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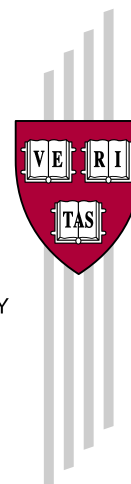

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G-24 Discussion Paper Series

Reform of the International Financial System and Institutions in Light of the Asian Financial Crisis

Yung Chul Park and Yunjong Wang

No. 12, July 2001

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

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REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM AND INSTITUTIONS IN LIGHT OF THE ASIAN FINANCIAL CRISIS

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Abstract

When East Asian countries came under speculative attacks in 1997, some of them were not able to defend themselves, and subsequently had to seek the financial assistance of IMF and accept its stabilization programmes. These crisis-hit countries were criticized for not having restructured their financial, corporate, and public sectors along the lines suggested by the Washington consensus. This failure was singled out as the main cause of the crisis and, understandably, these crisis-hit countries were subject to heavy doses of structural reforms. The East Asian crisis became contagious, even threatening the stability of major international financial centres. The severity and contagiousness of the East Asian crisis underscored the importance of, and renewed interest in, reforming the international financial system. Numerous proposals have been put forward. The G-7-led reform, however, has concentrated its efforts on reforming the financial and corporate sectors of developing economies, while by and large ignoring the problems of the supply side of international finance.

As was the case in the Mexican crisis of 1994/95, the appetite for radical reform of the international financial system has receded considerably in the wake of global recovery. The ongoing debate on the future direction of the international financial reform in fact suggests that most of the problems that beset the international financial system are likely to remain unchanged. This pessimistic outlook arouses deep concern in developing countries lest they remain vulnerable to future financial crises, even if they faithfully carry out the kinds of reform recommended by IMF and the World Bank. Given this reality, developing countries may have to develop a defence mechanism of their own by instituting a system of capital control and adopting an exchange rate system that lies somewhere between the two corner solutions.

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REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM AND INSTITUTIONS IN LIGHT OF THE ASIAN FINANCIAL CRISIS*

Yung Chul Park and Yunjong Wang

I. Introduction

Following the collapse of the Thai baht on 2 July 1997, the financial markets in other East Asian countries suffered similar and disastrous consequences up until mid-1998. The simultaneous financial meltdown in the East Asian countries has led to the widespread use of terms such as the Asian "flu", with the implication that this was a real case of contagion, where one country's crisis spread to other vulnerable countries. Many academic researchers and pundits have argued that the domino effects among the East Asian currencies were mainly attributable to deep-seated regional structural weakness. Blame has been heaped on "the Asian way".[1] One unpleasant term that has been coined to label this structural weakness is "Asian cronyism". The moral hazard problems existing in both the corporate and financial sectors are discussed in a more gentle tone in Krugman (1998a, 1998b), Fischer (1999) and Corsetti et al. (1998).

Contrary to the popular opinion in most creditor countries, however, the economic crisis in East Asia was not an "East Asian" one. The conditions that precipitated the crisis were by no means unique to the region. They had their roots in the liberalization of the financial sector prior to establishing an efficient framework of regulation and supervision, excessive borrowing and lending by private agents, and the inability and unwillingness of key players – including governments – to accurately assess risks. The resulting collapse of domestic financial and currency markets is a phenomenon already observed in the 1990s in Europe, Latin America, and then in East Asia. Furthermore, the continued spillover effects of the East Asian crisis hit the Russian Federation and reached Latin America.

The speed of recovery in East Asia since mid-1999 has been impressive. It is quite possible that East Asia will remain crisis-free for the next several years. Despite the optimistic outlook for East Asian recovery, there is also widespread concern that the

* We should like to thank to Dani Rodrik, Charles Wyplosz and the participants of the G-24 Technical Group Meeting , Geneva, 14–15 September 2000, for their valuable comments and suggestions.

economic upswing under way in the crisis-hit countries does not necessarily mean that the region is out of the danger zone. In the eyes of many East Asians, few of the structural deficiencies of the international financial system that also contributed to the crisis have been sufficiently rectified. Along with consistent and lasting structural reforms in East Asia, creating a new international financial architecture should be more balanced; it should address the problem of market failures that beset international capital markets and that often trigger financial panic and herd behaviour. Even if the most ambitious architectural reform would not forestall a future financial crisis, a new international financial architecture should temper the depth and scope of subsequent disruptions in the aftermath of the inevitable next financial crisis.

Since the East Asian financial crisis of 1997/98, numerous proposals for reforming the international financial system have been put forward.[2] From the viewpoint of the East Asian countries, relatively little has been accomplished vis-à-vis reducing the degree of instability in the international financial system and improving its capacity to manage crises when they occur. Thus, additional reforms are needed both to prevent such crises in the future and to respond more effectively to the painful disruptions that will inevitably occur. However, as in the Mexican crisis of 1994/95, the appetite for radical reform of the international financial system has receded considerably in the wake of global recovery. Signalling this new perception at their meeting in Cologne in June 1999, the G-7 Finance Ministers explicitly ruled out the creation of any new institutions and made it clear that their aim would be to work with the existing system, strengthening it when necessary (Group of Seven, 1999).

There is nothing wrong with incremental change as long as it yields positive outcomes. However, the reality is that the already slow progress would not safeguard financial stability in the emerging market economies (EMEs). As long as the structural problems on the supply side of capital are not addressed, the East Asian countries will remain as vulnerable to future crises as they were before. Would the international community need another global crisis or two before reaching the political consensus that seems almost impossible at this juncture?

In what follows, we shall examine various architectural reform issues in the light of the East Asian financial crisis. Because the international financial architecture covers such a broad area, this paper focuses on a few selected issues. Section II discusses the reform of international financial institutions (IFIs); section III examines the current process of setting and enforcing international standards; section IV deals with bailing in the private sector; section V examines the issue of exchange rate regimes and capital controls; and, finally, section VI considers an alternative safeguarding scheme – the so called "regional financial arrangements" – to supplement and complement the existing global financial architecture.

II. Reform of international financial institutions

A. *Role of international lender of last resort*

The debate on the need for an international lender of last resort (ILLR) dates back to the inception of the Bretton Woods system. Keynes put forward the plan to establish an International Clearing Union, which would issue new international money to be called *bancor*, and provide automatic financing of current-account deficits. The issue surfaced again in the 1970s, when the dollar crisis of August 1971 constituted a threat to the Bretton Woods parity system. With the collapse of the rule-based international financial order between 1971 and 1973, most industrialized countries moved towards floating. Furthermore, the international activity of commercial banks increased dramatically with the advent of the euro-currency markets, and the need for recycling the sizeable surpluses of OPEC countries complicated the international monetary order (De Bonis et al., 1999).

The issue of an ILLR may be simplified into two questions. The first is whether there is a need for an ILLR. If so, the second question is what institutions, or group of institutions, should assume the responsibility. According to Kindleberger (1973, 1989), the international dimension of crises makes a case for such a global institution. When a crisis is unfolding, countries may face limited access to capital markets, even though they are implementing appropriate policy corrections.[3]

As for the second question, the role of an ILLR had been informally performed by either the central banks or major financial centre institutions before the creation of the Bretton Woods institutions in 1945. The institutional setting that was shaped at Bretton Woods fell short of providing a full-fledged ILLR.

Instead, IMF was created as a quasi-lender of last resort or, as Fischer (1999) puts it, a crisis manager-lender in order to provide to its member countries the financial assistance needed to correct their external imbalances. However, the principles governing IMF's lending activities could hardly be reconciled with the classic Bagehot rules of (i) lending freely to solvent borrowers, (ii) against good collateral, and (iii) at a penalty rate.[4]

The current discussion on the reform of the international financial system effectively rules out the possibility of creating a world central bank. Eichengreen (1999a), for instance, dismisses the idea of a global central bank as quixotic. This leads to the question of whether and how the existing Bretton Woods institutions should be restructured to serve as a lender of last resort. On this question, there appears to be at least four competing approaches.

The first approach, which reflects the view of Kindleberger's detractors, proposes that even the limited role of IMF as a quasi-lender of last resort should be further circumscribed because it has become the source of moral hazard in the global financial system, and financial markets are intrinsically stable and efficient, as well to deal with crisis contagion. Although there is no empirical support for the moral hazard problem associated with IMF (Bergsten, 2000a), the Republican-led majority of the Congressionally appointed International Financial Institutions Advisory Commission (IFIC) (known as the "Meltzer Commission") calls for drastically shrinking both the scope of IMF intervention and the role of the World Bank in development finance. The majority report advocates turning most development finance over completely to private capital markets, except in the poorest countries, and restricting IMF lending to countries that pre-qualify according to strict free-market criteria.

