# Developing and Linking National Financial Infrastructure

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## INTRODUCTION

The Asian financial crisis surprised everyone, including the most sophisticated economists and financial analysts. When the currency problem erupted in Thailand on July 2, 1997, the international community did not foresee its potential contagious impact on the global economic landscape. The Thai currency crisis began spreading like wildfire among Asian countries. On July 11, about a week later, the Philippines and Indonesia widened the trading bands of their currencies (the peso and rupiah, respectively) from 8 percent to 12 percent. On July 14, Malaysia abandoned the defense of the ringgit, although Prime Minister Mahathir Mohamad launched a bitter attack on "rogue speculators."[1] Indonesia finally abolished its managed floating system through the use of a trading band on August 14. In the midst of this economic maelstrom, the Korean won also quickly depreciated, following a futile currency defense that cost Korea most of its foreign reserves. Korea widened its won trading band from 2.25 percent to 10 percent on November 19, and finally abolished its band and allowed the won to float on December 16.

Many academic researchers and pundits have argued that these domino effects among the Asian currencies were mainly attributable to regional structural weaknesses. Blame has been heaped on "the Asian way." The recriminations against the waste created by government-controlled corporations in Latin America in the 1980s have given way to accusations about the "incestuous" relationship in Asia between the government and the private sector. Contrary to popular opinion in most creditor countries, however, the economic crisis in Asia is not an "Asian" crisis. The conditions that precipitated the crisis are by no means unique to the region. They have their roots in badly managed government liberalization of the financial sector, excessive borrowing and lending by private industry, and the inability and unwillingness of key players—including governments—to accurately assess risk. The resulting collapse of domestic asset values (real estate and stock market prices) and currencies is a phenomenon already seen in the 1990s in Europe and Latin America, and now Asia.

1. Malaysia introduced the dollar-pegged system on September 1, 1998, in order to pursue an economic stimulation program with capital controls.

Although crisis contagion was most vividly observed among neighboring Asian countries, its continued spillover effects hit Russia and reached Latin America and even the oil-exporting countries. Furthermore, severe fallout from the Asian and Russian crises landed on the U.S. shore and forced the U.S. Federal Reserve to bail out Long-Term Capital Management (LTCM), a very large and highly leveraged hedge fund, to prevent further negative implosion from affecting the entire U.S. credit market. At that time, many economists expressed concerns about the possibility of global recession or, in the worst case, global depression.

It is no wonder that the Asian crisis is considered to be "the worst international economic crisis in fifty years," affecting two-thirds of the world population and putting nearly half of the global economy into recession. As a senior IMF official publicly acknowledged, the Asian crisis has been a painful learning process for everyone concerned. In coping with the Asian crisis, the IMF—which is so used to dealing with financially troubled economies whose problems usually involve public profligacy and weak macroeconomic fundamentals—started to apply its orthodox prescription of high-interest-rate policies and fiscal austerity measures along with rather drastic structural reform programs. Unfortunately, however, as the financially stricken Asian economies did not improve as quickly as was originally anticipated, and instead the crisis spread throughout the world, the IMF did take a more flexible approach to the problem.

Today we live in the age of rapid globalization. Thanks to the digital revolution and the internet, global financial markets have become even more deeply integrated. At the moment a young financial dealer hits his or her computer keyboard, unimaginable amounts of funds shift around, all over the world. This goes on 24 hours a day in real time. According to the Bank for International Settlement (BIS), the daily foreign exchange trading volume in the world amounts to US$1.5 trillion. Less than 10% of the total is directly related to bona fide real economic activities, such as exports and imports.

One can easily imagine how volatile the global financial capital flows, short-term flows in particular, could be since the "herd instinct" of investors is easily and suddenly affected by any kind of shock. Obviously, relatively weak and shallow emerging markets are the most vulnerable. As one observer puts it, "capital flows around the world are like the oceanic tides: in deep bays, tidal movements are little noticed, but in shallow bays, the ebb and flow of the global ocean create huge effects." Paul Volcker (1999) puts it in a different way: "small and open economies are inherently vulnerable to the volatility of global capital markets. The visual image of a vast sea of liquid capital strikes me as apt—the big and inevitable storms through which a great liner like the U.S.A. can safely sail will surely capsize even the sturdiest South Pacific canoes."

Such a global financial market and its potential volatility pose grave challenges for both individual nations and the regional and global communities. Each individual emerging market economy, in particular, should face the challenge of reducing its vulnerability to external financial shocks while the regional and global communities should find ways, and build mechanisms, by which the systemic risk of global financial instability can be minimized.

This paper is organized as follows. The next section discusses the lessons of the Asian crisis and its implications at the national, regional, and global community levels. The succeeding two sections review the regional actions taken in dealing with the Asian crisis, and then the global actions taken in dealing with the Asian crisis and its aftermath. The final section proposes and discusses long- and short-term agendas for regional financial cooperation.

## LESSONS FROM THE ASIAN CRISIS

In retrospect, the Asian financial crisis and its policy implications can be understood at the national, regional, and global level. At the national level, first of all, the Asian crisis led us to realize that strong macroeconomic fundamentals, such as high savings, low inflation, and low fiscal deficits, are not enough to prevent a nation's financial crisis. It highlights the importance of institutional factors such as good governance, the rule of law and its appropriate enforcement, in addition to strong macroeconomic fundamentals in place to prevent such a crisis. More specifically, it stresses the crucial importance of prudential regulation and appropriate supervision of financial institutions and strong and transparent corporate governance.

Such financial infrastructure and appropriate corporate governance structure are even more important when there are governmental policies or attitudes that would create a moral hazard on the part of financial institutions and business enterprises. When financial institutions somehow believe that the government will bail them out whenever they run into trouble, they could easily end up with over-borrowing and over-exposure to risks without proper hedging. It is also possible for corporate borrowers to over-borrow from financial institutions, both domestic and foreign, if they are led to believe that a "too-big-to-fail" policy exists implicitly or explicitly. At this point, we should remind ourselves that the Asian financial crisis was not caused by government profligacy, but by private-sector over-borrowing and over-investment, which made economies vulnerable to a sudden reversal of foreign investors' confidence. To minimize their vulnerability to the effects of contagion, it is critical to make the necessary structural reforms for their fragile financial institutions and weak corporate governance.

