International Financial System Reform: Lessons From The 1997-8 East Asian Crises

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This paper seeks to offer a vision of alternative international financial institutions more conducive to and facilitative of late industrialization and development more generally by drawing upon the recent experiences of East Asia, especially Southeast Asia. The next section will critically review the East Asian crises of 1997-8 as well as some aspects of the ensuing institutional and policy debate which led temporarily to some rhetoric on reforming the international financial architecture, the establishment of the Financial Stability Forum as well as other initiatives to address issues raised by the crises and their aftermath. This leads into some discussion of an agenda for international financial system reform in the interests of developing countries, although reform prospects have worsened with economic recovery and the apparently receding threat of fresh crises despite recent developments in Argentina, Turkey and elsewhere.

Lessons From the 1997-8 East Asian Crisis

In the wake of the Mexican crisis in early 1995, even the IMF stepped back momentarily from its earlier post-Bretton Woods advocacy of virtually unfettered financial liberalization. Unfortunately, the short-termism of financial markets extends to human and institutional memories as well as to related policy making and advocacy. The recent crises[i] have also seen 'market corrections' 'overshooting' well in excess of alleged 'misalignments' many times over. Further evidence of market-induced anarchy can be found in the 'herd behaviour' underlying so-called 'contagion' or 'domino' effects. While affected government and economies have been badly affected by the crisis since mid-1997, there is little evidence that the private sector culprits have suffered most as a consequence.

Perceiving the Southeast Asian region as much more integrated than it actually is (e.g. in terms of trade links excluding Singapore, the regional entrepôt), the panicky investment decisions of fund managers, often based outside the region — e.g. in Wall Street or the City of London — have often been 'herd-like,'[ii] causing 'contagion' or 'domino' effects throughout the region. The very logic and magnitude of hedge fund operations[iii] have tended to exacerbate these phenomena, with disastrous snowballing consequences for the region and beyond. Other international, regional and, increasingly, local currency speculators and hedgers have also been responsible, but mainly by reacting in their own self-interest to perceived market trends[iv].

There is little point in arguing that the crisis should not have happened since East Asian economic fundamentals were fine, even if that were true (for a nuanced contrarian position, see Jomo ed. 2001: chapter 2). In some instances, such denial exacerbated the problem as authorities did not recognize and respond to problems with any great sense of urgency. Unfortunately, as East Asia has painfully learnt, financial markets are driven by sentiments more than by fundamentals. Hence, although much more serious current account deficits elsewhere have not always resulted in crisis, it does not mean that an

economy can maintain such deficits indefinitely without being vulnerable to speculative attacks or loss of confidence due to circumstantial factors.

One cannot, for example, liberalize the capital account, and then complain when short-term portfolio investors suddenly withdraw due to their whims and fancies. As is well known, even Chile, once the darling of the Chicago monetarists, has long made it difficult — and costly — to rapidly withdraw capital from its economy, and treats foreign direct investment very differently from portfolio investment. Some authorities try to distinguish between portfolio investments that are simply short-termist from, say, pension funds with a more medium-term orientation. Financial liberalization means investors have a choice as to when they come and go[v].

In the decade before 1997, the crisis-affected East Asian economies, especially those which sought and received IMF emergency credit, became excessively reliant on such short-term capital inflows to finance their current account deficits. This problem was exacerbated by excessive imports to make more non-exportables such as buildings and infrastructure. Ostensibly prudent financial institutions often preferred to lend for real property and stock purchases, and thus secure assets with rising values as collateral, rather than to provide credit for more productive purposes.

While foreign banks were happy to lend US dollars at higher interest rates than available elsewhere, Southeast Asian banks and businesses were keen to borrow at lower interest rates than available domestically. The costs of hedging — a hundred basis points or so for ringgit-dollar, a few hundred for baht-dollar or rupiah-dollar — now look cheap in hindsight, but were avoided by borrowers to maximize their rentier margins as they generally expected their central banks to defend their currencies' unofficial pegs to the US dollar. The existence of a well-developed swap market allowed some Southeast Asian companies to tap into foreign capital markets, at reasonable cost, by swapping away currency risk. Hence, the problem was ultimately one of greed: the combination of lower foreign interest rates and seemingly fixed exchange rates caused most foreign exchange borrowers to gamble without prudently hedging.