As opposed to the idea of drastically reducing the role of IMF, it is possible to create a global crisis lending mechanism by strengthening IMF as a quasi-lender of last resort and at the same time complementing it with the liquidity support of the G-7 countries. This is the second approach.

In the current international context, it is not clear whether IMF, or IMF and the World Bank combined together, could even assume the role of a quasi-lender of last resort. The experiences with managing the Mexican and Asian crises in fact show that IMF simply does not have enough resources to lend in sufficient volume to end a financial panic, let alone prevent it, without brining in the liquidity support of the G-7 countries. In view of the critical role played by some of these countries in managing the crises in Mexico and the Republic of Korea, IMF together with the G-7 countries could develop an institutional lending arrangement that adheres to the Bagehot rules in crisis lending and substitutes for the role of an ILLR. To be viable, such an arrangement would require (i) a substantial increase in the amount of resources to be deployable at short notice by the Fund, and (ii) institutionalization of a second line of defence primarily supported by the G-7 countries. This is the second possible approach for the reform of the role of the Bretton Woods institutions as an ILLR.

Major steps have been taken in recent years to increase the amount of resources EMEs and other developing countries (DCs) could draw from IMF for their provision of liquidity. Notwithstanding these efforts, which have led to a series of quota increases, the size of IMF financial resources today, as a proportion of the total GDP of its member countries, is only one third of what it was at its inception in 1945.

Another problem concerning IMF facilities is that they cannot be disbursed in a speedy manner to countries suffering from a liquidity shortage. Realizing this limitation, IMF and the World Bank have introduced new facilities intended to increase the amount of resources to be deployed at short notice; these include: the Emergency Financing Mechanism, introduced after the Mexican crisis; Supplemental Reserve Facility (SRF), established in 1997; the Contingent Credit Lines (CCL), introduced in April 1999 by IMF; and the supply of guarantees by the World Bank. However, serious questions still remain as to whether these facilities could be activated in time to guard against a speculative attack.

While IMF together with the second line of defence supported by the G-7 could be a viable arrangement, it may not be readily acceptable to many EMEs and DCs, as it may justify a system of global financial governance controlled by the G-7 countries.

A third approach to reforming IMF as a quasi-lender of last resort emphasizes the need for create regionally based monetary funds to complement the role of IMF (Rose, 1998, Bergsten, 2000b). As will be shown in section VI, the idea of establishing a regional monetary fund in Asia has been strongly opposed by both IMF and the United States treasury on the ground that regional funds could weaken the role of IMF and also aggravate the moral hazard problem.

The fourth view is directed to a limited reform and a larger global role for both IMF and the World Bank. A minority report of the Meltzer Commission, written by C. Fred Bergsten and signed by several Democrats, calls for more limited reform and a larger global role for both institutions. At the recent meetings of the IMF International Monetary and Financial Committee (IMFC) and of the Finance Ministers and Central Bank Governors of the G-7 countries, virtually all of the radical proposals of the Meltzer Commission majority were rejected. They reaffirmed the central role of IMF as a quasi-lender of last resort, acknowledging the potential risk of moral hazard but placing it in a decidedly secondary position.

While in broad agreement on the role of IMF, the G-7 Finance Ministers, who convened on 8 July 2000 in Fukuoka (Japan), recommended two pricing changes in the management of IMF facilities, one of which is to increase the interest charges on all non-concessional facilities, with the rates set on a graduated basis, depending on the duration of the outstanding obligation. The new pricing structure is intended to establish more consistent incentives across facilities, encourage access to private capital, deter inappropriate large-scale access to and discourage prolonged use of IMF resources (Group of Seven, 2000).[5]

A second element of the pricing change of IMF facilities involves reducing the rate of charge and the commitment fee on CCL resources. The CCL was established in order to protect innocent victims from the perils of speculative contagion. These "good guys" would have pre-qualified for CCL access on the basis of well-defined and transparent standards of sound economic and financial policies. By making the CCL easier and more attractive to use, any currency contagion would quickly come face-to-face with a large liquidity backstop. However, there still remains the real issue of the mechanism to select a few "good guys" from among the many EMEs.[6]

B. *Conditionalities versus pre-qualification*

IMF's clear mission is to promote the financial stability and macroeconomic prosperity of its member countries. In dealing with the recent financial crises, however, IMF has included in its conditionality a large number of reforms in many sectors, including the corporate and public ones and the labour market. In the aftermath of the East Asian crisis, the IMF structural policy conditionality has become the target of intense criticism. In a recent paper, Goldstein (2000) describes a number of criticisms levelled against the IMF conditionality. One concern is that the IMF structural policy conditionality is often viewed by DCs as so costly and intrusive as to discourage seeking Fund assistance during crises. A second criticism is that in a crisis structural reforms will serve to frighten private investors about the seriousness of the problem, which will make it more difficult to restore market confidence. A third is that the Fund's conditionality is biased against DCs. The Fund often asks DCs for structural reforms that it would not ask of developed countries. The above three concerns are well worth noting, but they are secondary and do not address the fundamental problems of the IMF conditionality. One such problem is that when IMF strays from its core competence and expertise in macroeconomic and economic policies into longer-term structural reforms, the Fund may not be able to manage efficiently financial crises.[7]

Feldstein (1998) was the first to criticize IMF for moving beyond its traditional macroeconomic adjustment role by including in its programme a number of structural elements. However, Fischer (1999) in his reply to Feldstein (1998) asserts that the basic approach of IMF to these crises has been far better than if the structural elements had been ignored or the Fund had not been involved. Eichengreen (2000a) also supports the Fund's view that IMF cannot realistically be legislated out of the structural-reform business and, if there is one lesson to be learned from the Asian crisis, it is that structural weaknesses in prudential regulation, bankruptcy and insolvency procedures, and corporate governance can greatly aggravate macroeconomic instabilities. The Fund may have to continue to address these matters, but if it does, it should be more sensitive to the social, cultural and historical circumstances of its member countries.

The Meltzer Commission, on the other hand, was extremely critical of the existing approach to the Fund's conditionality. The majority on the Meltzer Commission concluded that "detailed Fund conditionality has burdened IMF programmes in recent years and made such programmes unwieldy, highly conflicting, time consuming to negotiate, and often ineffectual". It recommended permitting the Fund to lend only to those countries that pre-qualify for assistance by building impeccably strong banking systems. However, rigid rules for IMF lending are patently unrealistic. Lending only to the countries pre-qualifying for assistance would mean that the international community would be indifferent

to the fate of countries that do not meet the prequalification requirements, or to the instability that might be generated by systemic risks in the global financial markets. For these reasons, the Fund's conditionality cannot easily be replaced by the prequalifications proposed by the Meltzer Commission. However, conditionalities attached to the Fund's programmes should not go beyond its core competence to help crisis-affected countries gain renewed access to international capital markets. At the same time, they should be more carefully tailored to the very different economic conditions of EMEs and provide sufficient liquidity with promptitude and appropriate policy advice.

As far as financial and corporate restructuring is concerned, reform suggestions could be more effective if they were designed on a consultative basis, because structural reforms are long-term development issues that cannot be achieved in a short span of time.

The second critical problem of the IMF conditionality is that multiplication of reform measures and the reliance on structural benchmarks and programme reviews have made it difficult for Fund borrowers to comply with the conditionality. They have also increased the uncertainty faced by borrowers in a crisis situation. In East Asian crisis-stricken countries receiving IMF assistance, short-term policy goals were not necessarily consistent with medium-term structural reform objectives. Restructuring and reform would be imperative not only to minimizing the likelihood of an occurrence of the crisis but also to building a strong and sound foundation for the recovery of sustainable growth. However, a wide array of reform packages would entail institutional reforms, and adaptation would take time. Structural reform businesses are medium- or long-run development issues that cannot be easily achieved in a short span of time. If pursued aggressively without due consideration of implementation constraints, structural reforms could delay economic recovery, or end up being a perfunctory gesture (Park, 2000).

C. Governance of IMF

The G-7 Finance Ministers acknowledged that for IMF to maintain its legitimacy, credibility and effectiveness as a global institution in the international financial system, it is essential that IMF's decision-making structure and operation remain accountable. This announcement may be seen as a welcome sign of progress and shows that IMF is now examining the formula for calculating country quotas, which should reflect changes in the world economy.