While both directly and indirectly affected countries have to strengthen their self-defensive countermeasures to prevent a future financial crisis, we should draw our attention to the negative social impact of these structural reforms on the most vulnerable human beings. As pointed out in Rodrik (1999), market-oriented reforms require a social safety net to prevent individuals from falling through the cracks as economic change unfolds. Most Asian economies before the crisis did not adequately provide social programs and income transfers. Enterprise policies such as lifetime employment and the provision of social services were alternative means for social programs. However, it is clear that the provision of a social safety net is an important component of market-oriented structural reforms. It cushions the blow of liberalization among the most severely affected, it helps maintain the legitimacy of these reforms, and it averts backlashes against the distributive and social consequences of integration into the world economy.

Next, the Asian crisis also highlights the fact that ill-sequenced external liberalization does magnify the effects of the moral hazard problem of private borrowers. Properly and orderly sequenced external liberalization should be from the current account to the capital account, and capital account liberalization should be in the order of long-term to short-term. However, in the Korean case, for example, before the crisis occurred, short-term borrowing was encouraged even more than foreign direct investment and other long-term borrowing. This misguided policy, without having proper supervisory institutions in place, was primarily responsible for the term-structure mismatches of foreign borrowing and domestic lending.

Despite the Asian countries' dissatisfaction with global standards, which are practically dominated by Western influence, the consensus view stresses the importance of greater transparency and systematic adherence to internationally accepted auditing and accounting standards. If the true picture of these troubled countries' external debt structure and reserve status had been known, early warnings would have been heard from various sources. If consolidated financial statements of the Korean conglomerates (*chaebol*) had been made available before the crisis, their borrowing capacities would have been greatly curtailed.

On the other hand, we still do not have a consensus on how to deal with the volatility of short-term capital flows, at both national and global market levels. Often-heard voices advocate temporary controls over capital inflows à la Chilean scheme, which should be introduced before a crisis occurs, or controls on capital outflows, à la Malaysian way, which should be applied after a crisis arises, especially if a country is in the transition period of strengthening its institutional and regulatory domestic financial infrastructure. At the same time, the argument for an enhanced disclosure requirement and changes in current bank lending procedures to hedge funds is also gaining force. We should not be surprised to see more emerging markets trying various mechanisms for controlling short-term capital inflows, including hedge funds, on the one hand, and fostering long-term capital inflows, such as foreign direct investment, on the other hand.

At the regional level, there were also many calls for financial cooperation just after the Asian financial crisis broke out. However, the discussion on regional financial cooperation has largely remained within the realm of academia and has not been able to produce any tangible result. This is primarily due to the lack of a consensus in initiating a regional framework to respond to the crisis, in terms of both crisis management and crisis prevention.

Three Northeast Asian countries—China, Japan, and Korea—officially participate in regional forms such as ASEAN+3 and APEC, to discuss major issues concerning regional financial cooperation. However, in order to obtain more concrete results that can reflect the interests of this region, there needs to be a dialogue channel beforehand for a much closer regional financial cooperation to evolve. Such a dialogue is not necessarily exclusive to the neighboring countries around the region. Rather, it should evolve into an institution that strengthens and stabilizes the East Asian financial system. However, considering the fact that the Unite States is constrained to act globally and will not cooperate with the region as a region, the three countries have to form a consensus in Northeast Asia on a mutually beneficial basis. The political feasibility of a regional framework will not be a burden, if we start to lead a discussion on economic and financial issues in the relevant regional context.[2]

As exemplified by the launching of the Euro, the discussion on regional financial cooperation may focus on sophisticated topics such as monetary cooperation. However, more realistic and working-level agendas are likely to produce more tangible results. In other words, the task of regional financial cooperation is to be approached from a long-term and gradual perspective. As was the case with the Euro, the different levels of economic achievement among the East Asian countries must be considerably narrowed to meet the economic requirements for monetary cooperation. This is not to say that the discussion of monetary cooperation itself is futile. A consensus on monetary cooperation will emerge when the achievement of more specific agendas shows the possibility of regional financial cooperation.

2. In 1998, there was noticeable progress in the diplomatic relations among the Northeast Asian countries. The state visit of South Korean President Kim Dae Jung to Japan in October, followed by the Sino-Japanese and Sino-Korean summit meetings in November, greatly contributed to the consolidation of bilateral partnerships among the three countries. Despite some divergence of opinions on historical issues as reflected in the Sino-Japanese summit meeting, the leaders found their views converging on cooperation in economic and financial issues.

At the global community level, there already have been numerous suggestions for a new international financial architecture, including the role of the IMF and the way the IMF should operate. The currently existing international financial architecture, which is still based on the Bretton Woods framework designed more than 50 years ago, certainly is outmoded in this age of financial globalization. However, considering the current status of global leadership, it will take some time before the global community reaches a consensus on this issue. Many international gatherings have been held, primarily to deal with these issues, such as the G-22 Finance Ministers and Central Bank Governors meeting, the G-33 Seminars, the IMF Interim Committee's special meeting, and the regular G-7 Finance Ministers' meetings. But thus far, no decisive action has been taken, except the establishment of the Financial Stability Forum[3] and the introduction of the IMF's Contingent Credit Line.

In redesigning the international financial architecture, there are strong arguments for the necessity of reducing the moral hazard problem of international lenders. For example, as many economists have remarked, Mexico itself was not bailed out. Foreign investors—the banks and other financial institutions that had made dollar loans to Mexico, which Mexico could not repay—were the ones bailed out. In this connection, it is fortunate to have the recent IMF emphasis on the role of the private sector's burden-sharing in forestalling and resolving financial crisis. It is worth remembering that there are reckless lenders opposite reckless borrowers. In fact, the IMF's role can be modified to play a more active role as a mediator between debtors and creditors for the negotiations of debt rescheduling and forgiveness, or an "orderly workout" of external debt at the very early stage of financial trouble.

