KIEP

Discussion Paper 00-02

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

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INTERNATIONAL ECONOMIC POLICY

Final Draft
December, 2000

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

by

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[+] This paper was prepared for the G-24 research project. We would like to thank to Dani Rodrik, Charles Wyplosz and the participants of the G-24 Technical Group Meeting in Geneva, 14-15 September, 2000 for their valuable comments and suggestions. The views expressed here are those of the authors, and do not necessarily reflect those of either the Intergovernmental Group of Twenty-Four on International Monetary Affairs or the UNCTAD secretariat.
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Abstract

When East Asian countries came under speculative attacks in 1997, some of these countries were not able to defend themselves and subsequently had to seek the IMF financial assistance and accept its stabilization programs. 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 centers. The severity and contagiousness of the East Asian crisis underscored the importance of and renewed interests 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 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 that they will remain vulnerable to future financial crises even if they faithfully carry out the kinds of reform recommended by the IMF and the World Bank. Given this reality, developing countries may have to develop a defense 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.

1. Introduction

Following the collapse of the Thai baht on July 2, 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 like 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 have been discussed in a more gentle tone (Krugman, 1998a, 1998b, Fischer, 1998a, 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" crisis. The conditions that precipitated the crisis were by no means unique to the region. They have 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 1990's in Europe, Latin America, and then in East Asia. Furthermore, the continued spillover effects of the East Asian crisis hit Russia and reached Latin America.

The speed of recovery in East Asia since the middle of 1999 has been impressive. More encouraging is the widespread expectation that the ongoing recovery will continue in 2000 and help East Asia to return to its pre-crisis growth trend. 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 economic upswing underway 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

[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.

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 behavior. 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. As was in the Mexican crisis of 1994-95, however, the appetite for radical reform of the international financial system has receded considerably in the wake of global recovery. Signaling 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.

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. 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 will examine various architectural reform issues in 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 2 discusses the reform of international financial institutions. Section 3 examines the current process of setting and

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[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 signaled 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 in 1997-98 was the real watershed in this respect. The international financial system was seen to have seriously malfunctioned (Ahluwalia, 2000, p. 1).

enforcing international standards. Section 4 deals with bailing in the private sector. Section 5 examines the issue of exchange rate regimes and capital controls. Finally, Section 6 considers an alternative safeguarding scheme -- the so called "regional financial arrangements" -- to supplement and complement the existing global financial architecture.

2. Reform of International Financial Institutions (IFIs)

2.1 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. J.M. 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 international activity of commercial banks increased dramatically with the advent of the Eurocurrency markets and the need for recycling the sizeable surpluses of OPEC countries (De Bonis, Giustiniani, Gomel, 1999).

The issue of ILLR may be simplified into two questions. The first is whether there is a need for an international lender of last resort. 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 international lender of last resort had been informally performed by either the central banks or major financial center 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 international

[3] Many conservative economists, including Schwartz (1986), Meltzer (1986), and recently Bordo et al. (1996), have challenged Kindleberger's interpretation of the interwar experience on which he partially bases his argument and also his argument for intrinsic instability in the world financial market without an international lender of last resort. They reject the notion that markets are intrinsically unstable and need to be stabilized by an international lender of last resort. To the contrary, they argue that markets are intrinsically stable, efficient and smoothly operating and that contagion effects are negligible. They argue that an international lender of last resort would create a greater problem, rather than a solution. While Kindleberger's detractors may be theoretically justified, the herding behavior of investors, volatility and contagion continue to be the reality.

lender of last resort. Instead, the IMF was created as a quasi lender of last resort or, as Fischer (1999) puts it, a crisis manager-lender in order to provide financial assistance to its member countries needed to correct their external imbalances. However, the principles governing the IMF's lending activities could hardly be reconciled with the classic *Bagehot* rules of (1) lending freely to solvent borrowers; (2) against good collateral; and (3) at a penalty rate.