Hence, most such loans remained un-hedged as the Southeast Asian currencies seemed pegged to the US dollar since the mid-eighties' devaluations despite official fictions of exchange rates moving with the basket of currencies of major foreign trading partners. The banking boom in the region with international financial liberalization led to competitive lending reminiscent of loans to Third World governments in the late seventies (which built up to the debt crises of the early eighties). However, the new fiction in international policy-making circles then was that such accumulation of private sector debt did not matter as long as public sector debt was reined in.

Meanwhile, portfolio investors moved into the newly emerging stock markets of Southeast Asia with encouragement from the International Finance Corporation (IMF), a World Bank subsidiary. In Malaysia, for example, they came in a big way in 1993, only to withdraw even more suddenly in early 1994, leaving most retail stockholders in the lurch. But policy-makers seem to have short memories and did not learn the lessons from that experience as the new unsustainable build-up from 1995 sent stock prices soaring once again despite fast declining price-earnings ratios.

Thus, the Southeast Asian currency and financial crises from mid-1997 were primarily due to financial liberalization and its consequent undermining of monetary and financial governance. The 'quasi-pegs' of the region's currencies to the US dollar

and the encouragement of short-term[vi] foreign capital inflows — into the stock markets as well as in the form of borrowings — to close the current account deficit, also ensured that foreign savings supplemented the already high domestic savings rate to raise investment rates in the region. The quasi-pegs not only encouraged un-hedged borrowing from abroad, but also became targets for currency speculators as regional currencies appreciated with the US dollar despite declining export competitiveness as well as output and export growth. There is little evidence that such short-term capital flows contributed much to growth in the region. Growth had been rapid in East Asia mainly due to the high savings and investment rates without much need for foreign savings as well. In Southeast Asia, foreign direct investment has been important for industrialization and growth by providing access to foreign technology and markets, rather than for capital per se. Following Palma (2000), it seems that the additional capital inflows – in the form of loans as well as portfolio investments – mainly contributed to:

1. asset price bubbles, especially in the stock and property markets (especially Thailand and Malaysia).
2. consumption booms, which exacerbated the current account deficits due to the related increase in luxury consumption items rather than intermediate goods for re-export (e.g. Thailand, Malaysia, Indonesia).
3. over-investment, with 'too much money' chasing too few 'good investment opportunities' (e.g. South Korea).

Meanwhile, financial liberalization facilitated lucrative opportunities for taking advantage of falling currencies, thus encouraging currency and other related speculation, exacerbating currency volatility and eventually accelerating the collapse of regional currencies and share markets. All this, together with injudicious official responses, transformed the inevitable 'corrections' of the overvalued currencies in the region into major collapses of the currencies and stock markets of the region as panic set in, exacerbated by 'herd' behaviour and 'contagion'.

Although the financial systems in the region are quite varied (often reflecting colonial as well as post-colonial legacies and other influences) and are hardly clones of the Japanese 'main bank' system, as often wrongly alleged, they have nevertheless become prone to similar financial-property 'bubble' phenomena, albeit for somewhat different reasons. Arguably, the more bank-based systems of Thailand, Korea and Indonesia had stronger nexus of this sort compared to, say, Malaysia's much more stock market oriented financial system[vii]. With the currency collapses, the assets acquired by short-term portfolio and other investors in the region depreciated sharply in value, precipitating an even greater sell-out and panic, causing herd behaviour and contagion to spread across national borders to the rest of the region. Further property market and stock market collapses followed due to earlier uncoordinated over-building and the property-finance nexus as well as the consequent liquidity squeeze. Thus, financial interests were generally badly hit by this 'triple whammy' from the currency, stock and property markets.