## REGIONAL ACTIONS TO DEAL WITH THE ASIAN CRISIS

At the ASEM finance ministers' meeting in Bangkok on September 19, 1997, Japan proposed an Asian Monetary Fund (AMF) to prevent the recurrence of the Asian currency crisis and to institutionalize financial cooperation among the countries within the region. To discuss the details of the proposed AMF, an undisclosed meeting of deputy finance ministers from twelve Asian nations was

3. The G7 Ministers and Governors created the Financial Stability Forum at their meeting in Bonn on February 22, 1999. This Forum was established to promote the exchange of information and coordination among the national authorities, international institutions and international regulatory or exports groupings with responsibilities for questions of international financial stability. Its initial membership includes the finance ministers, central banks, and leading regulators of each of the G7 countries, together with the chairs of the international regulatory organizations, and representatives of the international financial institutions.

held on September 21 at the request of Japan, during the IMF and World Bank annual meeting. At the meeting, Japan's finance minister, Hiroshi Mitsuzuka, outlined the plan for the establishment of an AMF. He also expressed willingness to contribute one-half of the initial fund supply. The United States and the IMF representatives opposed the plan, saying that an AMF may weaken the existing international financial architecture under the IMF. Since there were significant differences of opinion regarding the establishment of an AMF, the meeting adjourned without agreement on the details.

The advocates of the AMF have nonetheless continued to assert the need for a regional lender of last resort, referring to the fact that the IMF allocation of funds for Asia is inadequate, considering the size of the Asian economies. It has also been pointed out that the size of the speculative capital is much larger than an individual country's foreign reserves for defending against a currency attack by speculative hedge funds. Japan has been particularly enthusiastic about the idea of setting up an AMF. Deputy Finance Minister Eisuke Sakakibara toured the ASEAN nations to explain Japan's plan. To abate the opposition from the IMF and the United States, he proposed to put the AMF under the control of the IMF, by having the same conditionalities for financial rescue operations, and by making the AMF play a role supplementary to the IMF.

To follow up on these events, fourteen deputy finance ministers and central bank representatives, as well as IMF, World Bank, and Asian Development Bank (ADB) representatives, gathered in Manila in November 1997 to discuss ways to stabilize the region's financial market (which was called the Manila Framework). During the preparations for the meeting, the United States and other developed nations managed to convince Japan not to pursue its AMF proposal, because such a plan would weaken the IMF's hegemonic power. The compromise plan was to strengthen the ability of the IMF to provide funds through early approval of the New Arrangements To Borrow (NAB) and cooperative lending agreements. The plan also included introducing a regional surveillance mechanism to strengthen the IMF's global surveillance capacity.

Although the idea of the AMF virtually ended with the adoption of the compromise plan, most members of the Asia-Pacific Economic Cooperation (APEC) forum created the Manila Framework Group as a regional forum in order to develop a concerted approach to restore financial stability in the region.[4] This has been achieved through initiatives such as regional surveillance, economic and technical cooperation to strengthen domestic financial systems and regulatory capacities, and cooperative financing arrangements that supplement those

4. In November 1997 APEC leaders endorsed the Manila Framework for enhanced Asian regional cooperation to promote financial stability. However, there have been no tangible results as yet.

provided by the international financial institutions. However, the Manila Framework has no formal status, secretariat, or other institutional foundation. Furthermore, it cannot provide financial resources to supplement IMF facilities in the region. Although ad hoc financing-package provisions were arranged in the Manila Framework as the second line of defense, such supplementary funding has not been implemented on a permanent and assured basis.

As serenity and confidence returned to the Asian financial markets in late 1998, the focus was centered on the issue of post-crisis recovery rather than crisis containment itself. In October 1998, Japanese Minister Miyazawa announced the Miyazawa Initiative, aimed at supporting five crisis-affected Asian countries, and promised to contribute US$15 billion. Of the US$30 billion of the funds, US$15 billion was arranged to facilitate trade finance and to provide other short-term capital support. Another US$15 billion was prepared for mid-to long-term support. At the end of May 1999, US$17.7 billion had been committed to support the five crisis-affected Asian countries.

Japan also initiated the second stage of the New Miyazawa Initiative. Its principle is to place greater emphasis on the market, since the Asian economies are entering a new stage of development. It includes assistance to mobilize private-sector capital, aiming at the stable economic development of Asia. The sum of 2 trillion yen of domestic and foreign private-sector funds for Asia will be provided through measures such as assistance for fund raising in international financial and capital markets by Asian countries, and assistance for investment in Asian private-sector enterprises via equity funds. In addition, upgrading and fostering of Asian bond markets with sufficient volume are urgent issues, as part of the efforts to establish a stable and sound financial system in the region. To promote this, the government of Japan is vitalizing the Tokyo market by promoting the issuance of Samurai bonds and upgrading the government bond markets and settlement systems.

China has also demonstrated its economic capability and responsibility in the face of the Asian crisis. Its economic performance and policy choices have become increasingly significant to the regional and global economies. In response to the bleak economic prospects in the region, the Chinese government increased fiscal spending on infrastructural investment and cut interest rates to boost domestic demand, instead of pursuing a policy of currency devaluation. Undoubtedly, China has won many credits from the international community by maintaining its de facto pegged exchange rate system since the outbreak of the currency crises in the region, while most other Asian currencies have competitively depreciated.[5]

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5. Among many praises, during his visit to China in late June 1998, President Clinton praised China for showing “great statesmanship and strength in making a strong

## Global Action To Deal with the Asian Crisis and Its Aftermath

### Strengthening the Role of International Financial Institutions

As the Asian financial crisis spread to other regions, one of the key concerns of the international community was whether the IMF's financial resources would be sufficient to provide emergency assistance to other mid-size member countries, such as Russia and Brazil. The IMF's net uncommitted usable resources for emergency loans, in special drawing rights (SDR), stood at SDR 22.7 billion at the end of 1997 and was further reduced to SDR 19.5 billion by late 1998 (Table 1). However, as total usable resources drastically increased in 1999, the IMF's net uncommitted usable resources amounted to SDR 60.1 billion or about US$81 billion. The reason for the recent increase in total usable resources is that the IMF decided, in its September 1997 annual meeting in Hong Kong, to increase quotas (contributions), for its 182 member countries, by 45% after the Asian financial crisis. However, the quota increase was not immediately put into force, mainly owing to the delay in approval of the U.S. Congress. During the Eleventh General Review of Quotas (January 22, 1999), the quota was finally increased from SDR 145.6 billion to SDR 212 billion.