The current discussion on the reform of the international financial system effectively rules out the possibility of creating a world central bank. Eichengreen (1999), 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 restructed 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 the 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 the IMF (Bergsten, 2000a), the Republican-led majority of the Congressionally appointed *International Financial Institutions Advisory Commission* (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 the IMF, it is possible to create a global crisis lending mechanism by strengthen the 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 the IMF, or IMF and 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 the IMF simply does not have enough resources to lend in sufficient volume to end a financial panic, let alone preventing it, without brining in the liquidity support of the G-7 countries. In view of the critical role played by some of the G-7 countries in managing the Mexican and Korean crisis, the 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 international lender of last resort. To be viable, such an arrangement would require (i) a substantial increase in the amount of resources to be deployable on short notice at the Fund and (ii) institutionalization of a second line of defense 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 DCs could draw from the IMF for their provision of liquidity. Notwithstanding these efforts, which have led to a series of quota increases, the size of the 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 of the IMF facilities is that they cannot be disbursed in a speedy manner to these countries suffering from a liquidity shortage. Realizing this limitation, the IMF and the World Bank have introduced new facilities intended to increase the amount of resources to be deployed on short notice. They 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 at the IMF, and the supply of guarantees on the part of the World Bank. However, serious questions still remain as to whether these facilities could be activated in time to guard against any speculative attack.

While the IMF plus the second line of defense supported by the G-7 could be a viable arrangement, it may not be readily acceptable to many emerging market economies and developing countries as it may justify a system of global financial governance controlled by the G-7 countries.

A third approach to reforming the IMF as a quasi lender of last resort emphasizes the need of creating regionally based monetary funds to complement the role of the IMF (Rose, 1998, Bergsten, 2000b). As will be shown in section 6, the idea of establishing a regional monetary fund in Asia has been strongly opposed by both the IMF and the U.S. treasury on the ground that regional funds could weaken the role of the IMF and also aggravate the moral hazard problem.

The fourth view is directed to a limited reform and a larger global role for both the IMF and also 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. The recent meetings of the IMF's International Monetary and Financial Committee (IMFC) and of the Finance Ministers and Central Bank Governors of the G-7 countries, also rejected virtually all of the radical proposals of the Meltzer Commission majority. They reaffirmed the central role of the 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 the IMF, the G-7 finance ministers, who convened on July 8, 2000 in Fukuoka, Japan recommended two pricing changes in the management of the IMF facilities. One change 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.[4]

A second element of the pricing change of the 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.[5]

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[4] The increase in the interest rates is not without 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 go to the 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 games. 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.

[5] 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 below that on the SRF. A post-activation review conducted by the 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 developments largely beyond its control. But the question still remains as to whether the market will accept the IMF's assessment. For these reasons, eligible applicants for the CCL are likely to be limited, and hence a larger group of innocent victims to speculative contagion would be excluded. The 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.

2.2 Conditionalities versus Pre-qualification

The IMF's clear mission is to promote financial stability and macroeconomic prosperity of the member countries. In dealing with the recent financial crises, however, the IMF has included in its conditionality a large number of reforms in many sectors including the corporate, and public sectors and the labor market. In the aftermath of the East Asian crisis, the IMF's structural policy conditionality has become the target of intense criticism. In a recent paper, Goldstein (2000) describes a number of criticisms leveled against the IMF conditionality. One concern is that the IMF structural policy conditionality is often viewed by developing countries as so costly and intrusive as to discourage to seek Fund assistance during crisis. A second criticism is that structural reforms in a crisis 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 the biasedness of the Fund's conditionality against developing countries. The Fund often asks for reaching structural reforms from developing countries that it would not ask of developed countries. The above three concerns are well worth noting, but they are secondary and are not addressing the fundamental problems of the IMF conditionality. One such problem is that when the IMF strays from its core competence and expertise of macroeconomic and economic policies into longer-term structural reforms, the Fund may not be able to manage financial crises in an efficient manner.[6]

Feldstein (1998) was the first to criticize the IMF for moving beyond its traditional macroeconomic adjustment role by including in the program a number of structural elements. However, Fischer (1998) in his reply to Martin Feldstein asserts that the basic approach of the IMF to these crises has been far better than if the structural elements had been ignored or the Fund had not been involved. Eichengreen (2000b) also supports the Fund's view that the 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 IMF may have to continue to address these matters, but in case they do, they should do in a 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 Fund conditionality. The majority on the Meltzer Commission concluded

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

that "detailed Fund conditionality has burdened IMF programs in recent years and made such programs unwieldy, highly conflicting, time consuming to negotiate, and often ineffectual." It recommended permitting the Fund to only lend to the 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 that pre-qualify for assistance would mean that the international community would be indifferent to the fate of countries that do not meet the pre-qualification requirements, or to the instability that might be generated by systemic risks in the global financial markets. For these reasons, the Fund's conditionality can not easily be replaced by the pre-qualifications proposed by the Meltzer Commission. However, those conditionalities attached to the Fund's programs should not go beyond its core competence that helps 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 the EMEs and provide sufficient liquidity in a prompt manner with a proper menu of policy advice.

