Complacency is Out of Place

Norbert Walter

The consensus which has emerged around an optimistic world economic forecast may be false; it may give a false sense of security. The best scenario, the most realistic scenario, for the United States of course is a soft landing, not only because they have placed their country in a particularly favourable structural setting, but also because if something goes wrong — and there is always something that can go wrong — the United States have a political machinery and a situation in which monetary and fiscal policy have all the instruments at hand and have proven that they will use them in a diligent way, if needed. This assurance of governance that could act in case of need is an important factor and points to a soft landing. This is a good underpinning for the world economy.

Where the financial markets in particular, but also most official forecasters are wrong, is on Japan. Complacency about the recovery in Japan is out of place. The balance sheet of neither the government nor the companies is in as good shape as is suggested by stock price developments in Japan and by the yen exchange rate. It is more difficult to get a society and an economy going when both are ageing, and when the means and attitudes adopted are not appropriate to setting realistic asset prices. It is possible that the government debt and the pension liabilities of companies are not properly accounted for. Therefore this very important pillar of the world economy, the second most important country, gives cause for concern.

Europe seems to be very remote from Asia, and it seems to be unimportant for Asia. This is a mistake, because it means we just do not exist in our own mindset, nor in the mindset of anybody else. Therefore nobody takes the region, Europe, seriously. It would be much wiser if we did so at home, and it would be much wiser if Asia considered Europe as the economic entity it is.

There is good news about Europe. Euro–sclerosis is mostly behind us and there are only a few governments that have not yet understood that there is no room for a third way. It is very obvious that one economic paradigm has won, the free market paradigm of the United States, and the faster we learn from it the better. That is probably something of an exaggeration; for an American audience, it would have to be put very

differently. For a European audience, it can be put even more directly, and for an international audience, it can be stated alongside some caveats. Of course Europe would not want to have as many young people in prison, nor as many lawyers per thousand inhabitants as in the United States. That is not optimal, but in most aspects of the societal setting, we could learn, and we would improve the efficiency and effectiveness of both Asia and Europe if we learned this lesson.

So Europe is moving in the right direction in terms of structural reforms. It is still hesitant but it is clearly moving, and we have a marvellous starting point in terms of cyclical performance. In addition, with the euro as weak as it is, and the misperception of the euro that is persistent in the United States, Europe and Asia alike will give us price competitiveness that we have not seen for a long time. Wage behaviour is excellent in Europe, and Europe will therefore outperform even the most optimistic forecasts for this year and next. So there is good news from that side for the international environment. In contrast talking about "Asia" makes less and less sense, because if there is one continent that is not homogeneous it is Asia. Of course, we discuss Japan and Asia, but even "Asia ex–Japan" is anything but homogeneous in terms of starting point; in terms of orientation; in terms of addressing the issues of structural deficiencies; in terms of relationships with specific countries. It is quite obvious that there are still a number of countries that talk about a market economy but do not mean it seriously. A look at any statistics in Asia and studying countries that still do not allow market prices to develop reveal no consistency. We, in Europe, have learned from the transformation countries of Central and Eastern Europe that, even if there are perfect national income accounts, you know little about a country if the deflators are not a reflection of individual preferences and production costs, but still reflect some form of central plan. They do not tell you anything about value added in such an economy. China has certainly to be mentioned in this context, and other countries in Asia should be mentioned here also.

As long as price structures do not reflect those preferences, what we will observe is "organised waste". This refers to systems which make ill use of the savings of relatively poor people. That is the case in quite a number of Asian countries which have high savings rates and low income levels. The people are being deprived because their savings are put to no good use: they are used in a way which is nothing but the organisation of the next round of waste. That is the type of thing we have to address at the roots. It is therefore so encouraging that everybody in the Forum has mentioned the important role of financial markets in the allocation of resources, but, if you allow that financial markets are needed to allocate resources, this implies that it cannot possibly be done by a financial sector that is interwoven with budget processes. If budget processes always intervene in these allocation processes, we end up with inferior allocation of capital. Therefore Germany, for example, which is insisting that almost half of the financial sector may not be in private hands, is not exactly in a good position to tell others how to structure their financial sector. France is not exactly a role model either. We do not have a system where capital is allocated through financial markets. It is allocated through the strange, insidious workings of a budget process, guarantees of all sorts, plus a financial sector. It is very obvious that we should be quite open about all that.