Another source of the replenishment of the IMF's resources was the amount pledged by the member countries through the General and New Arrangements to Borrow, which was about SDR 34 billion (or about US$46 billion) in May 1999. Also, the liquidity ratio (net uncommitted usable resources divided by liquid liabilities) has been improved from 48.2% in 1997 to 89.2% in 1998 and 96.9% in May 1999.

Some argue that the size of the IMF's emergency liquidity support is not adequate. There is certainly an "access limit" to how much support the IMF can provide to a specific country, when a series of currency crises simultaneously unfold around the world. Nevertheless, the volume of IMF assistance has drastically increased compared with the Latin American debt crisis of the 1980s. As shown in Table 2, since the Mexican peso crisis of 1994–95, IMF assistance has steadily increased.

There has also been criticism that the process of providing liquidity is unnecessarily prolonged when the crisis country is not able to fully accept the IMF conditionalities. However, we have to distinguish the general case from the Russian and Brazilian cases, where the liquidity provision was delayed because the authorities did not show an ample willingness to carry out the conditionalities. It may be argued that the conditionalities imposed significant

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contribution to the stability not only of the Chinese people and their economy, but the entire region, by maintaining the value of its currency." See also Kwan (1998).

constraints on domestic politics for those countries to promptly accept them, but the speed of emergency assistance depends more on the willingness of the crisis country to accept the conditionalities than any process problem inherent in the IMF itself.

Table 1. IMF financial resources and liquidity, 1997–99

| | Special Drawing Rights (SDR) | | | | US$ |
|---|---|---|---|---|---|
| Resources | 1997 | 1998 | Apr. 1999 | May 1999 | May 1999 |
| Members' currencies | 144.7 | 149.4 | 205.0 | 206.4 | 277 |
| Gold holdings | 3.6 | 3.6 | 3.6 | 3.6 | 5 |
| SDR holdings | 0.6 | 0.7 | 3.6 | 3.9 | 5 |
| Other assets | 0.3 | 0.3 | 0.4 | 0.3 | 0 |
| Total resources | 149.2 | 165.1 | 212.5 | 214.2 | 287 |
| Nonusable resources | 98.5 | 111.5 | 128.8 | 127.0 | 170 |
| Usable resources | 50.7 | 53.6 | 83.7 | 87.2 | 117 |
| Net uncommitted usable resources | 22.7 | 19.5 | 56.7 | 60.1 | 81 |
| GAB/NAB balances available | 18.5 | 18.6 | 34.0 | 34.0 | 46 |
| Liquid liabilities | 47.1 | 60.6 | 63.6 | 62.0 | 83 |
| Liquidity ratio (%) | 48.2 | 32.2 | 89.2 | 96.9 | 96.9 |
| US$ per SDR | 1.34925 | 1.40803 | 1.35123 | 1.34196 | – |

*Source: IMF Financial Resources and Liquidity Position*, June 1999.

Table 2. IMF commitment of liquidity support to the crisis countries, January 1999 (US$)

| Economy | Stand-by/EFF | Supplemental Reserve Facility (SRF) |
|---|---|---|
| Mexico (1995) | 17.8 billion (stand-by) | – |
| Thailand (1997) | 4.0 billion (stand-by) | – |
| Indonesia (1997) | 11.2 billion (stand-by→EFF) | – |
| Korea (1997) | 7.6 billion (stand-by) | 13.4 billion |
| Russia (1998–99) | 1.3 billion (EFF) in 1998<br>2.2 billion (EFF) in 1999 | 11.2 billion in 1998<br>0.4 billion in 1999 |
| Brazil (1998) | 5.4 billion (stand-by) | 12.6 billion |

*Source:* IMF.

The Supplemental Reserve Facility (SRF), a new fund facility, was created on December 17, 1997, during the Manila Finance Ministers' Meeting, in order to stabilize the financial market through the provision of short-term, front-loaded financial support at higher interest rates than normal IMF funding through a stand-by agreement (SBA).[6] In principle, any country may use the SRF. However, it is intended for situations where the effects of difficulty in one country may potentially destabilize the international financial system. The disbursement takes place when there is a chance for improvement in the balance of payments during a short period, based on bold restructuring policies and monetary policies.

This facility was applied to Korea on December 19, 1997, just after it was adopted. The decision to do so was based on the fact that Korea had received 20 times quota, which exceeded the typical credit limit of 3 times quota. This figure was the largest IMF package ever. However, this was a major improvement in the problem of access limit, which became critically recognized since the 1994 Mexican crisis. Korea could be a successful example of the SRF, as shown by the fact that the Korean Government began to deliver repayments in December 1998.

There have also been criticisms that the IMF liquidity provision does not play a preventive role. Some argue that the IMF should prevent financial crises or at least minimize the spread of crises by providing emergency assistance in advance when there are symptoms of the contagion effect, or when there is sufficient indication of a looming crisis. Taking this into account, the IMF has diversified its methods of liquidity provision by introducing the Contingent Credit Line (CCL) in 1999, following its adoption of the SRF in 1997.

On April 25, 1999, the IMF's Executive Board approved the CCL for member countries. Unlike the SRF, the CCL is intended solely for member countries that are concerned with potential vulnerability to contagion. Short-term financing—if the need arises—will be provided under the CCL to help member countries overcome the exceptional balance of payments financing needs that can arise from a sudden and disruptive loss of market confidence due to contagion. Such needs would be generated by circumstances largely beyond the member's control, and would stem primarily from adverse developments in international capital markets consequent upon developments in other countries.