As far as financial and corporate restructuring is concerned, reform suggestions could be more effective if they are designed on a consultative basis because structural reforms are long-term development issues that can not 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 program reviews have made it difficult for Fund borrowers to comply with the conditionality. They have also increased the uncertainty the borrowers have to face in a crisis situation. In the East Asian crisis countries, which received IMF assistance, short-run policy goods were not consisted with the structural reform objectives to delay recover and also to result in the superficial reform of the financial and corporate sectors of these countries (Park, 2000b).

2.3 Governance of the IMF

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

The structure of the IMF is similar to that of a credit union. Thus, the 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 of borrowers from the IMF.[7] A few rich industrial countries control the decision-making process as well as the operations of the IMF. Given this dominance, one could legitimately raise the concern that the 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" (Gregorio, Eichengreen, Ito, and Wyplosz, 1999).

In order to redress the imbalance between industrial countries and EMEs in managing the IMF, EMEs and DCs should be given the opportunity and be prepared to contribute more resources for the operation of the IMF. Commensurate with their enlarged contributions, the EMEs and DCs should be accorded greater representation both on the board of directors and in 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 the IMF is given a central role in the surveillance and enforcement of various standards.

One should, of course, recognize that the IMF is an international institution providing the public good of 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, the IMF will mostly be lending to EMEs and DCs in emergencies, and will serve as their crisis manager (Fischer, 1999). The IMF would seldom lend to the G-7 countries even when they were in a crisis. It is only natural and logical for EMEs and DCs to have a greater 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 the IMF. They may argue that without the dominant participation of the industrial countries, the IMF may suffer from leadership problems, deterioration of the quality of staff output, and laxity in the enforcement of standards and loan conditions. If the decision-making process at the IMF is not politically neutral, and for this reason the EMEs and DCs cannot expect more active participation in the

[7] The collapse of the par value system in 1973, combined with the growth of international capital markets, made the IMF irrelevant as a source of finance for industrial countries. No major industrial country borrowed from the IMF after 1976 and its financing role therefore focused only on developing countries, with countries in transition being added in due course (Ahluwalia, 1999).

IMF decision-making process, then the G-7 and the IMF should consider amending the IMF Articles of Agreement to strengthen the independence of the Executive Board and give the Fund financial independence (Gregorio, Eichengreen, Ito, and Wyplosz, 1999).

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

3. International Standards and Codes

Recent financial crises have underscored the idea that domestic financial institutions should be supervised and regulated adequately since 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 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 foster international trade and investment, as well as to increase transparency and to reduce moral hazard. Minimum standards are needed to reduce uncertainty about 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.

3.1 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 this infrastructure does not exist as in most developing countries, reforms in accounting standards, securities legislation, insurance legislation, and corporate governance in an emerging market economy could become faux 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 improves 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 emerging market economies 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 because 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. The success will also require domestic agents willing to comply with the new rules voluntarily. Without voluntary compliance, enforcing new standards will not be effective. For these reasons, Pistor (2000) argues that regulatory competition is preferable to harmonization, because the former could produce law of which relevance will be understood domestically and also will teach regulators that in the long run they will be better off by protecting investors and developing an effective legal system.

3.2 Too Many One-size-fits-all Standards.

From the perspectives of emerging market economies 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 additional 64 standards relevant for sound financial systems. Of these 12 deserve priority implementation and other 43 standards are complementary to the key codes.[8] 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 the EMEs and DCs.[9] If enforcement of common standards does not permit a degree of variance and flexibility at the individual country level, standardization efforts could result in a harmonization in a shrewd direction and hence incur enormous adjustment costs in the EMEs and DCs (Rodrik, 1999). With regard to IFI conditionality, some of the standards could act as the wedge with which a broader set of policy and institutional preferences -- in favor of an open capital account, deregulated labor markets, arms-length finance, and Anglo-Saxon style corporate governance -- will be imparted on the recipient countries (Rodrik, 2000).

