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Lessons for the Next Financial Crisis

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LEARNING FROM THE ASIAN DEBACLE

THE TURMOIL in Brazil in January was grim evidence that the global financial crisis that began in Thailand in June 1997 is far from over. Brazil showed that the international community has a long way to go to make the world economy more resistant to the kinds of shocks that have been occurring with increasing regularity. In fact, a recent series of intensive off-the-record discussions with a number of top Washington officials and Wall Street executives who have played crucial roles in the various rescue efforts—speaking not only in their constraining official capacities but also giving their private views—show that while there is some consensus about what happened and why, the major players are badly split over what must now be done. It is as if the global economy has just had a prolonged heart attack. The systemic failure was a total surprise to the doctors, all of whom had previously pronounced the patient not only healthy but robust. But the injured party is still in intensive care, and the physicians are arguing among themselves about the diagnosis and prescription.

To be fair, no one ever really had a clear picture of the global financial system, even before today's crisis-ridden uncertainties. It is not just that over $1.5 trillion in currency changes hands every day, nor that

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understanding some of the newer financial instruments requires a background in quantum physics, nor that the range of market players—from banks to hedge funds—keeps expanding, nor that the variety of countries participating in the global economy keeps growing. Besides all this, there is also a broad range of regulatory, supervisory, and political systems, and there are disputes about what political, economic, and social mechanisms are required to underpin modern capitalism. Not only do these mind-boggling complexities make it difficult to examine what happened and why, but the sense that the worst aspects of the crisis are over could erode the determination of weary crisis managers to take the painful measures necessary to prevent another calamity.

But act they must. The broader picture still looks grim. Developing country growth in 1998 was only 2 percent, roughly half its 1997 level, and is not expected to improve much this year. Private capital flows to emerging markets have all but dried up and will not soon recover. Some 36 countries, accounting for 40 percent of the developing world's GDP, probably suffered negative per capita growth in 1998. All across East Asia and Latin America, the social fabric continues to tear as poverty increases, with unforeseen economic and political consequences. Consider the situation in the five biggest emerging markets. Brazil is on the ropes. Indonesia is on the cusp of social revolution. Russia's economy is still in free fall. China's economic reforms are under great stress as exports slow dramatically, growth rates fall well short of their targets, and regional banks default on foreign debts. India's progress is stymied by internal political paralysis. All this is happening against the backdrop of a 50 percent decline in the growth of global trade from 1997 to 1998 and amid an inevitable slowdown in the United States and Europe, the only two regions of the world where growth rates are healthy.

Worst of all, the crisis has eroded the faith of many up-and-coming nations in modern capitalism itself. Although most foreign officials and business executives are reluctant to publicly voice their deepest concerns, a backlash is quietly building against unbridled economic liberalization and the chaos it has unleashed. The shift can be seen in the dramatic change in the global mindset since the mid-1990s, when so many governments were enthusiastic about concluding broad free trade agreements—in the Asia-Pacific, the Americas, and elsewhere. Now not only has the momentum stopped, but the threat of protectionism is mounting.

Considering all this, we must focus our attention on at least three basic questions: Where are the principal areas of agreement about the crisis? What are the fault lines of disagreement? And given these realities, what is a politically workable framework for future policy?

MISTAKES WERE MADE

WALL STREET and Washington do seem able to agree on the following few key areas:

The financial system is not stable. Even a quick glance at the 1990s—the Latin American debt crisis, the European monetary upheaval of 1992, the Mexican bailout of 1994, and now the current debacle—shows that the evolution of a global market has been tortuous. In developing nations in particular, the last two decades reveal increasingly volatile markets and increasingly massive economic damage. While every crisis is embedded in a different set of circumstances—bad macroeconomic policies in 1980s Latin America, excessive private sector debt in 1990s Asia—there are many common elements too, such as unwarranted euphoria on the part of lenders and investors and a rush to the exits when the bubble bursts. There is also solid agreement among Washington and Wall Street leaders that no matter what measures are now put in place, more crises inevitably lie ahead.