At present, it is unlikely that the creation of an international lender of last resort in the form of an international central bank will be realized in the

6. The traditional assistance in an SBA was up to three times the country's quota. This tradition was broken in the Mexican crisis. For Mexico, a three-times-quota SBA was US$7.8 billion. However, the IMF underwrote an effort to put together US$10 billion from non-G10 countries, but this never materialized. As a result, the IMF ended up pledging US$17.8 billion to Mexico, of which about US$12 billion was actually disbursed. This provided a precedent for a five-times-quota SBA for Thailand in August 1997. See Ito (1999) for more details.

foreseeable future. However, the need for such an institution is growing. According to Fischer (1999), two elements of Bagehot rules (penalty rate and the notion of lending freely) have been incorporated into the SRF, which can make short-term loans in large amounts at penalty rates to countries in crisis.[7] With regard to good collateral, the loss of market access that would result from default, and as Fischer correctly pointed out, the fact that the Fund and World Bank would be regarded as preferred creditors, would likely be sufficient "collateral."

### Concerted Efforts for Aggressive Monetary Easing

Following the wave of volatility unleashed by the Russian moratorium and Brazilian devaluation, aggressive monetary easing by major central banks has contributed to the stability of global financial markets. The crises in Russia and Brazil have been contained and the long-expected correction in the U.S. and European equity markets has not yet occurred. Instead, significant positive developments in the global economy have been broadly observed. In the aftermath of the sharp output contractions in Asia's crisis-affected economies, the economic slowdown seems to have bottomed out—most notably so in Korea. Massive current account adjustments have transformed precrisis deficits to surpluses, enabling the beleaguered economies to rebuild their once depleted foreign reserves. At the same time, the stunning recent contraction of emerging market credit spreads and the improved pace of debt financing mean that Asia is now regaining access to global financial markets. Investment sentiment toward many emerging market economies has rallied.

Concerted efforts for aggressive monetary easing led by the U.S. Federal Reserve, followed by central banks of other industrial countries during the second half of 1998, has contributed enormously to the rapid recovery of many of Asia's economies. The three cuts by the U.S. Federal Reserve during September through November reduced the U.S. Federal funds rate from 5.5 percent to 4.75 percent. Despite the limited room for monetary easing, Japan lowered the overnight lending rate from 0.45 percent to 0.25 percent and maintained an almost zero real interest rate policy. Given these developments, the other Asian countries, including even crisis-affected countries under the IMF program, were able to cut interest rates to as low as the precrisis level. These concerted global actions were conducive to restoring investors' confidence and containing the spread of financial crisis.

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7. The classic Bagehot rules for the lender of last resort are (1) lending freely to solvent borrowers, (2) lending against good collateral, and (3) lending at a penalty rate.

**Building a New International Financial System**

The international monetary and financial system has tended to evolve incrementally, from the gold standard, to the gold-exchange standard, to the Bretton Woods gold-dollar standard, to the post-Bretton Woods system of managed floating, and now to a system that is being designed under the name "new international financial architecture." According to Eichengreen (1999), only in 1944 can it be said that the international financial system was radically remade on the basis of an architectural blueprint. And the circumstances then were exceptional, indeed unique. The prewar system had been discredited. Today many participants agree on the need for reform, but by the standards of 1944 there is still a striking lack of consensus on reforms to be undertaken. And achieving that consensus is more complicated than in 1944 by virtue of the number of parties involved. In 1944 there were basically one and a half countries at the table.[8] Today the economic and financial world is a more multipolar place. This large number complicates the process of consensus building.

Despite slow progress, several steps have already been taken to strengthen the international financial architecture. According to Eichengreen (1999), the new international financial architecture is designed to be organized around four pillars:

- international standards for financial arrangements and practices
- Chilean-style taxes on short-term foreign borrowing as a form of prudential regulation to be imposed until countries have brought other forms of banking-sector supervision up to world-class levels
- greater exchange rate flexibility for the vast majority of emerging market economies
- collective action clauses in loan contracts to create an alternative to ever-bigger IMF bailouts.

If these four elements are successfully implemented, the international financial system would more effectively prevent crises, moderate the severity of crises when they take place, facilitate the recovery from crises, and contain the moral hazard in international financial markets. To do so, we should endeavor to construct more effectively workable schemes based on their logical foundations.

However, as time passes and the sense of urgency recedes, second thoughts inevitably develop. As Eichengreen (1999) pointed out, early enthusiasm for greater exchange rate flexibility has been tempered by awareness that more exchange rate volatility can mean less capital market access. Enthusiasm for Chilean-style holding period taxes to discourage excessive dependence on short-

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8. Eichengreen (1999) pointed out that in 1944 only the United Kingdom provided an effective counterweight to the United States.

term capital flows is tempered by questions about the scope for evasion and worries about increased costs of trade credit. The push for collective action clauses has been slowed by worries that they can be a source of moral hazard. Enthusiasm for international standards has been weakened by worries about their effectiveness.

Despite these constraints, we would live in a much safer world if we finally reform the international financial system. That is why we should continue to pursue these initiatives. However, crisis and contagion will still be an inevitable phenomenon even with a much stronger and sounder international financial architecture. In this sense, various regional financial arrangements would supplement the role of international financial institutions such as the IMF and the World Bank.

## ISSUES AND PROSPECTS FOR REGIONAL FINANCIAL COOPERATION

Research and policy innovation in regional financial cooperation need to go hand in hand. We can classify many important issues for discussion into a short-term, mid-term, and long-term agenda. Based upon the tangible results from the short term, agendas for the mid and long terms can be more constructively set up and pursued in a consensual and cooperative way. In particular, the three Northeast Asian countries of ASEAN+3 should form a dialogue channel to lead a regional financial cooperation initiative, and then move forward to construct mutually beneficial agendas with the ASEAN nations and others.

### Short-term Agenda

It will be more difficult to develop a short-term agenda about which the Northeast Asian countries are mutually concerned than to initiate a longer-term agenda. This is solely due to the lack of experience in having serious discussions on regional financial cooperation in this region. However, we do not need to be intimidated by the past inexperience. As we have ample opportunities to hold discussions at various forums, such as ASEAN+3, APEC, and G20, short-term issues, if resolved, should contribute to the stability of macroeconomic conditions and financial markets in the region. At present, the most important areas for discussion to promote regional financial cooperation in this region are:

- forming a regional consensus on strengthening and reforming the international financial architecture
- enhancing concerted efforts to strengthen the domestic financial system and foster Asian financial markets
- strengthening the regional surveillance process
- promoting economic cooperation in the area of trade and investment

- building a regular framework for dialogue to pursue further cooperation on a continuous basis.