For the poorest DCs, the budgetary cost of implementing the myriad of codes and standards can be enormous.[10] Data collection and processing, as well as strengthening the regulatory and supervisory standards would require technical assistance, equipment, training, and computerization. Without these being funded by external grants, the cash strapped DCs would have little choice but to squeeze the budget for 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 the EMEs and DCs. In realization of these difficulties, the G-7 finance ministers agreed to work together with the IFIs, the FSF, and international regulatory and supervisory bodies to provide technical assistance and training to emerging market and developing countries.

In order to reduce adjustment costs to manageable proportions, transitional arrangements may have to be made for EMEs and DCs to prepare for the

[8] The FSF's Compendium of Standards provides one-stop references for 43 economic and financial standards relevant for sound financial systems. These standards are no less important than complementary to the 12 key standards, dealing with particular functional areas. The FSF also notes additional standards not included in the Compendium. The proposed inclusion of these additional standards will bring the total number of standards in the Compendium to 64 from the current 43.

[9] Andrew Crockett of the 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" (excerpted from Archarya, 2000).

[10] Finger and Schuler (1999) show that the cost of implementing just some tiny aspects of the WTO commitments was significant for many developing countries. For example, poor and heavily aid-dependent economies such as Tanzania had to spend some US$ 10 million on modernizing its customs operation; Madagascar spent US$ 11 million to implement sanitary and phytosanitary standards; Algeria spent US$ 112 million on Locust control; and Russia spent US$ 150 million to improve 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 these poor countries (Soludo and Rao, 1999).

implementation of international standards as in trade negotiations. For example, the Trade-Related Aspects of Intellectual Property Rights (TRIPs) agreement,[11] which are the most comprehensive international standards on IPRs, gives different countries different transitional 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 transition period except for obligations pertaining to national and MFN treatment. But developing countries are also entitled to an additional five-year transitional period for product patents in fields of technology that are not protected by the time they apply the agreement. The least-developed countries are entitled to a ten-year transitional period from the date of the application of the TRIPs provisions -- that is, eleven 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 period.

3.3 Legitimacy

In most of the forums or agencies drawing up standards, the EMEs and DCs are not included or, at best, are underrepresented. Despite the lack of expertise among the 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, *a la* Uruguay Round (1986-93). This may be particularly necessary if the interest of the advanced countries, on the one hand, and that of the EMEs and DCs, on the other, diverge. The G-7 countries could take the initiative in starting a negotiation process among the 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 they understandably insist on standards that will serve their own interests.

The negotiations may not take many years, as the Uruguay Round did, but they will have to go through an arduous and protracted process of settling the differences between

[11] Despite WIPO efforts to promote international comity toward 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 noncompliance. These regulatory and institutional shortcomings prompted a bloc of U.S.-led industrial countries to push for the inclusion of IPRs in multilateral trade negotiations in the early 1980s (Primo Braga, 1996).

the industrial countries and the EMEs and DCs. Such a negotiation process will be costly, but unless the IMF member countries come to an agreement on internationally agreed common standards, one cannot ensure the compliance of the firms, banks, and governments of the EMEs and DCs. 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 the EMEs and DCs. Without such a process, it is quite possible that there would emerge only two sets of competing standards supported by the U.S. and the EU respectively. Neither set of standards would, in that case, reflect the needs or wishes of the EMEs and DCs.

3.4 Sovereignty and Global Governance

The establishment and enforcement of common standards could also raise the question of sovereignty in managing the financial systems and conducting monetary and fiscal policy in emerging market economies. Even if the G-7, the EMEs and DCs could come to an agreement on a set of international standards to be observed, there still remains the question of enforcement. As noted earlier, enforcement will typically be difficult unless some stringent and observable parameters are devised and subject to international surveillance. A relevant example is provided by minimum bank capital requirements, along the lines set out by the Basle Committee in 1988. Such requirements were introduced by most developing countries, but only nominally enforced.[12] For example, all the East Asian banks before the crisis generally satisfied the eight per cent BIS ratio.[13] The 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 Program, aimed at evaluating the health and vulnerabilities of member countries'

[12] 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 made things worse during the 1990s by stimulating short-term lending to developing countries (Rodrik, 1999)

[13] In 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 the BIS ratios of 7.4 per cent to 9.6 per cent as of the end of 1997. The reported BIS ratios did not accurately reflect the true state of banks' financial soundness 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 banks' health.

financial systems.[14] The program also includes the assessment of compliance with the BCBS Core Principles.

