.

There is some evidence that hedge funds, rather than precipitating financial turmoil in the three afflicted regions, actually lost money from it (especially in Russia, Hong Kong, and Malaysia). Nevertheless, some of the market-oriented skeptics would favor _ex ante_ disclosure by hedge funds of the extent and sources of their leverage, in the interest of increasing the information available to shareholders of the leveragees.

In the aftermath of the three financial crises of the past two years, it seems clear that where the particular impacted countries have instituted market-oriented policies and institutions, or at least have begun to do so, distinct signs of progress and incipient recovery have ensued. By the second quarter of 1999, Korea and Thailand have turned the corner. Their respective GDP growth is slightly positive in the case of Korea, and much less negative in Thailand than in the prior year. By the fourth quarter of 1999 both countries will probably experience positive growth rates. In both countries, foreign direct investment has resumed—in Korea, FDI increased nearly threefold to more than $2 billion in the first quarter of 1999, compared to the first quarter of 1998. Foreign exchange reserves have increased—slightly in Thailand and substantially to $59 billion in Korea, and Korea’s international credit rating has been significantly upgraded by Moody’s and Standard and Poor’s. In Brazil, where deficit spending has been restrained and the crawling currency peg has been removed, the real has recovered about half of its 1998 value, and foreign exchange reserves have increased by more than threefold.

Although neither Korea, Thailand, nor Brazil is out of the woods, their progress contrasts sharply with its absence in other countries that have not pursued market-oriented policies, notably, Russia, In-
donesia, and Malaysia, which continue to experience significantly negative rates of GDP growth, weakened currencies (in Malaysia temporarily buoyed by capital controls), and depressed asset values. The ruble remains at about a quarter of its prior year’s value, and its meager foreign exchange reserves have been further depleted. In both Indonesia and Malaysia, while there has been some recovery of currency and asset values, political rather than economic factors predominantly account for the economic quagmire that still engulfs them. Unless and until political stability and a more favorable and predictable policy environment is created, the outlook for Indonesia and Malaysia will remain dim.

In sum, the countries showing strongest signs of recovery from the financial crisis of the past two years are reducing their penchant for interventionist solutions and avoiding the perils of a possibly new financial architecture. More freedom, rather than more intervention, is the path to economic recovery and sustained growth. But so long as the interventionists retain the upper hand in the councils of Western governments and multilateral organizations, the international economy will be prone to financial as well as moral hazards.

*Postaudit*

The principal error in this assessment is my bearish call on Russia, which has performed better than I expected.