*Forming a Regional Consensus on Strengthening and Reforming the International Financial Architecture*

In order to preserve the stability of the international financial system, and to respond more effectively to financial crises when they occur, we have to strengthen and reform the existing international financial architecture. To accomplish this, more input from emerging economies should be incorporated in the continuing process of shaping a new international financial architecture. Japan is a key member country of the Financial Stability Forum and the G7 Finance Ministers meeting. Although there are many opportunities for non-Japanese Asian countries to present their views on this issue, it would be desirable to harmonize these views and develop an Asian view if necessary.

Recently, China, Japan, and Korea were invited to become member countries in the G20, which are composed of the G7 countries, eleven systemically significant emerging economies, and two Bretton Woods institutions (the IMF and the World Bank). The purpose for establishing the G20, as noted in the G7 communiqué of September 25, 1999, was to

> "broaden the dialogue on key economic and financial policy issues among systemically significant economies and promote cooperation to achieve stable and sustainable world economic growth that benefits all."

The three countries will find it more important to develop a consensus view that represents the region's countries and to show a leadership role in this region.

*Enhancing Concerted Efforts to Strengthen the Domestic Financial System and Foster Asian Financial Markets*

One of the striking elements of the recent crisis was the extent to which countries reached for short-term borrowing and thereby greatly increased their vulnerability to financial shocks. In order to reduce this risk, we should develop some guidelines for sound debt management on the borrowers' side and sound lending management on the lenders' side. In Korea's case, much of its external debt was short-term borrowing; this immediately led to a liquidity crisis. A sharply declining rollover ratio of short-term loans led to a cash flow mismatch.

In the regional context, therefore, we should discourage disproportionate reliance on short-term capital flows in favor of more stable long-term debt profiles and the development of domestic bond markets. On the borrowers' side, prudential regulations on short-term foreign currency exposures should be strengthened. On the lenders' side, similar prudential regulations on the exposure to emerging market risks should be appropriately imposed, and risk management should be strengthened.

In addition, the countries in this region should continuously pursue financial sector restructuring. Without sound financial institutions and adequate regulatory regimes, Asian financial markets will remain vulnerable to external shocks. Since financial restructuring is also closely related to corporate restructuring, we should also cooperatively pursue cross-border corporate restructuring at the industry level. To do this, the governments in this region should foster an environment facilitating cross-border mergers and acquisitions. In addition, corporate restructuring funds should be provided through cooperative regional financing arrangements.

A concerted Asian move toward developing local or regional currency-denominated bond markets will gain multipurpose benefits. First, bonds can help firms lock in long-term local currency funding at fixed rates and thus help stabilize borrowers and markets in troubled situations. To function effectively, however, fixed income markets require an appropriate technical and legal infrastructure. The Asian countries should make joint efforts to develop their bond markets. Second, Asian savings could be invested more in Asia rather than in New York or London. Despite Asia's high savings rates, recycling of Asian savings in and out of the region makes Asian financial markets extremely volatile. Japan, the country with Asia's highest savings rate, still invests in New York or London. The Japanese government's recently announced plan for developing Asian bond markets through a guarantee scheme will contribute to the development of regional bond markets.

*Strengthening Regional Surveillance*

A regional surveillance process is a mechanism to exchange appropriate and timely information among countries concerned, and to effectively coordinate relevant macroeconomic and financial policies on the basis of this updated information. To do this, the countries in this region could design a regular surveillance process on the basis of voluntary disclosure and sharing of pertinent and valuable information. Among others, capital flows, term structure of external liabilities and assets, and recent capital market developments in the respective countries would be a most valuable set of information. In some cases, the exchange of information by prudential supervisory agencies in the region will provide relevant information.

However, a more important thing would be to identify the factors that may spill over national borders, and find a joint solution to prevent adverse contagion from spreading to neighboring countries. This regional surveillance process would supplement and enhance the surveillance role of the IMF and would foster a successful implementation of a regional surveillance process, which the Manila Framework has also pursued.

*Promoting Economic Cooperation in the Area of Trade and Investment*
Financial cooperation is just one area for economic cooperation. Closer integration through trade and investment in the region will naturally intensify the necessity for regional financial cooperation. Despite the differences in the economic attainment levels in this region, trade and investment linkages based on comparative advantages and scale economies will strengthen the international competitiveness of this region's goods and services. It may be too early to assess the possibility of free trade areas in this region. However, it is a reality that only this region has no regional trade arrangement. Along with regional financial cooperation, we should simultaneously pursue economic cooperation in the area of trade and investment.

*Building a Regular Framework for Dialogue for Further Cooperation*
The task of regional financial cooperation should be approached from a long-term and gradual perspective, if we are to accomplish the visionary goal of establishing a cooperative body for coping with monetary and financial issues. It is Asia's fate that the political burden of geo-political issues remains to be dealt with, before our goal can be reached. However, this is not to say the discussion of an "Asian vision for the twenty-first century" in the area of monetary and financial cooperation itself is futile. The Northeast Asian countries should start to discuss more tangible issues and develop a more visionary agenda. To do this, we should build a regular framework for dialogue for further cooperation.

**Mid-term Agenda**
Very tentatively, as a mid-term agenda, the following issues could be considered:

- stabilizing the exchange rate volatility in this region
- developing a consensus on a regional cooperative financial arrangement
- initiating concerted efforts to provide development assistance to less-developed countries in the region.

*Stabilizing the Exchange Rate Volatility in the Region*
As pointed out in the Report of the G7 Finance Ministers during June 18–20, 1999, further work is needed on appropriate exchange rate regimes for emerging market economies. The choice of exchange rate regime is critical for emerging economies to achieve sustainable economic development, and also has important implications for the world economy. In principle, the most appropriate regime for any given economy may differ, depending on particular economic circumstances, such as the degree of integration into the world economy. Since economic circumstances vary over time, the most appropriate regime for any given country

may also differ over time.[9] In any case, stability depends on the exchange rate regime being backed by consistent macroeconomic policies and supported by robust financial systems.