We have heard quite a number of positive remarks during the Forum about the importance of private–public partnerships. Of course, private–public partnerships are a much better solution than insisting that governments plan and execute certain infrastructure projects, when they are definitely not good at it; on occasion one should be quite Hayekian. If there is too much private–public partnership, there is at least a risk that responsibility for investment will lie nowhere. Nobody feels responsible, neither the private sector nor the public sector. At the end of the day it is, of course, the taxpayer who has to pick up the bill. We should be quite clear about that. Again, a somewhat more Hayekian orientation would occasionally be helpful. If we embark upon private–public partnership, we should at least know that it is a transitional solution. We should decide what can be assigned properly and fully to the private sector and we should be quite clear as to what can only be done by the government sector. Setting the rules can only be done by the state and the government sector. If the government sector could abstain from intervention and instead set rules, we would all be better off. As for Asia and the financial sector, private flows are again very large, but Asia of course has not got back to where it was in middle of the 1990s when private capital flows were very, very large. There was only one constant over the last five years — a very promising constant; namely, that foreign direct investment flows into the region stayed at a reasonable level, somewhere around $50 billion. That is certainly encouraging because it shows two things: first, the region is still attractive; and secondly, the world's investors understand it, particularly those that have a long–term commitment understand it. That is very important.

It is also reassuring that equity investment, portfolio investment, into the region, after a low in 1998, is beginning to accelerate again and that very risk–oriented but open–minded analysis is obviously possible in this connection. At the same time it is also very obvious that neither lending banks nor bondholders have regained confidence. If we read the international financial institutions correctly, it seems safe to say that it is very difficult to see bank loans ever again resuming the role they had in the past. You can hardly expect it from commercial banks, after being burnt as they have been, and with the financial sector generally moving in the direction of disintermediation and securitisation. So bank loans are something that we will certainly need to review as a source of funds in the future. The other question is how well the bond markets will develop. Here, of course, we have to work hard on both sides — the recipients as well as the international community — in order to get out of the doldrums in which we still are.

As to the prospects of these various capital flows, and as to the necessary measures on the part of the recipients, it is quite obvious that a few stand out: above all regulation and supervision as one element in each and every nation state. The core principles of effective banking supervision not only have to be defined, that has been done; they also have to be implemented. Arguing that this should be done is, of course, something we should be fair and frank about. Again, the experience we have had in Central Europe after the transformation of this part of the world into market economies and democracies is probably quite indicative of the order of magnitude of the task. Suffice it to say that when we built up the East German financial sector, West German banks

sent something like 8 000 bank managers from West Germany into East Germany for a period of five years, and we cannot claim that the East German financial sector is up to international standards, even now.

It took an operation involving 8 000 qualified people for five years to set the stage for something that is reasonable. This was for 15 million people. So to argue for a similar task force for technical aid for Indonesia would involve 100 000 bank mangers from around the world going for five years to Indonesia. What about China on the same scale? All of us in the business of consulting and advising these countries should make ourselves aware of the dimension of the problem and not continue to talk as if small, international financial institutions like the Asian Development Bank, or the IMF or the World Bank for that matter, could provide, with their resources, something that is close to adequate. If we address the issue in this way it becomes very obvious that technical aid of this magnitude never could happen as a form of coercion or obligation by the developed world. It has to be the wish of Indonesia or China or Thailand, for that matter, to ask for this technical help because otherwise it would be considered as coercion, as conflicting with the internal determination, the democratic processes, of the relevant countries. This is a very delicate problem from both sides, and, again, what should be stressed, are its dimensions. We always underestimate them in a way that is difficult to understand. Some of us have never left the seminar of an elite university and therefore do not understand the dimensional problems. On the other side, quite a few politicians who have not been exposed to Western democracies have no idea how a world that wants to be more open feels if we are obliged to behave as if the national sovereignty in any one country in Asia could be upheld and, at the same time, the international support could be upheld as well.

Liberalisation and the development of domestic financial markets is the important issue, but that of course requires openness. It will not work unless a certain amount of international participation is allowed, in terms of ownership and management in the financial sector. If the process of adjustment is to take place in two decades or less, then the input of this management know–how through participation and ownership by foreign companies is essential. If countries insist that this is not a political option for them, they should be frank and fair to their citizens and the international community and say that they are not fully part of the international division of labour and an open international capital market for that period.

For those who move ahead, however, accepting regulation and liberalisation is not the end of the task. Quite a few countries, even investment grade countries, have learned that it takes constant investor–relations–oriented activity of governments and institutions if what is done at home is to be understood internationally. People who have been working in the investment banking sector in your government or your central bank are needed not only to do a brilliant job in the finance ministry and the central bank, but also to be available to communicate to the international investor — and that on a frequent basis.

