LETTERS

Capital account liberalization

Michael Mussa and Barry Eichengreen in "Capital Account Liberalization and the IMF" (*Finance & Development*, December 1998) describe some of the potential advantages and disadvantages of liberalizing the capital account. But it strikes me that they are singing from a rather old and out-of-date hymn sheet. Modern finance—and particularly portfolio—theory is well known, but the whole lesson from the last year and a half is that "the rules of the portfolio investment game and of global finance have changed irrevocably."

The theory of international diversification held that investors could reduce portfolio risk by exporting capital to emerging markets. However, this tenet of modern portfolio theory has taken something of a beating in the recent crisis. It appears that, in times of crisis, the actions of investors themselves increase volatility. This increased volatility drives up asset price correlations in instruments and markets that—according to fundamentals—should not be highly correlated.

Because portfolio theory tends to look at the "steady state," it cannot account for the effects of crises where traders themselves diverge from what their own models predict. So the lesson here is obvious: the theory of international diversification is useless in a contagion-plagued bear market where those markets are moving in lockstep.

Another myth exposed during the Asian crisis, but seemingly still subscribed to by Eichengreen and Mussa, is that of "perfect information" being the panacea for all our worries. This argues that "asymmetric information" is the primary reason for the inefficient distribution of resources by markets. The flaw in this approach is that information *is* as perfect as possible—but in times of crisis, it is just not being used. The crisis showed how the actions of the market players are not necessarily based on "fundamental economics in times of crisis," but on a search for liquidity, on herd psychology, and on expectations of what might happen, even if this is "irrational" in terms of underlying fundamentals.

Given these far-reaching reassessments of how markets work in times of crisis, I find it deeply disappointing that there has not been any change of rhetoric at the IMF concerning capital account liberalization. The authors extol the virtues of mobile capital, but fail to see the wood for the trees: developing countries cannot gain from this process because they do not have the capital from which to benefit in the first place. Capital account liberalization is a one-way street. The economies of developing countries are reduced to insurance policies for the portfolios of global investors. With little investment capital of their own, developing countries have little to gain from capital account liberalization—but are being asked to shoulder the downside risk for the richer countries.

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Deposit insurance and moral hazard

Should one throw away the life belt just as the storm blows up, or is it rather the very existence of a life belt that induces a sailor to expose himself to a stormy sea? Comparing deposit insurance schemes in various industrial countries ("What Deposit Insurance Can and Cannot Do," Ricki Tigert Helfer, *Finance & Development*, March 1999), one finds that they differ greatly as far as the level of protection is concerned, ranging from only about $30,000 to practically complete coverage, as in the case of German private banks. Yet one does not find a clear correlation between the comprehensiveness of an insurance scheme and the solidity of banking structures in a country. Strangely enough, a country like Germany, which, by international standards, even has an excessive level of consumer protection as far as bank deposits are concerned, is also able to boast one of the most solid banking structures.

The point is that an insurance scheme may well be comprehensive and undiscriminating as regards the size or profit situation of the banks participating. But it has to be financed by the banking industry itself and must exclude any taxpayer bailout of the banks. The assumption of financial responsibility and self-monitoring by the financial services sector itself will best rule out any misuse by individual banks. Moreover, any kind of government subsidy must be regarded as an unfair measure vis-à-vis international competitors.

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Illustration: cover, contents page, and pages 6 and 20, Glasgow and Associates; contents page and pages 24, 37, and 40, Massoud Etemadi; pages 9, 28, and 32, Luisa Menjivar-Macdonald; page 46, Lew Azzinaro.
Photographs: cover and page 16, Uniphoto; contents page and pages 50, 52, 53, 54, and 55, Pedro Márquez; pages 2 and 3, Denio Zara; authors' photographs, IMF Photo Unit.