The implications of what started in Thailand were badly underestimated. Major mistakes were made in reacting to the Asian crisis. For one thing, nearly all parties failed to correctly appraise the risk of contagion. At the annual meetings of the International Monetary Fund and World Bank in November 1997 in Hong Kong, shortly after the Thai economy started to implode, the consensus was that Indonesia was "safe." Even after Asian problems began to spread, most forecasters did not understand the impact on economic conditions. The IMF alone lowered its forecasts for global and emerging market growth twice in the last three months of 1998. In fact, as late as last summer, concern in the United States and Europe remained muted, and it took the combination of a Russian default and the near collapse of the Long Term Capital Management hedge fund to focus serious international attention on the growing problems. The changing rhetoric of President Clinton says it all. In November 1997 he called the Asian crisis a mere "glitch." In October 1998 he called it the most serious financial crisis in 50 years.

Lenders and investors deluded themselves. They stampeded into emerging markets when interest rates were low in the West and potential returns were higher in Asia and Latin America. In the mid-1990s, when new terminology transformed "developing countries" into "emerging markets," lenders and investors got sucked into thinking that the regulatory oversight in these countries was far more sophisticated than it was. They fooled themselves into believing that emerging markets were ready to fully participate in the turbulent world economy.

The nature of contagion was not well understood. In the past, a problem in one country—especially a small one like Thailand—would usually spread mostly to its principal trading partners and to countries in the region. But what happened in 1997 was more complicated. Inflated expectations about virtually all emerging markets had been building for several years in financial institutions around the world. When lenders and investors saw these hopes dashed in one country, they were quick to downgrade all other nations in the same category. In other words, contagion was as much in the mind of lenders and investors as in the markets themselves. Moreover, bankers and officials underestimated both the downward pressure on global commodity markets from the collapse in demand in Southeast Asia and the impact this would have on the many other emerging markets that are major raw-material exporters. And governments and markets alike failed to understand that in a crisis, market risk, credit risk, and political risk would all blend together. They were also taken aback by how quickly liquidity would dry up in a situation in which so much lending and investing was short-term and comprised of securities rather than conventional banking transactions.

The initial diagnosis missed the mark. The first analyses of the crisis in Southeast Asia failed to take enough account of the private-sector roots of the crisis—not government finances as much as overindebtedness of local corporations and poor debt and currency management on the part of local banks. The early assessments of the situation in Japan were also overly optimistic; some Western officials mistakenly thought that Japan would rescue Thailand the same way the United States helped Mexico in 1995.

All risk management systems failed. The risk assessment and risk management of foreign lenders and investors in emerging markets—both in private institutions and in governments—failed to foresee the buildup of unsustainable financial leverage. The IMF monitoring system did just as poorly. Everyone agrees that all these mechanisms need strengthening, and no one denies being totally surprised by the way that markets seized up and closed down in August and September of 1998—even in the United States, where the economy was so strong.

New financial players changed the rules of the game. Global finance is no longer a cozy club of finance ministers, central bankers, and big commercial banks. The Asian crisis revealed a much wider group of players. The evolution is clear: in the first two decades after World War II, foreign aid and other "official" capital was the main source of funds flowing to developing countries. In the 1970s and 1980s, commercial banks became the primary source. In the 1990s, a much larger cast took the stage: insurance companies, pension funds, hedge funds, and mutual funds. Future financial crises will increasingly involve securities markets, with their multiplicity of instruments, markets, trading strategies, and global linkages. All this will make crisis management infinitely more complicated because there is no one mindset at play, no one set of regulators, and no way to negotiate anything with so many diverse parties. Moreover, many participants who have not one iota of genuine interest in a country or the "global system" will flee at the first sign that the good times are over.

Investors fooled themselves about emerging markets.

Local politics are crucial. In retrospect, Wall Street and Washington now realize the overwhelming role that domestic politics played in frustrating crisis management. The Thai bailout unfolded amid a constitutional crisis, the South Korean rescue during a leadership transition, the Indonesian package amid widespread rioting that eventually led to the downfall of a dictator, and the Russian plan while the government was crumbling. It is now better understood that a successful stabilization and restructuring package cannot be forced down a country's throat. One of the enduring images of a mistaken approach is likely to be the photo carried in major newspapers of the IMF's managing director, Michel Camdessus, arms defiantly crossed over his chest, standing over former Indonesian President Suharto as the latter reluctantly signed an IMF agreement that was soon to collapse.