Following the collapse of the Thai baht's peg on July 2, 1997, the movements of the exchange rates of East and Southeast Asian countries—in particular, Thailand, Malaysia, Indonesia, the Philippines, and Korea—headed in a similar, downward direction during late 1997 and early 1998. We can also observe a strong correlation in the nominal exchange rates among the Asian currencies that have floating exchange rate regimes. In particular, the Korean won and Japanese yen have shown a strong co-movement, since Korea's foreign exchange market started to stabilize in mid-1998. At present, further work is needed to find a way out of the currency volatility in the regional context. Macroeconomic policy coordination based on close regional surveillance would contribute to currency stability in the region.

*Developing a Consensus on a Regional Financial Arrangement*

Dismayed by the IMF's inability to provide emergency financial assistance and its strict conditionalities, advocates of the AMF have emphasized the possibility that the AMF could be superior to the IMF in preventing and managing financial crises. Although the IMF has shown a limited capacity to act as crisis lender and crisis manager, this does not necessarily imply that a regional institution will outperform the global institution. To more effectively respond to the crisis, a new international financial architecture should be strengthened first, and a regional financial arrangement (RFA) should play a supplementary role. Thus, we need to focus our attention on the issue of how an RFA can be a complementary institution rather than a competing and substitutable one.

**Role of a Crisis Lender**

The IMF has strengthened its funding capacity through the SRF and CCL to act as a lender of last resort to individual countries. However, it is also little disputed that an RFA, once established, can complement the IMF in providing emergency assistance. At present, a natural question is whether there will be an adequate supply of U.S. dollars in the region, since the RFA would utilize the U.S. dollar.

9. In terms of foreign exchange regimes, the share of fixed exchange rates fell from about 60% in 1989 to about 45% in 1999, while the share of floating currencies rose from about 12% to 25% during the same period. According to JP Morgan (1999), the theme most likely to dominate foreign exchange markets in the years ahead is the continued trend toward a polarized global foreign exchange regime: fewer fixers, even fewer peggers, and an increasing number of floaters.

The foreign reserves of the ten East Asian central banks amounted to about US$740 billion at the end of 1998, as shown in Table 3. The amount of foreign reserves in the possession of the East Asian countries is not any smaller than that of developed nations in absolute terms. However, the foreign reserve position should also be considered in comparison with each nation's ability to repay its external debt and the stability of its financial system. In this regard, the foreign reserve positions of the Asian countries would not be very strong, given Asia's large external debt and underdeveloped financial system.

Table 3. Foreign reserves of Asian and other economies, 1993–98 (US$ million)

| Economy | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|
| Asia | | | | | | |
| Japan | 88,720 | 115,146 | 172,443 | 207,335 | 207,866 | 203,215 |
| China | 21,199 | 51,620 | 73,579 | 105,029 | 139,890 | 144,959 |
| Taiwan | 83,575 | 92,457 | 90,311 | 88,040 | 83,505 | 90,339 |
| Hong Kong | 42,986 | 49,251 | 55,398 | 63,808 | 92,804 | 89,601 |
| South Korea | 19,704 | 25,032 | 31,928 | 33,237 | 19,710 | 51,963 |
| Thailand | 24,078 | 28,884 | 35,463 | 37,192 | 25,697 | 28,434 |
| Malaysia | 26,814 | 24,888 | 22,945 | 26,156 | 20,013 | 24,728 |
| Indonesia | 10,988 | 11,820 | 13,306 | 17,820 | 16,087 | 22,401 |
| Philippines | 4,545 | 5,866 | 6,235 | 9,902 | 7,147 | 9,101 |
| Singapore | 48,066 | 58,177 | 68,695 | 76,847 | 71,289 | 74,928 |
| Subtotal for Asia | 372,668 | 465,135 | 572,298 | 667,362 | 686,005 | 741,667 |
| Other economies | | | | | | |
| Germany | 72,727 | 72,219 | 77,794 | 75,803 | 69,853 | 64,133 |
| France | 20,008 | 23,520 | 23,142 | 23,120 | 27,097 | 38,753 |
| Switzerland | 31,650 | 33,554 | 34,685 | 36,775 | 36,899 | 38,346 |
| United Kingdom | 34,630 | 38,530 | 39,180 | 37,120 | 28,880 | 27,360 |
| Italy | 25,140 | 30,107 | 32,942 | 44,064 | 53,431 | 25,447 |
| Canada | 10,471 | 10,219 | 12,629 | 18,028 | 15,122 | 19,911 |
| Subtotal for others | 194,626 | 208,149 | 220,372 | 234,910 | 231,282 | 213,950 |

*Source: International Financial Statistics 1999.*

Nonetheless, securing dollar liquidity for establishing an RFA, with contributions from each country's foreign reserves, appears to be a painless process, because this region, relatively, has enough foreign reserves when pooled together. Pooling dollar reserves among Asian countries can be utilized as a countermeasure to prevent financial crisis. However, this idea has advantages and disadvantages. The most significant advantage could be saving the Asian countries from having excessive holdings of foreign reserves. Second, the Asian countries could reduce their dependence on the U.S. dollar. Resources released from official foreign reserves could be more usefully mobilized for the growth and recovery of the region. On the other hand, there remain many difficult tasks in operating this scheme for pooling foreign reserves. Which of two approaches would be more efficient is still an open question: (1) establishing a regional monetary fund (a more institutionalized approach) or (2) a regional arrangement to borrow in the region (a contractual approach).

Given that the IMF's usable financial resources have recently been replenished, we should examine potential problems that may arise when the RFA provides liquidity support prior to the IMF in crisis situations. If the RFA support does not attach IMF-like conditionalities, it may incur a serious moral hazard problem in the international financial system. If Asian countries do not want strict conditionalities under the RFA, it would be more desirable to pursue a diverse set of credit lines, rather than creating a permanent institution such as the RFA. The backup facility, based on a currency swap between Korea and Japan, as part of the new Miyazawa Initiative, is a good example of bilateral financial cooperation. An extended form of this facility through a regional arrangement to borrow, based on contractual terms and conditions, would be a good scheme for an emergency credit support mechanism in a crisis situation.