The structure of IMF is similar to that of a credit union. Thus, IMF should be a universal institution working in partnership with all its members, based on their shared interests. However, unlike a typical credit union, there is a clear demarcation between net depositors (lenders) and net borrowers. Industrial countries constitute the majority of lenders, whereas EMEs and DCs make up practically all IMF borrowers.[8] A few rich industrial countries control the decision-making process as well as the operations of Fund. Given this dominance, one could legitimately raise the concern that IMF may be "too responsive to its principal shareholders, which are high income, international creditor countries whose interests do not necessarily coincide with those of the global society as a whole" (de Gregorio et al., 1999).

In order to redress the imbalance between industrial countries and EMEs in managing IMF, EMEs and DCs should be given the opportunity and be prepared to contribute more resources for the operation of the Fund. Commensurate with their enlarged contributions, EMEs and DCs should be accorded greater representation both on the board of directors and in the Fund's management. Many EMEs are more willing and able to share the burden of financing various IMF credit facilities than ever before. This issue of representation will become more contentious in the future, if IMF is given a central role in the surveillance and enforcement of various standards.

One should, of course, recognize that IMF is an international institution providing for the public good by contributing to international financial stability. Crisis management and prevention do have externalities, and are not only the responsibility of EMEs and DCs but also of the advanced countries. Looking into the future, IMF will mostly be lending to EMEs and DCs in emergencies, and will serve as their crisis manager (Fischer, 1999). IMF will seldom lend to the G-7 countries, even when in crisis. It is only natural and logical for EMEs and DCs to have a stronger voice in managing the organization that is primarily serving as their crisis lender-manager.

Industrial countries are likely to object to the idea of giving EMEs and DCs a larger representation in running IMF. They may argue that without

the dominant participation of the industrial countries, IMF may suffer from leadership problems, deterioration in the quality of staff output, and laxity in the enforcement of standards and loan conditions. If the IMF decision-making process is not politically neutral – and for this reason the EMEs and DCs cannot expect more active participation in the IMF decision-making process – then the G-7 and IMF should consider amending the IMF Articles of Agreement to strengthen the independence of the Executive Board and give the Fund financial independence (de Gregorio et al., 1999).

The rule requiring an 85 per cent super majority for important changes in IMF policy should also be amended. In an age when European and Asian governments complain that the Fund too often allows itself to be used as an instrument of US foreign policy, giving the United States effective veto power undermines the legitimacy of the institution worldwide (Eichengreen, 2000a). Reform of the procedure for appointing the Managing Director is imperative, so that there may be a more open process and candidates considered on their merits. The Executive Board should be more independent, for essentially the same reasons that it is desirable for the board of a national central bank to be independent of the government.

III. International standards and codes

Recent financial crises have underscored the idea that domestic financial institutions should be supervised and adequately regulated, as structural deficiencies – such as laxity in risk management, poor governance, inadequate loan classification and loose loan-loss provisioning – could invite crises and serious contagion. As a basic national financial infrastructure, a growing number of proponents suggest establishing a set of international standards and encouraging countries to adopt them. Harmonization of standards is also expected to help to achieve domestic financial stability (Eichengreen, 1999a).

The development and adoption of common standards is likely to reduce transaction costs in the process of financial integration, and therefore to foster international trade and investment, as well as to increase transparency and reduce moral hazard. Minimum standards are needed to reduce uncertainty concerning the substance of law in different jurisdictions (Pistor, 2000).

While the establishment and enforcement of international standards is an important step towards building a legal architecture for global markets, harmonization has met serious challenges on theoretical as well as political grounds. This section discusses some of these challenges.

A. *Standardization versus regulatory competition*

In a recent paper, Pistor (2000) argues that the existence of a fairly well developed, well functioning domestic legal infrastructure is a precondition for the success of the reforms related to standardization. When, as in most DCs, this infrastructure does not exist, reforms in accounting standards, securities legislation, insurance legislation and corporate governance in an EME could become artificial and superficial. Harmonization of standards and codes is often believed to accelerate the process of legal convergence, which is in turn expected to reduce transaction costs for transnational investors and improve the quality of legal institutions in the host countries. In contrast to this conventional view, Pistor argues that standardization could impede the development of effective legal systems in EMEs for a number of reasons.

Standardized rules and codes can be fitted into domestic legal systems and enforced only if they are compatible with other bodies of law that already exist in the standard receiving legal system. In the absence of complementarity between the new rules and pre-existing legal institutions, standardization may distort rather than improve the domestic legal environment. This is because, given the differences in different legal cultures, the standardization process may make it necessary to develop synthetic concepts to bridge the differences or agree to the lowest common denominator. Neither result is satisfactory for domestic law makers and economic agents, as harmonization will result in sub-optimal rules and prevent flexible adaptation to better rules and to changing circumstances.

Ultimately, the success of the proposed standards and codes will depend on the existence of local constituencies with a strong interest in and understanding of new rules. Success will also require domestic agents willing to comply with the new rules. Without voluntary compliance, enforcing new standards will not be effective. For these reasons, Pistor (2000) argues that regulatory competition is prefer-

able to harmonization, because the former could produce laws whose relevance would be understood domestically, and would also teach regulators that in the long run they would be better off by protecting investors and developing an effective legal system.

B. Too many one-size-fits-all standards

From the perspectives of EMEs and developing economies, there already exist too many standards and codes to be observed. The Financial Stability Forum (FSF) has now highlighted 12 key codes and standards that are crucial, and identified an additional 64 standards relevant to sound financial systems. Of these, 12 deserve priority implementation and another 43 standards are complementary to the key codes (FSF, 2000).[9] All countries cannot be expected to meet the same standards, since they are not at the same level of development. In particular, the one-size-fits-all approach is likely to ignore the institutional constraints of EMEs and DCs.[10] If enforcement of common standards does not permit a degree of variance and flexibility at the individual country level, standardization efforts could result in ill-judged or unhelpful harmonization, and hence impose enormous adjustment costs on EMEs and DCs (Rodrik, 1999). With regard to the IFI conditionality, some of the standards could act as the wedge whereby a broader set of policy and institutional preferences – in favour of an open capital account, deregulated labour markets, arms-length finance, and Anglo-Saxon-style corporate governance – would be imparted among the recipient countries (Rodrik, 2000).

For the poorest DCs, the budgetary cost of implementing the myriad codes and standards could be enormous.[11] Data collection and processing, as well as strengthening the regulatory and supervisory standards, would require technical assistance, equipment, training and computerization. Without their funding by external grants, the cash-strapped DCs would have little choice but to squeeze the budget for the most socially vulnerable groups (Soludo and Rao, 1999). Indeed, the implementation costs of building the necessary legal and institutional infrastructure where those standards and codes could work out effectively would be a formidable burden to taxpayers in EMEs and DCs. In realization of these difficulties, the G-7 Finance Ministers agreed to work together with the IFIs, FSF and international regulatory and supervisory bodies to provide technical assistance and training to EMEs and DCs.

In order to reduce adjustment costs to manageable proportions, transitional arrangements may have to be made for EMEs and DCs to prepare for the implementation of international standards, as in trade negotiations. For example, the Trade-Related Intellectual Property Rights (TRIP) agreement[12] – which is the most comprehensive set of international standards on intellectual property rights (IPRs) – gives different countries different transition periods, in addition to a one-year transition period after the entry into force of the WTO agreement. Developing countries and economies in transition are entitled to an additional four-year period, except for obligations pertaining to national and MFN treatment. But DCs are also entitled to an additional five-year period for product patents in fields of technology that are not protected at the time the agreement is applied. The least-developed countries are entitled to a 10-year period from the date of application of the TRIP provisions – that is, 11 years after entry into force of the WTO agreement – to enable them to comply with the obligations of the agreement. They are also allowed to request an extension of this transition period.

C. Legitimacy

In most of the forums or agencies drawing up standards, the EMEs and DCs are not included or, at best, are under-represented. Despite the lack of expertise among EMEs and DCs, if the G-7 countries really want to introduce a set of international standards, they should follow a more legitimate process of negotiation (e.g. like the Uruguay Round, 1986–1993). This may be particularly necessary if the interest of the advanced countries, on the one hand, and that of EMEs and DCs, on the other, diverge. The G-7 countries could take the initiative in starting a negotiation process among IMF members towards introducing international standards rather than tacitly consenting to a set of ready-made ones, because standard-setting should not be biased towards a particular model of an industrial country. Even major industrial countries cannot agree on specific standards for banking, corporate governance, disclosure and accounting, because understandably they insist on standards serving their own interests.