The higher interest rates demanded by the financial markets in 1998 added salt to the wound, but had limited success in attracting short-term capital inflows once again. But even when higher interest rates succeed in doing so, such flows can only be temporarily sustained and retained, at great and permanent cost to productive investments

in the real economy so important for realizing economic growth and development. And when inflows are eventually reversed in the precipitous manner experienced by East Asia from the second half of 1997, much collateral damage to the real economy can be expected – as with the region-wide recession of 1998.

As a consequence of these developments associated with external financial liberalization, Southeast Asia has faced four major domestic policy reform challenges, namely greater exchange rate flexibility, the urgency of financial sector reform, as well as handling asset-price bubbles and current account deficits. Without the advanced economies stabilizing exchange rates with regards to one another, the virtual or quasi-pegging of a developing economy's foreign exchange rate had clearly become very dangerous, as the crisis demonstrated. The continued large movements among the US dollar, the Euro and the Japanese yen threaten the monetary stability desired by countries unofficially pegging their currencies against any one currency, invariably the US dollar except for most former French colonies.

Also, though short-term capital inflows may temporarily supplement domestic savings, the reversal of such flows can create severe disturbances. While such flows may be influenced by economic fundamentals in the long term, they are usually determined by speculative sentiments in the short term. Short-term exchange rate adjustments — with disruptive consequences for domestic prices and wages — are then deemed necessary to stem sudden outflows, but these, in turn, offer opportunities for currency speculators.

Financial sector reform has to be thought of, not primarily with a view towards further liberalization, as usually encouraged, if not insisted upon by international financial interests, but instead, in terms of the prudential regulation needed to anticipate and respond to new challenges. While the problems caused by excessive as well as inappropriate regulation are often emphasized by advocates of liberalization, liberal banking policies have resulted in weak domestic banking sectors[viii] unable to withstand competition from abroad, and even the collapse or costly bail-out of weak banks. For most developing economies, policies of 'financial restraint' are still needed to 'direct' credit[ix] to finance productive investments, especially in priority areas — instead of, say, asset acquisition or consumption purchases (Chin and Jomo 2001).

Recent trends involving greater capital account convertibility, innovative financial instruments, and the proliferation of offshore financial centres, non-bank finance companies as well as 'private banking' also pose new challenges for financial regulation in the face of diminished transparency. Undoubtedly, easy credit, partly due to capital inflows, resulted in meteoric rises in real property as well as share prices desired by most of those involved. Banking regulation to minimize such asset price inflation deserves the highest priority, and is always difficult to achieve in 'good times' without precipitating an asset price meltdown, but was probably easier to achieve right after the asset price bubble had burst.

As in many other fast growth situations, current account deficits came to be considered 'natural' in Southeast Asia in the nineties before the crisis, as they supposedly simply reflected the excess of investments in the national economy over domestic savings. Hence, they were not seen as a cause for major concern in certain policymaking circles. However, their persistence in Southeast Asia became an indicator undermining financial confidence in the region, thus indirectly contributing to the crisis. However, the macroeconomic records of the four economies of Thailand, Indonesia, Malaysia and

South Korea show that despite persistent pre-crisis current account deficits in Thailand and Malaysia, the crises cannot be attributed to macroeconomic profligacy[x] (Jomo 1998). Instead, inappropriate financial liberalization, investor sentiment, herd behaviour, trans-border contagion and the reversal of short-term capital inflows were primarily responsible for the crises throughout the region[xi].

With more foreign bank debt liabilities and greater proportions of short-term debt, Thailand, South Korea and Indonesia were compelled to seek IMF emergency credit facilities and thus became subject to its conditionalities, which clearly exacerbated their economic contractions. While deflationary fiscal and monetary policies were temporarily introduced in late 1997, they were less severe and of shorter duration. Instead, contrarian rhetoric and policy initiatives were probably far more important in exacerbating the economic decline in Malaysia. Thus, financial market expectations also served to exacerbate the crises.