The Financial Stability Forum has recently elicited three key factors for fostering the implementation of standards.[15] First is to promote country ownership of implementing standards to make it rather sovereign while the international community can only encourage it through other channels. Second was to provide 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. Third is to mobilize scarce resources (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, the IMF is debating whether implementation of certain standards should be part of the criteria for access to the CCL. Finance ministers from G-7 consider whether a foreign bank' s home country adhere to international standards when evaluating if the foreign bank should be allowed entry to their market. The G-7 also recommended that the IOSCO and the Basle-sponsored working groups make membership in their bodies contingent on progress to implementation of standards. That is, the dominant view appears to support compulsory compliance.

If the 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 the EMEs and DCs to world capital markets and IMF credit facilities. One cannot also discount the possibility that industrial countries could use the incentive scheme to pursue their own interests. Any direct enforcement by IFIs will therefore impair

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[14] The 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.
[15] See FSF (2000b).
[16] The paper also suggests a five-stage strategy for fostering the implementation of standards.

- Identify and forge international consensus on key standards
- Prioritize standards for implementation taking account of country circumstances
- Design and effect an action plan to implement standards
- Assess progress in the observance of standards on an ongoing basis
- Disseminate information on progress in the observance of standards.

sovereignty and will diminish legitimacy.[17]

A 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 emerging market economies, the 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 will help 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 one can draw from the preceding analysis is that the country or a group of countries that develops, asks other countries to accept, and authorizes the IFIs enforce compliance with common standards, and codes in fact attempt to provide quasi governance of international finance since they are developing a de facto global legal architecture for financial markets through legal harmonization. Therefore, the EMEs may justifiably ask whether the group of countries promoting the 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 broke out, and spread to other countries, those innocent victims suffering from crisis contagion may expect that the group of countries providing quasi governance assist them with unconditional liquidity support. This is the reason why harmonization, to be acceptable, should be also accompanied by provision of a number of public goods such as the services of ILLR and regulatory authorities.

4. Bailing in the Private Sector

From the creditor and investor side, the past few years also have 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 for achieving greater private sector burden sharing are motivated by the perception that the official assistance to crisis countries creates a source of moral hazard

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

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 would not be rectified. In addition, because the Fund is almost always paid back, many critics point out that official assistance would merely allow 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 the architectural reform.

Historically, however, this issue is nothing 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 (Obstfeld and Rogoff, 1996). 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.[18] Nevertheless, the Latin American debt crisis of the 1980s ended up with the Brady Plan; it allowed debt forgiveness of about 35 percent for bank claims on much of the region (Cline, 1995). After the Mexican crisis, the 1996 G-10 report, 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 keen conflict of interests between creditors and debtors is pitted against each other, most conspicuous divergences persist in this area. The most unsettled part of the PSI issue would be on 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 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,

[18] Even if foreign lenders have only limited power to directly punish sovereign borrowers, the desire to maintain future access to credit markets provides an incentive to repay (Eaton and Gersovits, 1981). Furthermore, sovereign borrowers in emerging market economies are extremely sensitive to the "sudden stop problem." The sudden stop problem occurs when an adverse shock sets in, access to the international capital market is immediately denied to emerging market economies and consequently the crisis situation rapidly worsens (Calvo and Reinhart, 2000). In the present international capital market environment where borrowers in emerging market economies have made great sacrifices of output rather than default on debt, the issue of borrowers cheating lenders seems much less important than creditors' moral hazard (Miller and Zhang, 2000).

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 has 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 the IMF/WB meeting in April 2000. They distinguish two different cases. First, private sector involvement could be ensured primarily through reliance on the 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 could be required: if the financing requirement is large 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 (2000a), however, the cases of Ecuador, Pakistan, Romania, and Ukraine have been disappointing. The 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 a success. Requiring countries on the verge of sudden stop -- 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 lost confidence in the crisis country. In this regard, Eichengreen (2000a) contends that ex post measures would complicate the resolution process and aggravate the 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, the IMF could play a role as a crisis lender and manager. Although the IMF stays away from micromanaging the terms of debt restructuring, the 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 troubling, the IMF could endeavor to bring the involved players to the negotiation table. As Eichengreen (1999c) points out, however, this moral suasion would be hardly successful for various reasons. Then, what would be required for a workable voluntary approach?