Such negotiations may not take many years, as the Uruguay Round did, but they would have to go through an arduous and protracted process of settling the differences between the industrial countries and the EMEs and DCs. Such a negotiation process would be costly, but unless IMF member countries

come to an agreement on internationally agreed common standards, one cannot ensure the compliance of EME and DC firms, banks and governments. In order to reduce the number of participants and make the negotiations more manageable, one possibility is to limit participation in the initial stages to those EMEs and DCs with relatively resilient financial regimes. Not truly multilateral but sensibly plurilateral agreements on international standards would invite more participation from EMEs and DCs. Without such a process, it is quite possible that there would emerge only two sets of competing standards, supported by the United States and the European Union respectively. Neither set of standards would, in that case, reflect the needs or wishes of the EMEs and DCs.

D. Sovereignty and global governance

The establishment and enforcement of common standards could also raise the question of sovereignty in managing financial systems and conducting monetary and fiscal policy in EMEs. Even if the G-7, EMEs and DCs could come to an agreement on a set of international standards, there still remains the question of enforcement. As noted earlier, enforcement will typically be difficult unless some stringent and observable parameters are devised and subjected to international surveillance. A relevant example is provided by minimum bank capital requirements, along the lines set out by the Basel Committee in 1988. Such requirements have been introduced by most DCs, but only nominally enforced.[13] For example, before the crisis all the East Asian banks generally met the 8 per cent BIS ratio.[14] Awareness of these problems has generated an intense debate on how to provide an effective surveillance mechanism. A concerted effort in this direction is the joint IMF-World Bank's Financial System Stability Assessments Programme, aimed at evaluating the health and vulnerabilities of member countries' financial systems.[15] The programme also includes assessment of compliance with the BCBS Core Principles.

The Financial Stability Forum has recently elicited three key factors for fostering the implementation of standards (FSF, 2000). The first is the promotion of country ownership of implementing standards to make it rather sovereign while the international community can only encourage it through other channels. The second is the provision of incentives for the observance of standards; market incentives (e.g. different credit ratings, borrowing spreads, asset allocations, etc.) and official incentives (e.g. financial and technical assistance, market access, etc.) should be considered. The third is the mobilization of scarce (human and financial) resources by enhancing international cooperation.[16]

Regarding implementation and enforcement, opinions are divided on whether the process should be voluntary or compulsory. For example, IMF is debating on whether implementation of certain standards should be part of the criteria for access to the CCL. The G-7 Finance Ministers consider whether a foreign bank's home country is adhering to international standards when evaluating whether the foreign bank should be allowed entry to their market. The G-7 recommended the IOSCO and the Basel-sponsored working groups to make membership in their bodies contingent on progress in the implementation of standards. That is, the dominant view appears to support compulsory compliance.

If IMF and other IFIs are given authority to enforce compliance with the common standards, the surveillance mechanism implies that those countries which fail to observe the agreed standards can be penalized in terms of incentives. However, many EMEs and DCs will find it difficult to accept these incentive-based proposals, because such schemes raise the issue of fairness and national sovereignty. If the incentive system is determined and administered by both IFIs and the regulatory authorities of industrial countries, in reality this means that industrial countries can dictate the access of EMEs and DCs to world capital markets and IMF credit facilities. Also, one cannot discount the possibility of industrial countries using the incentive scheme to pursue their own interests. Any direct enforcement by IFIs will therefore impair sovereignty and diminish legitimacy.[17]

Universal adoption of common standards on accounting, disclosure and banking, for example, is likely to promote deeper financial integration at the global level. From the perspectives of EMEs, deeper integration could mean considerable erosion in their policy autonomy, and hence the necessity to coordinate their macroeconomic and other policies with those of developed countries. Although the advocates of common standards claim that the universal acceptance of common standards would help to stabilize international financial market and reduce the frequency of financial crises, there is no evidence to support such an argument. On the contrary, as Pistor (2000) notes, harmonization may produce perverse results.

An important conclusion to be drawn from the preceding analysis is that a country or group of developing countries asking other countries to accept and authorize IFIs to enforce compliance with common standards and codes is in fact attempting to provide quasi-governance of international finance, since IFIs are developing a de facto global legal architecture for financial markets through legal harmonization. Therefore, EMEs may justifiably ask whether a group of countries promoting universal standards is also prepared to produce public goods such as the services of a lender of last resort. This question arises because there is no guarantee that those EMEs which faithfully comply with the common standards will become less vulnerable to financial crises. If a financial crisis breaks out and spreads to other countries, those innocent victims suffering from crisis contagion may expect the group of countries providing quasi-governance to assist them with unconditional liquidity support. This is the reason why harmonization, to be acceptable, should also be accompanied by the provision of a number of public goods, such as the services of an ILLR and regulatory authorities.

IV. Bailing in the private sector

From the creditor and investor side, experience over the past few years has reminded us that they tend to underestimate risks as they seek for higher yields. In other words, international lenders have as much responsibility for the crisis as emerging market borrowers; for every questionable borrower there is a questionable lender.

Efforts to achieve greater private-sector burden sharing are motivated by the perception that official assistance to crisis countries creates a source of moral hazard on the part of private-sector creditors. If private-sector creditors are bailed out through official assistance without bearing any cost of the crisis, their habitual poor lending and reckless investment decisions will not be rectified. In addition, because the Fund is almost always reimbursed, many critics point out that official assistance merely allows private creditors to be repaid at the expense of the taxpayers of the crisis country (Eichengreen, 2000a). On both efficiency and equity grounds, bailing in the private sector – private-sector involvement (PSI) – has become a core part of architectural reform.

Historically, however, this issue is not new. The legal doctrine of sovereign immunity would appear to exempt the property of foreign governments from the jurisdiction of domestic courts. Over the years, the practical application of the doctrine has increasingly given creditors leverage to retaliate against defaulting sovereigns. Creditors' legal rights of direct punishment could make it difficult for a country in default to gain access to new international loans. Restricted sovereign immunity certainly has merit in the sense that it would address debtors' moral hazard (Dooley, 2000; Friedman, 2000). Nevertheless, the Latin American debt crisis of the 1980s ended up with the Brady Plan; it allowed debt forgiveness of about 35 per cent for bank claims on much of the region (Cline, 1995). After the Mexican crisis, the 1996 G-10 report – the so-called "Rey Report" – also recommended various proposals for bailing in the private sector. Furthermore, this issue resurfaced after the Asian financial crisis and other subsequent emerging market crises.

However, since the keen conflict of interests between creditors and debtors is pitting them against each other, very conspicuous divergences persist in this area. The most unsettled aspect of the PSI issue concerns the question of whether the nature of PSI should be based on predetermined rules or should be handled on a case-by-case basis. Some want those rules to be very hard and tight, while others want to leave a degree of flexibility. The June 1999 the G-7 report proposed a compromise approach for the PSI framework – a "case-by-case approach with principles and tools". G-7 consensus contends that since the cases for private-sector involvement will be sufficiently different, no general set of principles will be adequate to cover every case; there will have to be case-by-case variations.

Although G-7 allegation contains some truth, constructive ambiguity could become a source of confusion and arbitrary decision. Bergsten (2000a), among the critics, contends that clear rules, tailored to different types of crises, need to be developed for PSI in order to replace the ad hoc approach now being pursued to bail in the private creditors. Under the broadly defined PSI framework laid out in the 1999 Cologne Summit, the G-7 put forward "operational guidelines" for PSI at IMF/WB meeting in April 2000. They distinguished two different cases. First, private-sector involvement could be ensured primarily through reliance on IMF's traditional catalytic role: if the member's financing requirements are modest; or if the member has good prospects of rapidly regaining market access on appropriate terms, even in cases in which the financing requirements are at large. Second, more concerted forms of PSI

might be required: if the financing requirement is great and the member has poor prospects of regaining market access in the near future; or if the member has an unsustainable medium term debt burden.

These operational guidelines could be valid. As noted in Eichengreen (2000b), however, the cases of Ecuador, Pakistan, Romania and Ukraine have been disappointing. IMF's efforts to condition official assistance on PSI – specifically, on the willingness of investors to roll over maturing debts, inject new money, or restructure existing debts – have been less than successful. Requiring countries on the verge of a sudden standstill – being denied access to international capital markets – to first raise new money as a precondition for IMF assistance is certainly unrealistic, given the palpable reluctance of investors who have lost confidence in a country in crisis. In this regard, Eichengreen (2000b) contends that *ex post* measures would complicate the resolution process and aggravate economic conditions, since an effective bargaining table between international creditors and the crisis country would not be conceivable in most cases.

Despite the disappointing performance of the recent IMF experiments with small poor crisis countries, the official sector will need to insist on appropriate debt restructuring with private creditors as a condition for IMF financial assistance. To make operational guidelines more workable, IMF could play a role as a crisis lender and manager. Although IMF avoids micromanaging the terms of debt restructuring, IMF could provide bridging loans while the negotiations are in progress, provided it is convinced that the crisis country is negotiating with its creditors in good faith. Or if voluntary negotiations are problematic, IMF could endeavor to bring the involved players to the negotiation table. However, as Eichengreen (1999b) points out, for various reasons this moral suasion would hardly be successful. Then, what is required for a workable voluntary approach?