Transparency, information disclosure, and adequate financial regulation were sorely lacking. There is no controversy in principle about the need to strengthen the financial systems of individual countries via more accurate and timely financial reporting, tighter financial regulations, and better corporate governance of private-sector banks and companies. The fact is that emerging market countries often have not disclosed their true reserves or their total liabilities in a regular and up-to-date way. Their lax banking supervision and corporate oversight fell far short of what was necessary for an open global economy.

The IMF, mistakes notwithstanding, was and remains crucial to economic stabilization and recovery. Despite all the controversy surrounding the IMF's policies and the withering criticism of several highly respected economists, the overwhelming weight of opinion on Wall Street and in Washington favors strengthening the fund. Not everyone agrees on the exact nature of its role, but all believe that some global institution needs to be in the center of the storm and that it is wiser to use the IMF as the starting point than to craft something altogether new.

In sum, while many serious mistakes were made, there is broad agreement on the need to strengthen the global financial system so that it is as strong as some of the better-run national financial systems. And there is no doubt, either, that this is among the most difficult public policy challenges of our times.

THE BATTLEGROUND

IN SOME CASES, key officials diagnose the financial crisis differently; in others, they disagree on the details of implementing the next steps. Among the main questions being argued over are the following:

Were the IMF stabilization packages poorly constructed? The fund's many defenders say that it did the best it could with the information available at the time, particularly given the fact that countries came to it late in the game and agreed to its programs only well after the crisis became advanced. For its part, the IMF itself conceded in January that it had been too sanguine about the prospect of a serious economic downturn and that its assessments of the markets' response had been flawed. But there is still serious criticism, too, and it goes like this: The IMF was too focused on defending fixed exchange rates. In so doing, it let speculation build up, which eventually forced the rates to collapse anyway but also did more damage to the country in question than would have happened had devaluation occurred at the outset. The IMF failed to see that the Asian crisis was primarily about excessive leverage in the private sector. In forcing tighter fiscal and monetary policy, the fund precipitated widespread bankruptcies where there were not effective bankruptcy laws and killed the growth that would have been essential for private-sector restructuring and recovery. Some critics further argue that the fund should have been far less intrusive, focusing on stability first and phasing in large-scale restructuring of the economies later; others accuse the IMF of failing to take societal needs into account, thereby sowing the seeds for political problems for years to come.

Is it a mistake to push financial liberalization in emerging markets so fast? For several years the conventional wisdom in Washington was that emerging markets should quickly dismantle financial controls on all kinds of capital inflows. This free market doctrine was mirrored by similar calls to lift restrictions on trade and to hold democratic elections. Everyone now realizes that emerging markets were walloped by the quick exit of short-term capital, but there is no consensus on whether capital controls on short-term inflows should be encouraged in the future. Some key officials still hold that full financial liberalization is the least bad alternative and that the imperative now is to move ahead simultaneously with financial liberalization and the shoring up of domestic financial systems. But many others believe this approach is now discredited, that adequate domestic regulation in emerging markets will take many years at best, and that some controls on incoming short-term capital are essential.

What are the relative roles of the public and private sectors? Officials argue intensely about the issue of "moral hazard"—the awkward term used to signify the danger that lenders can be reckless because they feel assured that the government will bail them out. A key dispute revolves around the question of who should construct rescue packages—the IMF and governments alone, or these public entities along with private lenders and investors? (Here, private participation could mean some combination of maintaining credit lines, providing new money, and negotiating debt-restructuring agreements.) Some Washington politicians need to show the voting public that private lenders and investors are suffering some losses from the debacle and that government funds are not just being used to bail out Wall Street. But beyond that, many see that the problems in emerging markets were in large part caused by overlending and overinvesting by the private sector, which therefore has some responsibility for cleaning up the mess it created.

Some in Washington want to show voters that they are not just bailing out Wall Street.