Quite a few interesting models have been established. Mexico may be a case worth looking into. This investor–relations activity of countries has to be something that is carried out regularly. The road show cannot only begin when a crisis is imminent. It has to be done on the basis of, say, a quarterly review and a quarterly press conference. The analysts must be invited in order to make them understand the policies. Of course all of this would be much better if, at the same time, there were macroeconomic stability. It is quite obvious looking into the trade numbers, the intra–region trade numbers of Asia, that if Asia, with more than 50 per cent trading within the region, still embarks upon an exchange rate regime that is either oriented towards the dollar or oriented towards the yen, the region will run into certain types of difficulty.

It is equally obvious that it will be very difficult, if not impossible, for the next decade or so to form something like an Asian monetary union. In the 1980s Japan and the yen would have been an excellent candidate for that, but this is no longer the case and it is clear that, as long as no new hegemony develops in economic and financial terms, and as long as the renminbi is not even a convertible currency, there is no obvious candidate for forming an Asian monetary union.

Given the exchange rate vagaries that exist for the dollar, the yen and the euro, a region that is trading increasingly with itself, but which relies in its exchange rate regimes on an outside anchor, is exposed to unnecessary risks for the time being. That is something worth discussing, and it would be wise for Asian institutions to work very hard at establishing regional institutions and exchange rate arrangements that at least orient themselves towards approaching an Asian monetary union in the longer–term future.

In the meantime, it is very difficult to know whether to advise Indonesia to have a floating exchange rate or a currency board. Indonesia is an obvious case: it is a very important case and a very delicate one. Those who claim that the best scheme for Indonesia is floating should remember what happened to the rupiah and what it meant for debt service; those who advocated a currency board should understand that they would be taking monetary policy away from Indonesia. Which regime would be more favourable is unclear, but it is certainly a very important issue, one which we have to address, and the old recipes that we, the Old World, have given probably deserve close consideration.

Help for the region from the international community is still a factor, and it is very wise not to get rid of the existing international institutions. We would have to reinvent them. Not that they cannot be improved, but it is very obvious that the alternative to an IMF that is coercing countries into certain policies, would be the United States and Europe coercing certain states into certain policies because otherwise the international division of labour would suffer even more. So international institutions are the best institutional set–up that we can have for the time being. These institutions should focus on what they are best at, and the new managing director of the IMF is

heading towards such a division of labour. Similarly, the World Bank knows its own brief, and the IMF will not do the World Bank's projects. It will be helpful if the intended division of labour between the two institutions is taken more seriously.

What would be helpful in the view of the private sector would be an end to loose talk about bailing in the private sector or coerced burden sharing. If the private investor smells that this is what the world is out for, private capital flows could dry up and that would certainly not be very helpful. Again, the IMF understands the message and will not move any further in that direction — or certainly not in a coercive way.

The implementation of standards and codes: after the crisis we have had, this is something that we, the international community, have to bring about. The private sector should be proactive in this field, for it is very obvious that it would be in the private sector's own interests to implement standards and codes in order to reduce the risks. One element to help the bond market to develop again in Asia and in other emerging countries would be a voluntary agreement that there should be an orderly debt workout and that certain clauses should be included in the new issues of international bonds; collective action clauses may be a way out. This should be not only talked about, but done.

On the part of the investors, on the part of the financial sector, there is a great need for an improvement in our risk management, and after the failures — not only with LTCM but also with others — it is quite obvious that we have to do much more frequent stress testing of our models. We have relied on old patterns, on old parameters, for too long and we should be more imaginative in doing this job, especially stress testing, and doing scenario analysis for that matter. The avoidance of herding effects would of course be another element, but it is unclear whether we can achieve this target in the new structure where pension funds, or life insurance companies, play a bigger role — even though these are institutions which by their very nature should look to the long term rather than the short term.

In the old days we had strategic investors and in many cases these were just families, individuals. They obviously had a long–run perspective. Today, among portfolio managers — even in insurance companies or pension funds — it seems we have nothing but short–term orientation. Making herd effects less probable appears to imply that we have to change some of our remuneration policies within the financial sector. If policies, factually, reward a lot of trading, it should be no surprise that certain attitudes are preferred. Therefore, at the end of the day, we will have to debate truly and openly staff remuneration policies in the financial sector in order to get away from the contagion effects that we have seen in the past. Ultimately, it is extremely important that the traders' bosses feel themselves to be responsible. Only if big institutions fail in the financial sector in the coming years, i.e. the "too big to fail" doctrine fails in a number of cases, will prudent behaviour and less herd effects and less herd instinct prevail.