First, IMF's analytical capacity would be a most important ingredient for diagnosing the nature of the crisis. Once the creditors' grab race has started, if IMF judges that the nature of the crisis is closer to illiquidity rather than insolvency, IMF may be expected to play a role as mediator in arranging an effective bargaining table. This proactive role of IMF would relieve the market participants' panicking behaviours. However, it would be technically difficult to distinguish an illiquidity crisis versus insolvency crisis when a crisis abruptly erupts. It would take time for creditors and the debtor country to reach a correct diagnosis on the nature of the crisis.

When the government of the Republic of Korea decided to turn to IMF, it expected the Fund's rescue package, agreed on 3 December 1997, to suffice to stop capital outflows. On the contrary, the foreign creditors accelerated their retrieval of short-term credits. As the liquidity situation further worsened, the Korean government, in close consultation with the G-7 countries, urgently initiated negotiations with foreign creditors to reach a temporary standstill arrangement. After a series of intensive negotiations, the government and 13 representatives of the foreign creditor banks reached on 28 January 1998 a consensus on maturity extension principles. As the case of the Republic of Korea vividly shows, foreign creditor banks were not assured of its underlying creditworthiness, even with IMF official assistance. IMF's catalytic role in bringing the private creditors back to normal would be supported only when IMF could successfully assure the creditors of the member's good prospects for regaining market access in the near future, even in cases where financing requirements were large.

Second, more reliable workout-type solutions could be required when the nature of the crisis is rather closer to insolvency, as in the cases of Ecuador, Pakistan and Ukraine. As almost unanimously proposed by the international community, it would be worthwhile to amend bond contracts to include sharing clauses, majority voting clauses, and minimum legal threshold clauses. If those provisions were incorporated into international sovereign bond contracts, IMF would not need to immediately provide official assistance to a country in crisis. A fair burden sharing could be voluntarily settled through successful debt restructuring facilitated by those provisions. However, little concrete progress has been made to date.

There are various reasons for this lack of progress. First, on the side of the creditor, this is related to the issue of international standards in the area of sovereign bond contracts. The United States is reluctant to follow the market standard governed by UK law, since the US Trust Indenture Act of 1939 would need to be modified. Historical path dependence hinders a common standard to be universally adopted. Second, on the side of the debtor, American-style international bonds have been the most prevalent bonds issued by EMEs and DCs until recently. Most EMEs and DCs worry that such bonds might raise the cost of borrowing. Although recent

empirical work by Eichengreen and Mody (2000) suggest that such anxiety does not seem be well-founded,[18] countries with poorer credit ratings would face more difficulties in financing development projects when collective action clauses (CACs) are incorporated into their sovereign bond contracts. Third, the use of debt exchange offers obviates the need for CACs, as in the case of Pakistan, where restructured bonds all included CACs. Indeed, as shown in all recent cases of bond restructuring (Ecuador, Pakistan, the Russian Federation and Ukraine), debt exchanges are the norm, and CACs are not needed or used when available (Roubini, 2000).

V. Exchange rate regimes and capital controls

In the wake of the Asian currency crisis, a number of relatively fixed-rate countries were forced to abandon their pegs. Many economists and policy makers argued that these regional currencies were overvalued on the eve of the crisis, although the lack of an operational definition of overvaluation is still troubling. However, pre-crisis Asia was not on a rigid dollar peg, as most countries in fact adjusted their rates from time to time. Statistically, there is no correlation between pre-crisis rigidity, or overvaluation of the domestic currency, and the severity of subsequent currency attacks (Ohno, 1999).

The soft-peg exchange rates of East Asian currencies have been blamed for the generation of crises. As a result, the so-called “corner solutions” – greater flexibility or credible institutional assurance, like a currency board system – are gaining wider support. However, the international community should squarely recognize an important source of systemic vulnerability: the G-7 currency gyrations in recent years have far exceeded any conceivable shifts in economic fundamentals. In particular, the sharp swings in the yen-dollar rate contributed greatly to the outbreak of the Asian crisis. Every 10 per cent decline of the yen vis-à-vis the US dollar takes US$ 20 billion off the trade balances of the rest of Asia (Bergsten, 1999). Every time the yen appreciates against the dollar, the economic growth of non-Japanese Asia picks up, as happened between 1986 and 1988, and again between 1991 and 1995. The reverse is also true when economic growth decelerated and the asset-price bubble burst on the back of a weaker yen in 1989/90 and again in 1996/98 (Kwan, 2000). The soft-peg currencies were extremely vulnerable to volatile fluctuations of the yen-dollar rate. The procyclical aspect of capital flows in and out of East Asia is closely related to the instability of the yen-dollar rate.[19]

The international community has encouraged EMEs and DCs to adopt appropriate exchange rate regimes, but it has been voiceless in reducing the systemic risks generated by G-7 currency gyrations. The flexible exchange rates of the G-7 currencies quite often tend to overshoot wildly and generate equally disruptive misalignments.[20] For the G-7 the goal of currency reform can best be pursued by maintaining substantial flexibility but modifying the method by which it is managed. For the past decade, interventions have always come long after large misalignments have set in and severe economic damage has resulted (Bergsten, 1999).

The G-7 and IMF generally agree that no single exchange rate regime is appropriate for all countries or in all circumstances. In any case, stability depends on the exchange rate regime being backed by consistent macroeconomic policies and supported by robust financial systems. As is also well recognized, countries cannot simultaneously maintain an independent monetary policy based on domestic objectives, open capital markets and an exchange rate peg.

As long as EMEs and DCs maintain open capital accounts, only two options – flexible exchange rate regimes or those having very hard pegs (e.g. the adoption of a common currency or of a currency board) – may be suitable in the light of the “impossible trinity” hypothesis.[21] However, the adjustment process of a flexible exchange rate regime with free capital mobility could easily generate a cycle of boom and bust in EMEs and DCs. In many East Asian countries, for instance, foreign portfolio investors have become dominant players in determining the direction of asset price movements, since these countries further opened their capital markets during the crisis period. Suppose that the ongoing recovery in East Asia attracts large capital inflows in the region. These large inflows could rekindle asset price bubbles and speculation. When a currency appreciates as a result of capital inflows, market forces can create expectations that will induce even greater capital inflows, further pushing for greater appreciation in the nominal exchange rate, together with a larger trade deficit.

Furman and Stiglitz (1998) provide a very plausible story by which, given the circumstances of the East Asian economies, a floating exchange rate would have exacerbated the problems. With irrational ex-

pectations, investors may extrapolate the exchange rate appreciation, so that investing in, say, Thailand looks an even better deal, with huge real estate returns plus an appreciating currency. The increase in the exchange rate discourages exports, and thus allows internal macroeconomic balance to be achieved at a lower interest rate than otherwise. But suddenly one day the real estate bubble bursts. In the process, capital flows reverse, and the exchange rate plummets.

This thought experiment put forward by Furman and Stiglitz (1998) makes clear that flexible exchange rate regimes would not necessarily have insulated the East Asian economies against the ravages brought on by a sudden change in expectations in a world with no restrictions on capital flows. As also noted in IMF (2000), large exchange rate fluctuations in small- or medium-sized open economies may have significant economic costs. While it is important for exchange rates to be allowed to adjust in response to market pressures, it may also be appropriate to use domestic monetary policy, or intervention, to limit fluctuations to the extent they affect inflation and inflationary expectation. Thus, IMF acknowledges that EMEs and DCs can manage exchange rate fluctuations through an alternative nominal anchor, such as inflation targeting. However, it is still uncertain whether this nominal anchor could effectively relieve the exchange rate misalignment caused by the constant pressure of capital flows. Sterilized intervention could more effectively forestall the emergence of such misalignments.

A common currency, or currency board regime, could be an alternative exchange rate arrangement to replace a flexible exchange rate regime, while maintaining capital mobility. Most EMEs in East Asia would not find it practical or politically acceptable to move in this direction. A common currency could be considered, in the very long term, as a regional monetary arrangement. Even with political consensus, the huge menu of preconditions for a regional currency bloc will take up a great deal of time.[22]

If the EMEs and DCs are going to stay with flexible exchange rate regimes, they must consider the introduction of capital controls over short-run capital movements to ease the burden of adjustment through exchange rate fluctuations. In this respect, IMF, while advocating the overall liberalization of capital account transactions, points to the need to implement measures to influence the volume and composition of capital flows. Such measures could include taxes on short-term foreign borrowing and prudential limits on offshore borrowing (Council on Foreign Relations, 1999, Furman and Stiglitz, 1998).