First, the IMF's analytical capacity would be a most important ingredient for diagnosing the nature of the crisis. When creditors' grab race sets in, but if the IMF judges that the nature of the crisis is closer to illiquidity rather than insolvency, the IMF is expected to play a role as mediator for arranging an effective bargaining table. This proactive role of the IMF would relieve the market participants' panicking behaviors. 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 Korean government decided to go to the IMF, it expected that the IMF rescue package agreed on December 3, 1997 would 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 Korean government and 13 representatives of the foreign creditor banks reached a consensus on maturity extension principles on January 28, 1998. As the Korean case vividly shows, foreign creditor banks were not assured of underlying creditworthiness of Korea even with the IMF's official assistance. The IMF's catalytic role to bring the private creditors back to normal would be supported only when the IMF could successfully assure the creditors of the member's good prospects for regaining market access in the near future even in cases in which the financing requirements are 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, the IMF would not need to immediately provide official assistance to the crisis country. 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.

This lack of progress has various reasons. First, from the creditor side, this is also related to international standards issue in the area of sovereign bond contracts. The United States is reluctant to follow the market standard governed by U.K. law, since the

U.S. Trust Indenture Act of 1939 would need to be modified. Historical path dependence hinders a common standard to be universally adopted. Second, from the debtor side, 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 would raise the cost of borrowing. Although recent empirical work by Eichengreen and Mody (2000) suggest that such worry seems not be well grounded,[19] 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, Russia, and Ukraine), debt exchanges are the norm and the CACs are not needed, nor used when available (Roubini, 2000).

5. 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 importantly to the outbreak of the Asian crisis. Every 10 percent decline of the yen vis-à-vis the US dollar takes US$ 20 billion off the

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[19] 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.

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.[20]

The international community has encouraged the 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.[21] 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, the interventions have always come long after large misalignments have set in and severe economic damage has resulted (Bergsten, 1999).

The G-7 and the IMF generally agree that no single exchange rate regime is appropriate for all countries or in all circumstances. In any case, however, it is also noted that 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 the 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 light of the Impossible Trinity Hypothesis.[22] However, the adjustment process of a flexible exchange rate

[20] 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 the mid-1990s, and its subsequent depreciation. They also find that real investment and speculative financial capital within and into East Asia responded too much to the yen-dollar movements. In a similar vein, Ogawa, Ito and Sasaki (1999) propose a regional basket currency arrangement to mitigate an adverse impact of the yen-dollar exchange rate fluctuations on the trade balance.

[21] 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 overvalued again. 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 percent against the yen and 40 percent against the D-Mark from early 1996 to mid-1998 and late 1997, respectively. See Williamson (1999) for further elaboration on exchange rate misalignments.

[22] 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

regime with free capital mobility could easily generate a cycle of boom and bust in the 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. The ongoing recovery in East Asia has been attracting 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 expectations, investors may extrapolate the exchange rate appreciation, so that investing in, say, Thailand looks an even better deal, with the 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 burst. 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 that exchange rates 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, the IMF acknowledges that the EMEs and DCs can manage exchange rate fluctuations through an alternative nominal anchor, such as inflation targeting. However, it is still uncertain that 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.

In addition, a perverse belief is that flexible exchange rates are also expected to wipe out the "off-balance sheet" liabilities of the government and in so doing reduce the

controls as in the case of China and more recently, Malaysia since September 1998, both fixed exchange rate regime and independent monetary policy can be compatible.

frequency of currency crises. In a fixed, or pseudo-fixed, exchange rate regime the liabilities of the public sector would include also the central bank commitment to convert to foreign currency the short-term liabilities of the banking sector (Chang and Velasco 1998, 1999). This obligation would enormously increase the amount of potential short-term foreign borrowing. Any shocks to foreign currency reserves or to money supply could shake market confidence in the stability of the exchange rate and would generate selling pressures on the market, transforming contingent liabilities into effective liabilities. However, the fact that the Asian crisis was not limited to currency but involved insolvent bank runs as well, floating the exchange rates did not prove to be a sufficient measure to revert these economies to stability.[23] This may have been the consequence of large implicit liabilities associated with bank protection.

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. Albeit political consensus, the huge menu of preconditions for a regional currency bloc will take up a great deal of time.[24]

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, the 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 capital

[23] In the 1992 ERM crisis, the run on weaker currencies was not paralleled by a run on the public debt of high indebted countries, such as Italy, or by a run on individual banking system. Contagion was limited to the currency market and once the exchange rate commitment was lifted in England and in Italy, the crisis subsided (Chang and Velasco, 1998).