Many on Wall Street view the problem differently. Some think that Washington is riveted excessively on commercial banks and not enough on the plethora of other lenders and investors who would, in any event, never participate in rescue packages—either because it is just not part of their mindset or, as in the case of pension funds, because they have a legal obligation to withdraw their money when indices change. Some top bankers think that IMF and government officials are misreading the nature of markets altogether. They reject the notion that the private sector does not sustain losses; after all, their shareholdings and share prices plummet. In addition, these executives believe that the IMF packages are and should be short-term measures that help emerging markets reenter private markets, without which developing countries cannot grow. In this respect, if things go well, bankers expect once again to be lending, investing, and taking more risks, all of which they see as another part of sharing responsibility.

Washington and Wall Street also disagree on the proper balance between public and private responsibility for providing better financial information on emerging markets. Private lenders and investors want the IMF to make public the information it obtains from emerging market governments. The IMF fears that in doing so, its sources of reliable information as well as its sensitive political relationships will be destroyed. So while everyone wants more and better information, there is little consensus about who should collect it, verify it, or make it public—and beyond that, on whether the information should be used voluntarily by market participants or whether they should be pressured by supervisors to do so.

How long will it take for emerging markets to recover? More than a dispute among economic forecasters, this question reflects different views about the depth of the problems in emerging markets. Many private lenders believe that a number of emerging nations can return to the markets reasonably quickly, albeit with higher borrowing premiums. But even if this happens, others are looking beyond the rhetoric of "building a new architecture for the global financial system" and asking hard, practical questions about the system's plumbing and electrical work. In their view, it could take years to establish sound regulatory systems, train banking and stock market regulators, and create an environment for rigorous credit analysis in local banks and investment houses. For them, the big question is whether the international community has the patience to roll up its sleeves and address these hard realities or whether it will take the fact that emerging nations are reentering global financial markets as a sign that it is again time for business as usual.

Did Washington adequately factor foreign policy considerations into global financial management? By all accounts the State Department was at the table when most of the critical issues in the crisis were discussed. The National Security Council weighed all the views, although there may have been some needless and counterproductive overlap between its work and that of the National Economic Council. But on many important questions, the State Department's advice was decisively overruled. For example, when Thailand asked for immediate assistance from individual governments in the early stages of its implosion, the department argued that the United States had to join others like Japan in coming to Thailand's aid since it could not abandon an ally in times of such stress. This advice was not followed, and the United States did not contribute to the aid package. When Japan offered to put up $100 billion as part of an Asian fund, State Department officials argued that the United States should negotiate some arrangement with Japan rather than kill the proposal. It was ignored again. In the case of Indonesia, the State Department called for a less intrusive approach to restructuring out of fear of massive social unrest—and yet again it lost the argument.

U.S. diplomacy during the crisis revealed a gigantic gap. When Asia blew up, the Treasury Department had the crucial relationships with finance ministers and central bank directors and understood both the technical details and policy issues. On the other hand, there were two levels of policy questions: one relating to stemming the economic hemorrhaging and another relating to political stability, alliances, and longer-term questions about Asia's and Russia's place in the broader international system. The State Department was ill-equipped to lead on the former, and the Treasury Department had neither the mandate nor the expertise to focus on the latter.

THE FIREWALL NEXT TIME

THERE IS, of course, no panacea for global financial crises. By nature, financial calamities are messy affairs; all players scramble to cover up their mistakes and protect their interests, and there are always intense conflicts between creditors and debtors and between government and private sector participants. But the key players ought to be able to agree on a plan of action. The following is the kind of framework that might gain acceptance; it is not a set of original ideas but an attempt to synthesize various Wall Street and Washington views and recommendations into an effective program that could be broadly supported. To be sure, this is not a dramatic set of proposals (it does not, for example, include a global central bank, which some have advocated), but it is still a great improvement over where things stand now—and it is politically realistic.

The crucial challenge facing policymakers and financiers is the development of a stronger infrastructure for global capitalism. When all is said and done, the world economy is crisis-prone because it is evolving at breakneck pace and has many seriously weak economic and political links. The crisis was the fruit of a general overestimation of the strength of the framework for global finance and—in Washington, at least—a hubristic belief that emerging markets would adopt American-style capitalism and were close to doing so. Blind faith in the "magic of the market" replaced any historical perspective about what countries needed to do to build solid modern banking and regulatory systems. In addition, the regulatory systems of the advanced countries and those that have been emerging on a global scale—such as the prudential standards required by the Bank for International Settlements (BIS), the Swiss-based consortium for key central banks—all proved inadequate.