Throughout the region since the crises, there have been ‘fire-sales’ going on at ‘bargain basement prices’, with foreign investments taking up the best assets available for a song. If one accepts that the currency as well as more general financial crisis means that these assets have been grossly under-priced by international standards, one cannot expect any management improvement (Krugman 1998b), given the likelihood that the new foreign owners need not be more efficient to be able to buy up these assets.

The currency and financial crises in Southeast Asia suggest that the region’s economic miracle had been built on some shaky and unsustainable foundations. Recent growth in both Malaysia and Thailand had been increasingly heavily reliant on foreign resources, both capital and labour. Limited investments and inappropriate biases in human resource development had held back the development of greater industrial and technological capabilities throughout the region.[xii] Southeast Asia’s resource wealth and relatively cheap labour sustained production enclaves for the export of agricultural, forest, mineral and, more recently, manufactured products, but much of the retained wealth generated was captured by the business cronies of those in power, who contributed to growth by also re-investing captured resource and other rents in the ‘protected’ domestic economy in import-substituting industries, commerce, services and privatized utilities and infrastructure.

Later, recovery in the region, especially in Korea and Malaysia, was principally due to successful Keynesian reflationary efforts. The recoveries suggest that the emphasis by the IMF and the financial media on the prior necessity of corporate governance reforms has been misguided, i.e. such reforms are not a pre-condition for economic recovery. Instead of the Anglo-American-inspired corporate governance reforms promoted, corporate governance, international financial system and other reforms should create new conditions for renewed growth, development and ‘catching up’.

A Crisis of a New Type

With the benefit of hindsight, it now seems fair to say that no one really anticipated the crisis in East Asia. There were, of course, sceptics who regarded the claims of an East Asian economic miracle as somewhat exaggerated, albeit for different reasons, e.g. because they had not achieved much productivity growth and would eventually run up against diminishing returns (Krugman 1994); others argued that the performances of the

Southeast Asian newly industrializing countries were significantly inferior compared to Japan and the first-tier newly industrializing economies (Jomo *et al.* 1997).

It is now clear that the East Asian crisis differs from conventional currency crisis scenarios in at least several important ways (Krugman 1998a):[xiii]

a) the absence of the usual sources of currency stress, whether fiscal deficits or macroeconomic indiscipline;[xiv]
b) the governments did not have any incentive to abandon their pegged exchange rates, e.g. to reduce unemployment;
c) the pronounced boom-bust cycles in asset prices (real property and stock markets) *preceded* the currency crisis, especially in Thailand, where the crisis began;
d) financial intermediaries have been key players in all the economies involved;
e) the severity of the crisis in the absence of strong adverse shocks;
f) the rapid spread of the initial crisis in Thailand, even to economies with few links or similarities to the first victims.

Very importantly then, the traditional indices of vulnerability did not signal a crisis as the source of the problem was not to be found in the governments *per se* or in national income accounts. The (mainly private) financial intermediaries were 'not part of the governments' visible liabilities until after the fact.' Hence, one cannot adequately make sense of the crisis in terms of conventional currency crisis models (Krugman 1998a).[xv] Instead, Montes (1998) attributed the Southeast Asian currency crisis to the 'twin liberalizations' of domestic financial systems and opening of the capital account, as liberalizing the capital account essentially guaranteed non-residents ease of exit as well as fewer limitations on nationals holding foreign assets, thus facilitating capital flight.

Consequences of International Financial Liberalization

The prevailing system of flexible exchange rates was introduced in the early seventies, inaugurating a new international monetary regime with very mixed consequences. Hence, the current regime is relatively new, only beginning after US President Richard Nixon's 1971 unilateral withdrawal from – and destruction of -- the post-war Bretton Woods' system of fixed exchange rates — which had pegged the US dollar to gold at US$35 per ounce and the ringgit to the US dollar at RM3. Under the new regime, the volume of foreign exchange spot transactions had grown to more than 67 times the total value of the international commodity trade by 1995, or more than forty times the value of all international trade (including 'invisibles' or services).[xvi] Viewed from a historical perspective then, such currency trading is hardly natural, inevitable or even desirable[xvii].