**Role of Regional Surveillance**

The IMF conditionalities are often criticized for being too severe, or inappropriate for each country's specific situation, or both. In other words, the critics say that not only is the IMF unable to prevent financial crises before they occur, it is also incapable of managing crises once they do take place. The argument is that an RFA can do the job of monitoring better than the IMF, which has its operations spread out all over the world. In addition, contagion effects spread to the regional financial market first, hence the superiority of the RFA. However, this has yet to be confirmed by further research, and development of more concrete action programs. In order for the regional surveillance system to function more efficiently, the sharing of data on individual financial institutions, regional financial markets, and macroeconomic indicators is necessary.

After the AMF proposal failed, the Manila Framework replaced the AMF proposal. It was agreed that the Manila Framework would continue to discuss the monitoring and cooperation of economic and financial problems in the Asia-Pacific region, but there has been no further development since then. Monitoring is meant to generate timely information useful to policymakers and market participants. For policymakers, timely information identifies harmful factors to which policy corrections can be applied. Even with the information, policy-makers must make judgments about whether perceived factors are ultimately harmful or not, and must decide which policy instrument to use. Furthermore, policymakers, in possession of information that might affect the markets, should consider the potential effect the announcement and disclosure of such information may have on markets. In this regard, a monitoring and surveillance mechanism, without proper regulatory authority, may lead to the possibility of information distortion or moral hazard problems, in that individual countries would not be willing to reveal information disadvantageous to their countries.

At a global level, the IMF has made substantial progress in promoting enhanced disclosure of economic statistics and indicators, and in developing voluntary codes of good practice and standards to ensure appropriate transparency of the processes by which governments formulate macroeconomic and financial policies. The IMF has also approved a number of measures to increase transparency in member countries' economic policies as well as in its own operations. With considerable progress already having been made in the development of standards and codes of good practice, the key challenge now facing the international community is to encourage implementation. The Financial Stability Forum has taken up the issue and is pursuing the implementation of the necessary steps.

At the regional level, the Manila Framework has also pursued a regional surveillance mechanism. However, it is not yet decided how a regional surveillance process would complement the global surveillance process. A peer review, each of the other's economic and financial situations, and shared experiences on the policy challenges facing respective economies, such as the ASEAN Surveillance Process (ASP), could be extended to the RFA. However, such an enlarged regional surveillance process is likely to face many technical difficulties unless it is to have sufficient analytical instruments and monitoring authority.

A regional financial arrangement could set up both regular and ad hoc surveillance committees to conduct the job of monitoring on a continuous basis and evaluate the necessity of emergency credit provision on an ad hoc basis. These surveillance committees could advise necessary policy guidelines to individual member countries during noncrisis periods, but they could also ask for some joint actions by member countries in order to prevent the spread of contagion when a country is likely to be in or is struck by a crisis.

**Scope of Membership**

Determining the scope of membership of an RFA is fundamentally different from creating an optimum currency area such as the Economic and Monetary Union (EMU) in Europe. The membership should be based on a consensus among the Asian nations, and other external factors, while creating an optimum currency area involves a lot of technical issues that need to be resolved for monetary cooperation. According to the optimum currency area theory, the symmetry of the shocks, factor mobility, openness of the economy, interdependence, and policy objectives of the countries should be considered in determining the scope of membership. However, in the case of an RFA, some flexibility is possible. The scope of the membership considered thus far includes ASEAN+3 and the Asian countries within APEC. This is because it is easier to achieve a consensus on whether to create an RFA by expanding and developing the existing channels for dialogue.

**Providing Development Assistance to Less Developed Countries**

The leadership of China, Japan, and Korea in initiating regional cooperation should also consider a plan for providing development assistance to less developed countries in the region. Equitable growth in the region will greatly contribute to regional stability in both the economic and the political arenas.

**Long-term Agenda**

Finally, a long-term agenda for an Asian vision for the twenty-first century remains an open question. One possible item for a long-term agenda is the issue of a single Asian currency or a regional currency grouping. Some of the key areas of discussion center on whether the region should retain its close links to the U.S. dollar, move toward greater use of the Japanese yen, or aim to link its currencies to a tripolar system incorporating the dollar, euro, and yen. There is also debate about whether the region should seek to create an Asian currency unit that would be used as a benchmark for the individual currencies.

Curiously, the most recent advocate of the merits of an Asian currency has been the chief executive of the Hong Kong Monetary Authority, Joseph Yam—the man responsible for maintaining the only significant fixed dollar parity left in East Asia.[10] Noting the failure of the yen to establish itself as an international reserve currency for Asia, Yam suggested recently that countries in the region might want to consider the possibility of creating an Asian currency that would serve as an anchor currency for the region. Such a development would reflect trade links, enable reserves to be retained in the region rather than invested elsewhere, and make regional currency markets more liquid and less susceptible to manipulation. However, the idea of an Asian currency faces innumerable political and economic obstacles, which in the short to medium term at least seem insurmountable.

A single currency implies a degree of political cooperation that is not currently conceivable in East Asia. Furthermore, an Asian currency system built

10. As in JP Morgan (1999), the creation of an Asian currency unit would provide Hong Kong and even China with an "exit strategy" to move away from currency pegs that, in both cases, look tough to sustain over the longer run. Kwan (1998) also pointed out that Hong Kong has paid high costs to defend the dollar peg and consequently would become the last country to recover from the Asian financial crisis.

around one individual currency, in approximately the way that much of Asia long followed an informal dollar standard, looks unlikely. In particular, the idea will not easily be made acceptable to other East Asian countries, considering the absence of regional political consensus.

In addition, East Asian economic systems, patterns of trade, and levels of economic development are far more diverse than those manifest in the EMU, and appear currently to preclude the sort of coordination that is required to launch a regional currency unit. For example, in the euro zone, the highest per capita income is 3.8 times that of the lowest. In comparison, Japan's per capita income is 46 times that of China's. The most important prior condition for successful monetary cooperation is the convergence of the economic attainment level in the region. To do this, Asian dynamism should be continuously pursued to promote the convergence of the three countries in terms of various economic standards.

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