If the crisis does anything, it should bring home to us the awesome amount of infrastructure that must now be built. For emerging markets this will mean a generation of training in financial regulation, supervision, and the creation of bankruptcy laws and systems of corporate governance. For advanced nations it will require prudent supervision of the buildup of leverage by major lending institutions, including their exposure to hard-to-regulate hedge funds. On a global scale, close coordination among international financial institutions will be essential.

For starters, responsibility among international institutions needs to be delineated more clearly. The infrastructure for globalization cannot be built if global financial institutions are at odds with one another, as the IMF and the World Bank have been when constructing some of the rescue packages. The IMF should focus on financial stabilization, rescue packages, collection of information on fiscal and monetary policy, and tighter economic monitoring. The BIS ought to have oversight for banking and financial regulation. The World Bank is best positioned to handle issues such as social safety nets, bankruptcy procedures, and corporate governance. Regional institutions such as the Asian Development Bank should work with countries in their geographic and cultural vicinity to create peer review processes, identify "best practices," and oversee educational and training forums for emerging market economic officials. In addition, regulators of all countries should coordinate much more. A board of regulatory overseers, established under the auspices of the BIS and designed to spot gaps in the system and monitor progress toward closing them, would be a good idea, but setting up such a board should not be confused with getting the plumbing right in individual national systems.

Moreover, market mechanisms ought to be used as much as possible to discipline excessive lending and borrowing. There should be little controversy about the need for developing countries to publish more information sooner. The wrangling over whether the IMF should take the lead in this area, given the risk of undermining its confidential relationships, could be addressed by having the fund develop an extensive template for information and its timely disclosure. Emerging countries could fill in the blanks voluntarily, and the information could be verified by the IMF. The market would likely ensure that those governments that do not wish to participate would forfeit new loans and investments, but individual governments would have to choose whether to put themselves in this position. The IMF, however, would not be obligated to disclose the substance of discussions about policy intentions, which would remain confidential. The statistics thus provided would, of course, guide lenders and investors. But this will not be enough. Supervisors in advanced countries also ought to use this information in discussions with those who are being regulated—a move that would further concentrate the minds of lenders.

The world needs to walk away from countries unwilling to make serious changes.

Regulators also need to get a better handle on the leverage exercised by hedge funds and other unregulated entities. One way to do this would be to require banks and other institutional lenders to fully disclose their positions vis-à-vis hedge funds to regulators. The lending institutions could then no longer hide behind a professed lack of information on what the hedge funds are doing. Since banks and big financial institutions provide the bulk of the money that can be leveraged, hedge funds would automatically be reined in. In addition, there could be more self-regulation among issuers and traders of derivative instruments. Industry guidelines and standards for disclosure would be very constructive—so long as there is some peer-group enforcement.

In a more market-oriented system, governments and the IMF would have to recognize that it is unrealistic to pressure private lenders to stay in the game when a crisis flares. Even if arms could occasionally be twisted, the ill will that would be engendered is not worth the cost. In any event, the global financial system is too porous to enforce such burden-sharing, and the long-term cost will discourage important lending in the future.

This is not to say that governments and key private sector participants should not try to work closely together; as in South Korea, there may be opportunities to link government financial help to private sector debt restructuring. Nor is it to say that governments will always bail out the private sector. Governments and the IMF need to walk away from countries that are not interested in serious policy adjustments, as they did in the case of Russia.

As for controls on incoming short-term capital, it would have been wiser, in retrospect, for emerging markets not to have liberalized their financial systems as fast as they did. But reimposing controls would be too difficult to effectively manage; better to seek more market discipline on lenders and borrowers via information disclosure and shrewder overall financial regulation and supervision.

More important than capital controls, which are hard to implement and which create their own distortions, is the establishment of effective bankruptcy laws in emerging markets. More crises are sure to occur, and countless firms will be rendered insolvent unless there are formal, legally mandated restructuring procedures in place. The orderly restructuring of failed enterprises is a fundamental institution of capitalism, but the adequate systems for doing so simply do not exist in most emerging markets.