[24] Bayoumi, Eichengreen and Mauro (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 those political criteria. If China, Japan and Korea as well as new members of ASEAN are considered as a potential members of the regional currency bloc, however, even the economic criteria pointed to by the theory of optimum currency area (OCA) would not be satisfactorily fulfilled.

inflows, especially short-term capital inflows. Thus, there may be a need for EMEs to manage massive, short-term capital inflows, while they should continue to strengthen their financial system.[25] 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, the EMEs and DCs, if necessary, may install the capability of implementing unremunerated reserve requirements (URR) and minimum holding periods (MHP) on capital inflows. This Chilean scheme is widely supported by various economists on prudential grounds.[26]

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 mislabeling the nature of capital flows (Edwards, 1999b). With respect to the economic performance of capital controls, Edwards (1999b) disputes that desired goals of capital controls were only 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 percent 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 moving 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 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, are not focused 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 will help strengthen and

[25] Johnston and Otker-Robe (1999) stress that capital controls can be used as a third line of defense following the first line of defense (banks' own risk management practices) and the second line of defense (regulatory supervision). Capital controls are inferior to voluntary risk management and prudential regulations for two reasons. First, capital controls are not well designed to address the principal types of risks involved in cross-border transactions. Capital controls attempt to eliminate various risks by limiting capital flows in general – rather than addressing the risks directly – thereby removing the potential benefits from such flows. Second, capital controls are prone to evasion, which may increase risks to the financial system.

[26] See Bhagwati (1998), Cooper (1998), Eichengreen (1999a, b, c), Sachs and Woo (1999), and Stiglitz (1999).

stabilize emerging market financial markets. If the reserve requirements are prohibitive enough to alter the composition of debt profiles, these desirable investors might avoid those EMEs and DCs having capital controls. In this regard, this 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 Chilean 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 so that the policy is effective. However, this makes them technically and politically unfeasible.

A large, but not diversified financial system is highly exposed to systemic crises. An economy having an equally deep but more diversified financial sector, where equity and bond markets are also well developed, would be positioned to 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, developing 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 inter-bank funding from more developed to developing economies (Chang and Majnoni, 1999). The lesson that market freedom requires regulatory vigilance has been driven home recently by the experience in East Asia. In South Korea and Thailand, as in so many other developing countries, financial liberalization and capital-account opening led to financial crisis precisely because of inadequate prudential regulation and supervision (Rodrik, 2000).[27]

[27] Furman and Stiglitz (1998) also blamed East Asian governments for undertaking rapid financial and capital account deregulation without addressing the concomitant need to beef up their supervisory capacity. Kane (2000) attributes policy mistakes to the perverse belief that financial deregulation would enable their insolvent banks to grow their way out of trouble.

6. Regional Financial Arrangements

6.1 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 was, however, strongly opposed by the U.S., the European countries and, of course, the IMF for a number of reasons. Eichengreen (1999c) 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 (1999c), 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 (1999c) 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-defense mechanism to the extent it could help 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 East Asia 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 moral hazard problem.

However, moral hazard is not a problem that will beset only regional arrangements. The 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 the 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 is, therefore, a new system of global governance, which may include a global central bank and global regulatory authorities. In the case of the financial markets, and the financial services industries, the scope of governance should be increased to the level of the world 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, 1999c). As a second best alternative to the global governance system, global standards and codes of conduct on banking, corporate governance, management of monetary and fiscal policies, and many others, have been proposed to be adopted by EMEs and DCs and also enforced by the 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.

6.2 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 will be oriented toward a withdrawal from the global economy and, hence, 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 toward regionalization in this century, and the current initiatives represent efforts to facilitate their members' participation 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 the 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 Asia to work together to create their own system of defense. For these reasons, there has been increasing support in East Asia for developing a regional defense 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 thirteen countries. The agreement is widely perceived as a major step toward 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, Korea is currently building a level of reserves (US$ 91.43 billion as of the end of August, 2000) equivalent to 20 percent 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 of the EMEs and DCs could enter into an arrangement for precautionary lines of credit with private financial institutions. They could also rely on the 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, may 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 much reserves as it would otherwise if it can borrow from the credit facility. The group of thirteen 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 *ten* percent of the total amount will be sufficient to provide a first and second line of defense 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 the IMF. For example, an East Asian regional fund could provide additional resources to the 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 the IMF by monitoring economic developments in the region and taking part in the IMF's global surveillance activities. The East Asian monetary fund could also be designed initially as a regional lender of the last resort while the 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.