While there remain differences of view on the merits of capital controls, the mainstream view is that capital controls cannot substitute for sound macroeconomic policies, although they may provide a breathing space for corrective action. However, the flexible exchange rate regime alone may not be able to reduce massive, especially short-term, capital inflows. Thus, there may be a need for EMEs to manage such inflows, while continuing to strengthen their financial systems. As it is generally agreed that the Chilean scheme on capital controls was successful in lengthening the average maturity of the country's external debt, EMEs and DCs could provide themselves with the power to implement unremunerated reserve requirements (URR) and minimum holding periods (MHP) on capital inflows. This Chilean scheme is widely supported by various economists on prudential grounds.[23]

Despite justifiable reasons for adopting capital controls, the legal controls on capital flows are not always effective because economic agents attempt to evade the controls by over-invoicing imports, under-invoicing exports, and mislabelling the nature of capital flows (Edwards, 1999a, b). With respect to the economic performance of capital controls, Edwards (1999b) disputes that desired goals of capital controls have only been achieved. According to his empirical results, Chile's capital controls did appear to increase the maturity of its foreign debt significantly. However, even in 1996 more than 40 per cent of Chile's debt to banks in the BIS "reporting area" had a *residual maturity* (not *contractual maturity*) of less than one year, and the total volume of aggregate capital flows into Chile during the 1990s did not decline. The controls on capital inflows had no significant effect on Chile's real exchange rate, and only a very small effect on interest rates. Chile's capital controls policy helped to reduce stock market instability, but the controls were unable to isolate Chile from the very large financial shocks stemming from East Asia in 1997–1999.

There is another potential difficulty with the Chilean type of capital controls – the adverse selection problem. Some foreign investors, including commercial and investment banks, do not focus exclusively on speculation for short-term earnings. Indeed, many international lenders often move into emerging markets in search of long-term investment opportunities and establish long-term relationships with local financial institutions. Yet, uniform reserve

requirements on all types of capital inflows penalize not only short-term speculators but also those investors who help to strengthen and stabilize emerging financial markets. If the reserve requirements are prohibitive enough to alter the composition of debt profiles, these desirable investors might avoid EMEs and DCs with capital controls. In this regard, the Chilean scheme cannot be a purely unilateral move taken by an individual EME or DC. Most EMEs and DCs facing volatile capital movements are still very reluctant to adopt this scheme because it might provide unclear or incorrect signals to the international financial markets.

While the Chilean scheme of capital controls is a unilateral approach taken by an individual country, Tobin taxes would be a global approach to discourage short-term speculation in currencies. In other words, Tobin taxes should be universally implemented by all countries simultaneously for the policy to be effective. However, that would make them technically and politically unfeasible.

A large, but undiversified financial system is highly exposed to systemic crises. An economy with an equally deep but more diversified financial sector, where equity and bond markets are also well developed, would be resilient to contagious shocks. Thus, a number of structural policy actions should be geared to strengthen the financial sector. A partial list would include the development of capital markets, effective corporate governance, prudential supervision and regulation, and a cautious policy of financial liberalization. In particular, the development of capital markets is essential to the emergence of long-term debt instruments.

Too often, financial liberalization – both internally and externally – has been synonymous with the accelerated development of short-term instruments. Domestic financial liberalization, with its removal of limits on bank interest rates, credit expansion and required reserves, has often resulted in the fast acceleration of bank credit and conversely of money aggregates. External liberalization, in turn, has prompted a large upswing in short-term interbank funding from more developed to developing economies (Chang and Majnoni, 2000). The lesson that market freedom requires regulatory vigilance has been driven home recently by the experience in East Asia. In the Republic of Korea and Thailand, as in so many other DCs, financial liberalization and capital account opening led to financial crisis precisely because of inadequate prudential regulation and supervision (Furman and Stiglitz, 1998; Rodrik, 2000).

VI. Regional financial arrangements

A. *Arguments against regional financial arrangements*

After the crisis touched off in July 1997, creation of a regional monetary fund in East Asia was proposed by Japan and received a positive response from a number of East Asian countries. The idea, however, was strongly opposed for a number of reasons by the United States, the European countries and, of course, IMF. Eichengreen (1999b) and others dismiss the contention that an East Asian regional fund may have a comparative advantage in diagnosing regional economic problems and prescribing appropriate solutions on the basis that it will increase competition in the market for ideas. A more serious argument is that East Asians are not ready for, or capable of, creating and managing an effective regional monetary fund. According to Eichengreen (1999b), in contrast to Europe, for example, East Asia lacks the tradition of *integrationist* thinking and the web of interlocking agreements that encourage monetary and financial cooperation in Europe.

For over a half century, European countries have worked very hard to develop a wider web of political and diplomatic agreements which encourage them to cooperate on monetary and financial matters. Certainly, such a web does not exist in East Asia. As for East Asia's limited capacity, Eichengreen (1999b) has a point. If the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for finance. However, East Asia may be on the brink of an historical evolution, as Europe was half a century ago (Bergsten, 2000b). Having suffered such a painful and costly financial crisis, the East Asian countries are prepared to set aside their differences and to work together to develop a region-wide self-defence mechanism to the extent it could help to protect themselves from future crises. After three years of crisis management, East Asia has developed a large pool of skilled and experienced people capable of managing regional financial cooperation among the countries in East Asia. Furthermore, the type of arrangements currently being discussed in the region do not necessarily require integrationist thinking or a web of interlocking agreements, as in Europe.

Furthermore, East Asians may not be prepared to negotiate an international treaty which includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly. This

unwillingness would make it difficult for the regional fund to impose politically unpopular policies on the member countries and, hence, may pose a serious problem of moral hazard.

However, moral hazard is not a problem that will beset only regional arrangements. IMF is not immune to this problem, and the task force report of the Council on Foreign Relations (1999) advises "the Fund to adhere consistently to normal lending limits to redress the moral hazard problem". The reasons why East Asian financial arrangements would suffer more from the moral hazard problem than IMF, or any other regional institutions, have not been made clear. As Sakakibara (2000) puts it, if those countries unaffected by the East Asian crisis do not have any political incentive to contribute their own money, they should say so instead of using the moral hazard argument as an excuse for opposing regional arrangements in East Asia.

Another controversial argument against regional financial arrangements is that there may be no need for regional funds and other arrangements in a global economy where much of the trade in goods and services is increasingly conducted in cyber space. The ongoing revolution in information and communications technology will accelerate both globalization and virtualization. What the world economy needs, therefore, is a new system of global governance, which may include a global central bank and global regulatory authorities. As for the financial markets and financial services industries, the scope of governance should be raised to the global level so as to realize scale economies and to accommodate the market forces driving financial globalization. That is, public goods, such as the services of a lender of last resort and regulatory institutions, could be better provided at a global level.

While in theory, the creation of a system of global governance may sound reasonable, in reality it is politically unacceptable and must be dismissed as quixotic (Eichengreen, 1999b). As a second best alternative to a worldwide governance system, the adoption of global standards and codes of conduct on banking, corporate governance, management of monetary and fiscal policies, and many others, has been proposed by EMEs and DCs and also enforced by IMF. Doubts have been raised as to the effectiveness of international standards, and the legitimacy of imposing them on EMEs and DCs has been questioned.

B. *Rationales for regional financial arrangements*

Any argument for regional arrangements must begin by answering the most fundamental question of whether regional groupings, whatever forms they may take, are conducive to, or likely to interfere with multilateral free trade and the orderly globalization of financial markets. Despite many misgivings about the role of regional economic arrangements that have grown in number in recent years, the experiences of the past decade suggest that they have been a complement and supplement to multilateral trade and financial liberalization. That is, they have been building blocs rather than stumbling blocs for a more integrated world economy. There is no evidence suggesting that an East Asian financial arrangement would be oriented towards a withdrawal from the global economy and, hence, would erect barriers to global financial integration.

As Lawrence (1996) points out, the forces driving the current wave of regionalism may differ fundamentally from those driving earlier moves towards regionalization in this century, and the current initiatives represent efforts to facilitate participation by their members in the world economy rather than their withdrawal from it. Developing countries are motivated to join regional groupings as their participation could facilitate implementation of a strategy to liberalize and open their economies. Since most of the East Asian EMEs are pursuing *export cum foreign investment*-led policies, they will gain very little by forming a regional arrangement that is designed to thwart globalization.