Much more attention must also be given to strengthening the overall global financial system. Emerging markets are relatively small boats in a turbulent sea. Thailand and its neighbors were whipsawed less by their own policy mistakes than by factors well beyond their control. These included dramatic currency realignments that undermined their competitiveness and grave economic mismanagement in Japan, which accounts for more than half of Asia's GDP. Japan's blunders led to the closing of important export markets for Asia's emerging countries as well as a withdrawal of lending by Japanese banks. In addition, global macroeconomic policy was too restrictive after the crisis broke; central banks in advanced countries were slow to grasp the magnitude of the global problem that was emerging. Federal Reserve Chairman Alan Greenspan admitted for the first time that the United States could not prosper in a world of chaos only in September 1998—15 months after the crisis broke—and he had to lower interest rates thrice in rapid succession.

An emphasis should also be put on crisis prevention. Once a crisis flares—once it hits *The New York Times*—there are almost no good alternatives. Chaos reigns, decisions have to be made in the absence of decent information, and politics becomes unmanageable. All this puts a premium on addressing problems at their earliest stages. The Brazilian package of late 1998 was, of course, designed to be preventative, and it faltered because of domestic politics. The lesson is that prevention requires both external and internal preparation. Nevertheless, the efforts of the IMF and others did buy Brazil time and prevented a blow-up on the heels of the Russian and Long Term Capital Management debacles.

The world needs to do better next time. Several preventive measures could be taken. For example, while the controversy over the right exchange-rate regime may never be resolved, this much can be agreed upon: If emerging markets want fixed exchange rates, their commitment to hold firm must be highly credible. This means either a currency board in which all local currency is exchangeable into hard currency reserves—in dollars, euros, or yen—or participation in a regional currency arrangement. Otherwise, a country should have floating rates. Anything in between is too dangerous. The worst of all worlds is to devalue in a panic. Counseling emerging markets on how to establish one of these two regimes should therefore be one of the IMF's principal responsibilities. Doing so will build bulwarks against the next market attack.

The IMF should begin raising funds for future bailouts soon, not when the next disaster strikes.

Another way to help ward off crisis is for emerging markets to hold much larger currency reserves. Those that did so fared best in this crisis. After all, modern crises are likely to arise quickly and fiercely through capital markets. As part of this strategy, countries should emulate Argentina and line up large credit lines to bolster their positions in advance of a meltdown.

A third preventive measure is for IMF rescue packages to be substantial and credible. The IMF should begin raising funds for future bailouts soon—and not on the eve of another debacle. Strikingly, the IMF's resources are much smaller than they used to be relative to the global economy. After the current capital expansion is complete, the fund's resources will total around $275 billion. But were the ratio of these funds to global GDP the same as it was in 1945, the amount would be closer to $800 billion.

Prevention also means that governments need to be encouraged to go to the IMF for help at an earlier stage. If more information is disclosed and private lenders and investors withdraw in the face of a deteriorating situation revealed by the new numbers, countries at an early stage of crisis may have no choice but to approach the IMF sooner rather than later. To make sure this happens, however, the fund could hold out incentives of loans at lower rates for countries who come in for preventive reasons.

Given what we now know about the unpredictable nature of contagion, as soon as there is a hint of crisis it makes sense to shore up other countries that have similar features or are nearby. When Thailand devalued the baht, the IMF, to its credit, was quick to conclude a deal with the Philippines, which to this day has done much better than most of its neighbors. When Brazil devalued its currency in January, the IMF immediately offered help to Argentina and Mexico.

Finally, there could be more contingency planning in the global financial arena. Such exercises might be run discreetly by the BIS and its membership of central bankers. Very little of this goes on now. As with planning for war, the odds of getting the scenario right are slim. But practicing readiness ensures that the troops remain alert at all times.

GIRDING FOR THE NEXT DISASTER

THE PROBLEMS—and remedies—go beyond economics. The worlds of finance and foreign policy need to be bridged. In the end, many of the biggest problems with financial management are political: crony capitalism, corruption, too much or too little government involvement, and government resistance to taking certain risks to change policies. Countries have memories, too, and if treated too harshly, enmity could emerge another way at another time.