6.3 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. However, it is still at an early stage and it is not altogether clear at this stage whether they will be able to successfully negotiate the creation of such arrangements, given the different 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 at this stage it is 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 Korea.

Now that China is about to join the WTO, Chinese policymakers 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, they 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 U.S. and the European Union, the East Asian countries must decide whether a regional cooperative mechanism will help 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 they are prepared to do to support the establishment of East Asian financial arrangements. Japan must find ways in which it could collaborate with China on resolving 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 the 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 to the international financial system, as the Asian Development Bank have 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 develop action plan, and how they believe it fits in with global systems. Outsiders also need to listen carefully and support them, if possible, in an outward-looking direction (Bergsten, 2000b).

7. Concluding Remarks

Unlike in other commodities and services, trade in financial intermediary services is dominated by industrial countries: practically all developing countries 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. The IMF, which serves as a quasi lender of last resorts, is often viewed as the handmaiden of the U.S. Treasury. Because of these features of international finance, trade in financial services and assets is often perceived to be one-sided and unfair to developing countries.

Since the early 1990's, developed countries led by the U.S. have exerted pressure on developing countries 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 these countries were not able to defend themselves and subsequently had to seek the IMF financial assistance and accept its stabilization programs. 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 stability of major international financial centers. The severity and contagiousness of the East Asian crisis underscored the importance of and renewed interests in reforming the international financial system. 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

With the recovery of East Asia and receding of the fear of contagion, the G-7 and international financial institutions have not been able to garner as much support as they would need 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 that they will remain vulnerable to future financial crises even if they faithfully carry out the kinds of reform recommended by the IMF and the World Bank. Given this reality, developing countries may have to develop a defense 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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국문요약

1977년 일련의 동아시아 국가들이 국제자본의 투기적 공격과 자금유출로 인하여 심각한 유동성 위기에 직면함에 따라 IMF에 구제금융을 신청하기에 이르렀다. 위기 당사국들은 지난 경제발전기간 동안 누적되어 왔던 금융, 기업, 공공부문의 구조적 문제점들로 인하여 위기가 촉발되었다는 비난으로부터 자유로울 수 없었다. 이러한 논조는 이른바 워싱턴 컨센서스(Washington Consensus)를 대변하는 것이기도 하였다. 따라서 IMF 구조조정 프로그램의 정당성은 더욱 확고하였고, 위기 당사국에 적용된 구조조정 프로그램은 과거 어느 위기시보다 강도가 높은 것이었다. 그러나 동아시아 금융위기는 여타 지역으로 확산되었고, 국제금융 중심지의 안정을 위협하기도 하였다. 이러한 동아시아 금융위기의 심도와 전염성은 국제금융체제 개편의 필요성을 새롭게 각성시키는 계기로 작용하였다. 이에 여러 가지 새로운 제안들이 제시되었다. 그러나 G-7을 중심으로 한 국제금융체제 개편은 개도국의 금융 및 기업부문을 개혁하는 데 주력하였을 뿐, 국제금융시장의 공급측면이 안고 있는 문제점을 개선하는 데는 여전히 미흡하였다고 평가할 수 있다.

1994~95년 멕시코 위기에서와 마찬가지로 국제금융체제의 근본적 개혁은 세계경제가 빠른 회복세를 보임에 따라 그 열기가 식어가고 있다. 향후 국제금융체제 개편의 방향도 위기를 촉발시켰던 국제금융시장의 근원적 문제를 해결하기에는 여전히 역부족일 것으로 보인다. 이와 같은 비관적 전망은 특히 신흥시장국가들이 아무리 철두철미하게 금융 및 기업부문을 개혁한다고 할지라도 여전히 미래의 금융위기에 취약할 수밖에 없을 것이라는 신흥시장국가들의 우려를 대변하는 것이기도 하다. 이러한 현실적 상황인식 하에서 신흥시장국가들의 선택은 자본통제 및 중간환율제도를 도입함으로써 자구적인 방어수단을 마련하고, 아울러 지역적 차원에서 불완전한 기존 국제금융체제를 보완하는 지역금융협력을 강화하는 일일 것이다.

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94320
9 788932 240916
ISBN 89-322-4091-4
89-322-4086-8 (세트)