Financial Hypocrisy

BY JOSEPH E. STIGLITZ

This year marks the tenth anniversary of the East Asia crisis, which began in Thailand on July 2, 1997, and spread to Indonesia in October and to Korea in December. Eventually, it became a global financial crisis, embroiling Russia and Latin American countries, such as Brazil, and unleashing forces that played out over the ensuing years: Argentina in 2001 may be counted as among its victims.

What is remarkable to me today is that there are those who favor easy money to bail Wall Street out of the current credit crunch to dam the problems that could otherwise flow downstream. Is this learning or hypocrisy? I fear hypocrisy.

A LONG HARD RECOVERY

There were innocent victims of the East Asian crisis, including countries that had not even engaged in the international capital flows that caused the crisis. Indeed, Laos was among the worst-affected countries. Though every crisis eventually ends, no one knew at the time how broad, deep, and long the ensuing recessions and depressions would be. It was the worst global crisis since the Great Depression.

As the World Bank's chief economist and senior vice president, I was in the middle of the conflagration and the debates about its causes and the appropriate policy responses. This summer and fall, I revisited many of the affected countries, including Malaysia, Laos, Thailand, and Indonesia. It is heartwarming to see their recovery. These countries are now growing at 5% or 6% or more—not quite as fast as in the days of the East Asia miracle, but far more rapidly than many thought possible in the aftermath of the crisis.

Many countries changed their policies, but in directions markedly different from the reforms that the IMF had urged. The poor were among those who bore the biggest burden of the crisis, as wages plummeted and unemployment soared. As countries emerged, many placed a new emphasis on "harmony," in an effort to redress the growing divide between rich and poor, urban and rural. They gave greater weight to investments in people, launching innovative initiatives to bring health care and access

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to finance to more of their citizens, and creating social funds to help develop local communities. In contrast, the IMF policies often ignored these social dimensions. In Thailand, IMF induced cutbacks in the health budget led to a resurgence in AIDS, which the government had done so much to curtail. Not surprisingly, the pro-creditor bankruptcy laws which they foisted on countries often met with resistance.

LESSONS LEARNED OR IGNORED

Looking back at the crisis a decade later, we can see more clearly how wrong the diagnosis, prescription, and prognosis of the IMF and United States Treasury were. Had, for instance, Korea's problems been as severe and fundamental as they had suggested, Korea would not have enjoyed the rapid comeback it had. The fundamental problem was premature capital market liberalization. Malaysia imposed capital controls, and as a result it had the shortest and shallowest of downturns; and when it recovered, it was left with less of a legacy of debt. Yet this lesson seems to be ignored with respect to India. It is ironic to see the US Treasury Secretary once again pushing for capital market liberalization in India—one of the two major developing countries (along with China) to emerge unscathed from the 1997 crisis.

It is no accident that the very countries that had not fully liberalized their capital markets have done so well. Subsequent research by the IMF has confirmed what every serious study had shown: capital market liberalization brings instability, but not necessarily growth. (India and China, who have not liberalized capital markets, have been the fastest-growing economies.)

Of course, Wall Street (whose interests the US Treasury represents) profits from capital market liberalization: they make money as capital flows in, as it flows out, and in the restructuring that occurs in the resulting havoc. In South Korea, the IMF urged the sale of the country's banks to American investors, even though Koreans had managed their own economy impressively for four decades, with higher growth, more stability, and without the systemic scandals that have marked US financial markets with such frequency.

In some cases, US firms bought the banks, held on to them until Korea recovered, and then resold them, reaping billions in capital gains. In its rush to have Westerners buy the banks, the IMF forgot one detail: to ensure that South Korea could recapture at least a fraction of those gains through taxation. Whether US investors had greater expertise in banking in emerging markets may be debatable; that they had greater expertise in tax avoidance is not.

HYPOCRISY OR LEARNING IN THE SUB-PRIME CRISIS?

The contrast between the IMF/US Treasury advice to East Asia and what has happened in the current sub-prime debacle is glaring. East Asian countries were told to raise their interest rates, in some cases to 25%, 40%, or higher, causing a rash of defaults. In the current crisis, the U.S. Federal Reserve and the European Central Bank cut interest rates, fearing the collapse that high interest rates could cause.

The countries caught up in the East Asia crisis were lectured on the need for greater transparency and better regulation. But lack of transparency played a central role in this past summer's credit crunch; toxic mortgages were sliced and diced, spread around the world, packaged with better products, and hidden away as collateral, so no one could be sure who was holding what. Yet, there is now a chorus of caution about new regulations, which supposedly might hamper financial markets (including their exploitation of uninformed borrowers, which lay at the root of the problem). Finally, despite all the warnings about moral hazard, Western banks have been partly bailed out of their bad investments.

It would be reassuring if this contrasting attitude to today's crisis represents a learning of what I preached ten years ago. Am I too cynical in suggesting that it is simply hypocrisy?

Following the 1997 crisis, there was a consensus that fundamental reform of the global financial architecture was needed. Why has nothing been done? Look no further than the fact that while the current system leads to unnecessary instability and imposes huge costs on developing countries, the current system serves the profit interests of many well. It is not surprising, then, that ten years later, there has been no fundamental reform. Nor, that the world is once again facing a period of global financial instability, with uncertain outcomes for the world's economies.

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