There have been several developments that have encouraged the formation of a regional financial arrangement in East Asia. As already pointed out, one development has been the slow progress of the reform of the international financial system. The urgency of reform in the G-7 countries has receded considerably with the rapid recovery of East Asia. The slow progress has been further complicated by the perception that a new architecture, as it is designed, may not be effective in sustaining global financial stability. Nor would it safeguard financial stability in EMEs and DCs. As long as the structural problems on the supply side of capital are not addressed, the East Asian countries will remain as vulnerable to future crises as they were before. Instead of waiting until the G-7 creates a new architecture, whose effectiveness is at best questionable, it would be in the interest of East Asian economies

to work together to create their own system of defence (Park and Wang, 2000). For these reasons, there has been increasing support in East Asia for developing a regional defence mechanism in the form of financial cooperative arrangements. This support has culminated in the Chiang Mai initiative of ASEAN+3 to create currency swap arrangements among 13 countries. The agreement is widely perceived as a major step towards strengthening financial cooperation among the East Asian countries.

Many EMEs and DCs, in particular those which have experienced a financial crisis, are taking measures to build up their foreign currency reserves above the level that has been regarded as adequate in terms of their import requirements. For instance, the Republic of Korea is currently building a level of reserves (US$ 91.43 billion as of the end of August 2000) equivalent to 20 per cent of its GDP, largely because of the increased volume of its capital account transactions. By any measure, this level is excessive, costly, and represents a clear case of resource misallocation. To reduce the amount of reserve holdings, at least some EMEs and DCs could enter into an arrangement for precautionary lines of credit with private financial institutions. They could also rely on IMF as a quasi-lender of last resort, which could provide an additional issuance of SDRs.

There are other schemes for reducing the holdings of foreign currency reserves. For example, a group of countries, not necessarily from the same region, might decide to pool a certain percentage of their reserves to create new credit facilities for themselves. An individual country belonging to the arrangement would not have to hold as large reserves as it otherwise would if it could borrow from the credit facility. The group of 13 East Asian countries (ASEAN+3) has command over a large amount of foreign currency reserves, estimated to be more than US$ 800 billion. Depending on how these reserves are pooled together and managed, a mere 10 per cent of the total amount would be sufficient to provide a first and second line of defence against any speculative attack. If the East Asian countries had been able to cooperate to use part of their reserves to supply short-term liquidity to Thailand, East Asia could have been spared the misery of recession and social dislocation.

There is also the argument that regional financial management could be structured and managed to be complementary to the role of IMF. For example, an East Asian regional fund could provide additional resources to IMF, while joining forces to work on matters related to the prevention and management of financial crises. An East Asian monetary fund could also support the work of IMF by monitoring economic developments in the region and taking part in IMF's global surveillance activities. The East Asian monetary fund could also be designed initially as a regional lender of last resort, while IMF assumes the role of prescribing macroeconomic policies to the member countries of the East Asian monetary fund.

Finally, East Asians must begin to examine the possibilities and desirability of cooperation and coordination in exchange rate policies, creation of a regional currency unit, and eventually an East Asian common currency. An East Asian monetary fund could serve as a forum for such an examination, although these monetary options are not viable at this stage.

C. Challenges and tasks

Three years have passed since the crisis. Asia returned to positive growth in 1999, much faster than had been expected. Some economists would like to call this recovery a tenuous one, hinting that a double dip could be expected unless fundamentally important structural problems are successfully addressed. It is certainly true that we cannot overemphasize the importance of restructuring the economy into one possessing strong economic fundamentals. However, it is also important to prepare for regional financial arrangements that could greatly contribute to the stability of the financial system in the region, unless the architectural deficiencies of the global financial system are satisfactorily rectified.

There has been an emerging consensus in East Asia that East Asians must join forces to establish regional financial arrangements which will help them fend off speculative attacks and, in so doing, stabilize the East Asian financial markets (Park and Wang, 2000; Wang, 2000). However, it is still at an early stage and it is not yet quite clear whether they will be able to successfully negotiate the creation of such arrangements, given the various interests of different countries with respect to regional financial cooperation. Details of the swap arrangement mechanism among the ASEAN+3 countries will have to be worked out, and it is still too early to tell whether ASEAN will be able to design a scheme acceptable not only to ASEAN member states but also to China, Japan and the Republic of Korea.

Now that China is about to join the WTO, Chinese policy makers realize that they may have to liberalize and open their financial markets and financial services industries sooner than expected. They also realize that, as the country with the largest market, China must contribute to, and cooperate with, other countries in order to sustain financial stability in East Asia. However, China will find it very difficult to support any regional arrangements dominated by Japan.

In promoting regional cooperation in East Asia, Japan has a very important role to play as the second largest economy in the world and as a member of the G-7. While Japan and the other East Asian countries cannot, and should not, ignore the wishes of the United States and the European Union, the East Asian countries must decide whether a regional cooperative mechanism would help to restore the dynamism and vitality the region was accustomed to before the crisis. In recent months, Japan has become, once again, more active in advocating the creation of East Asian monetary and financial arrangements, at least informally. In order to attract wider support from other East Asian countries, Japan must tell them what its national interests are and what it is prepared to do to support the establishment of East Asian financial arrangements. Japan must find ways in which it could collaborate with China to resolve regional economic issues.

East Asia has a long way to go before formalizing, and putting into effect, the Chiang Mai initiative and launching other types of cooperative mechanisms. In this regard, Japan should be able to provide leadership in papering over the differences among East Asian countries that are likely to emerge in the negotiation process. In addition, most of all, Japan should be prepared to provide a large share of the resources needed to facilitate regional financial cooperation without dominating the other countries.

Finally, but most importantly, Asian regional initiative should contribute to the stability of the international financial system, as the Asian Development Bank has done for global development finance for over 30 years. A first requirement for achieving cooperative evolution with the rest of the world is for East Asians and outsiders to consult actively and candidly, perhaps with the United States in APEC and with Europe in ASEM (the Asia-Europe Meetings). East Asians need to tell the international community clearly what they are motivated to do, how they are developing a plan of action, and how they believe it will fit in with global systems. Outsiders should also carefully listen to and support them, if possible, in an outward-looking direction (Bergsten, 2000b).

VII. Concluding remarks

Unlike trade in other commodities and services, trade in financial intermediary services is dominated by industrial countries: practically all DCs are net importers, whereas most of the developed countries are net exporters of financial services. At the same time, most of the developing countries are recipients of foreign direct and portfolio investment supplied by advanced economies. The rules and regulations governing trade in financial services and capital account transactions are not well established. IMF, which serves as a quasi-lender of last resort, is often viewed as the handmaiden of the US Treasury. Because of these features of international finance, trade in financial services and assets is often perceived to be one-sided and unfair to DCs.

Since the early 1990s, developed countries led by the United States have exerted pressure on DCs to adopt market-oriented reforms. Although they were not prepared in the absence of an efficient system of financial regulation and supervision, they nevertheless proceeded with financial market opening.

When East Asian countries came under speculative attacks in 1997, some of them were not able to defend themselves, and subsequently had to seek IMF financial assistance and accept its stabilization programmes. These crisis-hit countries were criticized for not having restructured their financial, corporate, and public sectors along the lines suggested by the Washington consensus. This failure was singled out as the main cause of the crisis and, understandably, these crisis-hit economies were subject to heavy doses of structural reforms. The East Asian crisis became contagious, even threatening the stability of major international financial centres. The severity and contagiousness of the crisis underscored the importance of, and renewed interest in, reforming the international financial system. The G-7-led reform, however, has concentrated its efforts on the financial and corporate sectors of developing economies, while by and large ignoring the problems of the supply side of international finance.

With the recovery of East Asia and the receding fear of contagion, the G-7 and IFIs have not been

able to gather as much support as needed for the reform. The ongoing debate on the future direction of the international financial reform in fact suggests that most of the problems that beset the international financial system are likely to remain unchanged. This pessimistic outlook arouses deep concern in developing countries lest they remain vulnerable to future financial crises, even if faithfully carrying out the reforms recommended by IMF and the World Bank. Given this reality, DCs may have to develop a defence mechanism of their own by instituting a system of capital control and adopting an exchange rate system that lies somewhere between the two corner solutions.

Notes

1 Socio-political-legal explanations have dominated the journalistic explanations of the Asian crisis, and perhaps these are most readily understandable to the general public. The calls against "korupsi, kolusi and nopotismi" (KKN) in the midst of political changes and the political movements in East Asia which the crisis has spawned find resonance in this explanation. See Montes and Popov (1999) for further discussion.