Better financial diplomacy could ease economic and political turmoil. Countries must "buy into" the stabilization program at hand, which may require extensive negotiations. The style and gravitas of the senior negotiator could make a world of difference both in a country's willingness to accept a stringent adjustment program and in the IMF's understanding of the legitimate political constraints on the governments with which it is dealing. Enlisting former top officials from treasuries and central banks and assigning them to the IMF to work with the most senior public officials in emerging markets could help erase the perception that the IMF is sending a staffer who, despite impeccable academic credentials, has never borne operational burdens in a tumultuous economy.

Second, there ought to be more of a distinction made between stabilization and restructuring. Much of the latter should be done in steps, not all at once. The wholesale and immediate restructuring that is being asked of Asian economies would be totally unacceptable in the West—the equivalent of demanding that, say, the United States cut expenditures, raise taxes, change its banking regulations, and restructure its *Fortune* 100 companies. Sometimes the desired changes are simply not feasible without making the problem much worse—for example, forcing bankruptcies in Thailand, which lacks effective bankruptcy laws. Such changes will eventually be necessary, but the sheer intrusiveness of the conditions will probably either make the initial crisis worse and necessitate a much longer bailout period or engender social turmoil.

Third, leadership is needed to manage the financial system. Even allowing for the fact that markets cannot be dictated to, there are far too many actors for any coherence. Someone has to lead. For better or worse, that has to be the United States. Neither the tradition of leadership nor the mechanisms exist for this in Europe or Japan, and international institutions do not have the clout. But taking the lead in financial diplomacy is no easy task. It would require more U.S. efforts to bring in other nations with resources, such as Japan, the European Union's members, or even China, with its substantial reserves and influence in Asia. It would also entail enlarging the G-7 to include several key emerging countries, such as China, Brazil, and India, and making a reinvigorated G-10 or G-15 the overseer of the global financial system.

Washington, however, is not yet ready to lead. The State Department's historic tendency to downplay the importance of economics in foreign policy runs deep in its culture, but that will have to change radically if America's broad foreign policy interests are to be served. This means major shifts in the way young foreign service officers are selected and trained. It means selecting more ambassadors with the experience necessary to report on and operate in an environment of continual economic turbulence. Global leadership in an era of economic and financial turmoil also has major implications for the way the State Department is organized, including the need to vastly enhance the influence of the under secretary for economic affairs in the councils of whatever administration is in power.

Equally daunting is the need to change Congress' behavior. In conducting global financial diplomacy, America's Achilles' heel is that, at the very time that such efforts are becoming more complex, not only is there frighteningly little knowledge and interest in Congress about them, but there is not a majority in either political party for active U.S. global engagement. Just look at congressional positions on the adequacy of IMF resources or on granting the White House "fast-track" negotiating authority for trade pacts. America simply will not be able to lead if it is hamstrung by an inward-looking Congress.

We should also not forget the sine qua non for American leadership: an exceptionally strong economy and globally competitive U.S. firms. Whatever may be said about American behavior in the Asian crisis, it has been an enormous advantage to the United States to have been able to face the challenge with low inflation, low unemployment, a budget surplus, and strong corporate performance. No amount of rhetoric or willpower can substitute for these kinds of conditions.

It will not be easy, but the global community can do significantly better at minimizing the frequency, severity, and scale of financial crises. A series of meetings coming up—the IMF–World Bank interim meeting in April, the G-7 summit in June, and the annual IMF–World Bank meeting this fall—could provide a consensus and an action plan before the millennium arrives. Reorienting and strengthening the base of American financial diplomacy could begin with the 2000 elections. Every course has its risks, and lessons learned in one crisis will never provide the full script for addressing the next, but they can surely help. The direst threat to the world's ability to learn from what has happened, however, is neither a paucity of first-rate talent in Washington and on Wall Street nor a lack of good ideas. Rather, the biggest problem is that the current crisis might appear to be abating, thus lulling everyone into moving on to other issues. That would be an immense tragedy, for the one certainty is that we have not seen the end of serious global financial turmoil.