2 Two previous crises in the first half of the 1990s did not provide a wake-up call to the international financial community. The ERM crisis of 1992 was primarily a currency crisis, and the industrial countries affected did not experience a financial crisis with a disruptive impact on the real economy. The Mexican crisis of 1994/95 was a full-fledged currency and financial crisis, which signalled the need for an architectural reform of the international financial system. However, the warning was muted as the crisis was managed well, and Mexico made a quick recovery. The East Asian crisis of 1997/98 was the real watershed in this respect; the international financial system was seen to have seriously malfunctioned (Ahluwalia, 2000: 1).

3 Many conservative economists, including Schwartz (1986), Meltzer (1986), and recently Bordo et al. (1996), have challenged Kindleberger's interpretation of the inter-war experience on which he partially bases his argument and also his argument for intrinsic instability in the world financial market without an ILLR. They reject the notion that markets are intrinsically unstable and need to be stabilized by an ILLR. They argue that an ILLR would create a greater problem, rather than a solution.

4 Bagehot (1886) set out his proposals first in *The Economist*, of which he was editor in the middle decades of the nineteenth century.

5 The increase in interest rates has some problems, however. If the SRF penalty rate were to be extended to all non-concessional IMF lending, it could worsen the underlying external position of the borrowing country rather than improve it. When countries finally decide to ask the Fund for emergency loans, they are already in dire circumstances, where the private sources of international financing have almost dried up. For the SRF, the penalty rate is reasonable, but the initial rate of charge on other non-concessional IMF loans that is as high as the SRF rate may not be justifiable, because the decision to go to the Fund is likely to be less price-elastic. Furthermore, whatever the economic merits, the decision to appeal to IMF is politically costly from the viewpoint of the incumbent government, since domestic political opponents may take advantage of the relatively powerless authorities. In most cases, the crisis-affected countries tend to request IMF loans late in their survival game. In this regard, a "conditionality-equivalent" interest rate is high enough to deter, at least, the moral hazard of the incumbent government (Goldstein, 2000). An additional interest premium cum conditionality would be excessive and, in most cases, make it more difficult for borrowers to service their external debts.

6 A selection process for pre-qualified countries has a trade-off between eligibility and extra burden for complying with pre-qualification standards. Moreover, as long as countries applying for the CCL could be interpreted as countries in trouble, not many countries are likely to apply for the CCL, even if the rate of charge and the commitment fee on CCL resources are significantly reduced to below that on the SRF. A post-activation review conducted by IMF could in theory reassure the market that the economic situation for a pre-qualified country requesting activation of the CCL is not directly related to its own policy mistakes but to developments largely beyond its control. However, the question still remains as to whether the market will accept IMF's assessment. For these reasons, eligible applicants for the CCL are likely to be limited, and hence a larger group of innocent victims of speculative contagion would be excluded. IMF should therefore be more cautious in exercising its leverage in admitting eligible candidates by imposing high standards based on its discretionary policy preference. If this were not the case in practice, many potentially eligible EMEs and DCs would find no incentive to pre-qualify.

7 See Council on Foreign Relations (1999) and Park (2000) for a discussion of this problem in the context of the East Asian crisis.

8 The collapse of the par value system in 1973, combined with the growth of international capital markets, made IMF irrelevant as a source of finance for industrial countries. No major industrial country borrowed from IMF after 1976, and its financing role therefore has focused only on DCs, eventually also adding countries in transition (Ahluwalia, 1999).

9 The FSF Compendium of Standards provides one-stop references for 43 economic and financial standards relevant to sound financial systems. These standards are no less important than complementary to the 12 key standards, dealing with particular functional areas. The FSF also refers to additional standards not included in its Compendium; the proposed inclusion of these new standards would raise the total number in the Compendium from the current 43 to 64.

10 Andrew Crockett of the Bank for International Settlements (BIS) appreciates the complexity of implementing standards: "It would be unreasonable to expect an emerging or developing country with a rudimentary financial sector to comply with standards that an advanced financial center has reached only after decades of development. Sensitivity will be required to balance the desire to move quickly to best practice, with the need to recognize practical constraints" (Archarya, 2000).

11 Finger and Schuler (1999) show that the cost of implementing just some tiny aspects of the WTO commitments was significant for many DCs. For example, poor and heavily aid-dependent economies, such as the United Repub-

lic of Tanzania, had to spend some US$ 10 million on modernizing their customs operations; Madagascar spent US$ 11 million to implement sanitary and phytosanitary standards; Algeria spent US$ 112 million on Locust control; and the Russian Federation spent US$ 150 million on improving the disease control component of food-processing facilities. These are only the minimum aspects of the spending required to comply with global standards. Imagine, then, what the total spending would mean for the budgets of poor countries (Soludo and Rao, 1999).

12 Despite WIPO efforts to promote international comity towards IPR protection, countries had achieved little harmony by the mid-1980s. In most cases, WIPO conventions simply required that their signatories follow national treatment, and they lacked minimum standards either for levels of protection or for the coverage of subject matter. The prevailing perception of the industrial countries was also that the WIPO lacked effective powers to discipline signatories for non-compliance. These regulatory and institutional shortcomings prompted a bloc of US-led industrial countries to push for the inclusion of IPRs in multilateral trade negotiations in the early 1980s (Primo Braga, 1996).

13 The capital adequacy standard has made long-term loans more expensive, as banks are required to hold higher capital for these loans. This particular feature may have worsened the situation during the 1990s by stimulating short-term lending to DCs (Rodrik, 1999).

14 In the Republic of Korea banks had no difficulty in satisfying the BIS ratios. At the end of 1997, immediately after the crisis, the BIS ratio on average remained at 8.67 per cent. Moreover, five non-viable banks that were closed in June of 1998 were reported to have BIS ratios of 7.4 to 9.6 per cent at the end of 1997. The reported BIS ratios did not accurately reflect the true state of the financial soundness of banks for various reasons. Inadequate loan loss provisions, partial recognition of stock revaluation losses, and loose loan classification standards and accounting rules led to a discrepancy between official figures and the actual state of the health of banks.

15 IMF is also working, together with the World Bank and others, on producing reports on the observance of standards and codes; there were about 20 countries in the pilot project as of April 2000.

16 The paper also suggests a five-stage strategy for fostering the implementation of standards: (i) identifying and forging international consensus on key standards; (ii) prioritizing standards for implementation, taking account of country circumstances; (iii) designing and installing an action plan to implement standards; (iv) assessing progress in the observance of standards on an ongoing basis; and (v) disseminating information on progress in the observance of standards.

17 Acharya (2000) also asserts that IMF's role should be limited to the dissemination of information; it should not extend to incorporating standards as part of Fund conditionality.

18 Eichengreen and Mody (2000) suggest that spreads on bonds with CACs are lower for good-credit countries and higher for poor-credit countries. In this regard, they conclude that the credit market would function better by differentiating sovereign credit risks and the benefits of reducing debt-restructuring costs outweigh the risk of strategic default.

19 Kwan (2000) and Ueda (1998) assert that one of the key determinants of the boom-bust cycle in East Asia was the sharp appreciation of the yen against the dollar between the mid-1980s and mid-1990s, and its subsequent depreciation. They also find that real investment and speculative financial capital within and in East Asia responded too much to the yen-dollar movements. In a similar vein, Ogawa et al. (1999) propose a regional basket currency arrangement to mitigate an adverse impact of the yen-dollar exchange rate fluctuations on the trade balance.

20 Floating exchange rates have repeatedly led to the emergence of large misalignments. The US dollar went from being chronically overvalued in the mid-1980s to undervalued in early 1995 to again overvalued. The yen has been a large part of the obverse side of that roller-coaster, with the euro's current undervaluation another part of the obverse. For instance, the US dollar rose by 80 per cent against the yen and 40 per cent against the deutsche mark from early 1996 to mid-1998 and late 1997, respectively. See Williamson (1999) for further elaboration on exchange rate misalignments.

21 If capital mobility is perfect, a fixed exchange rate and an independent monetary policy are not consistent with one another. However, if a country is to give up free capital mobility by imposing capital controls, as in the case of China, and more recently Malaysia since September 1998, both a fixed exchange rate regime and an independent monetary policy can be compatible.

22 Bayoumi et al. (1999) assert that the essential preconditions for a durable regional arrangement in ASEAN countries are political rather than economic, and by almost any measure Asia comes less close than Europe to meeting such political criteria. However, if China, Japan and the Republic of Korea, as well as new members of ASEAN, are considered as a potential members of the regional currency bloc, even the economic criteria pointed to by the theory of an optimum currency area (OCA) would not be satisfactorily fulfilled.

23 See Bhagwati (1998), Cooper (1998), Eichengreen (1999a, b), Sachs and Woo (1999), and Stiglitz (2000).

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