An explosion of international financial flows has followed the substitution of the Bretton Woods system of fixed exchange rates with a new system of flexible exchange rates. Strong speculative motives can generally be ascribed to most such international capital flows. However, the abandonment of fixed exchange rates has also been associated with a retreat from capital controls -- which was the international norm before the seventies -- permitting many investors to diversify to their advantage. In any case, the trend picked up momentum from the 1980s, leading to a US$1250 billion daily foreign exchange market by 1997, and the proliferation of new financial instruments.

With foreign exchange spot transactions now worth so much more than the total value of international commodity trade transactions, the financial sector has become increasingly divorced from the real economy. With the recent proliferation of new

financial instruments and markets, the financial sector has an even greater potential to inflict damage on the real economy. Ever since Lord Keynes advocated 'throwing sand' into the financial system to check the potentially disastrous consequences of unfettered liberalization, Keynesians — and others — have been wary of the financial liberalization advocated by ideological neo-liberals and their often naïve allies. But the lobby for financial liberalization remains much stronger and far more influential, dominating most of the business media and the key financial institutions internationally, especially in the US. More importantly, many of the alleged benefits of financial liberalization have not been realized, as the following summary of findings by Eatwell (1997) shows.

a) Financial liberalization was expected to move resources from capital-rich to capital-poor countries,[xviii] when, in fact, net flows of finance — and of real resources — have been very modest, and mainly toward the capital-rich.[xix] Of course, until the 1997 crises, most net flows to the 'capital-poor' were mainly to 'emerging markets' in East Asia – which, arguably, contributed to asset price bubbles and, eventually, to financial panic as well as currency and stock market collapse.
b) While liberalization was expected to enhance opportunities for savers and lower costs to borrowers, savers have benefited most from higher real interest rates.[xx]
c) The new financial derivatives — expected to improve risk management — have actually generated new systemic risks, especially vulnerable to sudden changes in sentiment.[xxi]
d) Improved macro-economic performance — with greater investment and growth expected from better allocative efficiency — has not been realized; in fact, overall macroeconomic performance has been worse than before liberalization.[xxii]
e) Financial liberalization has introduced a persistent deflationary bias on economic policy as governments try to gain credibility to avert destabilizing capital flows, instead of the supposedly 'healthy discipline' on governments which was expected to improve macroeconomic stability.

Financial markets seem to function in such a way as to impose their own 'expectations' on the real economy, thus defining their own 'fundamentals' and logic, which in turn become self-fulfilling prophecies. In other words, they do not just process information in order to efficiently allocate resources. Since financial markets operate like Keynes' 'beauty contests' and the real economy has no automatic tendency to converge to full-employment growth, the presumptions of market participants are imposed on the economy.

The threat of instability in the now massive capital market forces both government and private investors to pursue risk-averse strategies, resulting in lower growth and employment creation. A deflationary bias in government policy and the private sector emerges in response to the costly risks of violating the rules of the game. This is exacerbated by the high costs of debt due to high real interest rates owing to efforts to maintain financial stability in a potentially volatile world. Thus, 'long term price stability' supersedes a 'high and stable level of employment' as the policy priority. Theoretically, such a monetarily stable system, involving relatively slow growth and high unemployment, can last indefinitely.

Also, a 'sophisticated' liberalized financial system in an 'emerging market', prioritizing flexibility or the possibility of easy exit, is almost necessarily fragile, as reflected in:

a) liquidity crises, reducing real output;
b) private sector risk aversion, encouraging short-termism;[xxiii]
c) public sector risk aversion, resulting in a deflationary policy bias;
d) persistent pressures for ever greater flexibility, increasing the ease of exit.

The benefits that the deregulation of financial controls have brought to 'emerging markets' must therefore be weighed against increased instability due to enhanced ease of exit. While increased flows of (real) foreign direct investment generally require agreement to unrestricted profit repatriation, this is quite different – with different implications -- from the 'instant exit' conditions demanded by financial markets.[xxiv]

There is considerable evidence that, in the longer term, most post-war economic development has been associated with developmental states. Also, the post-war Golden Age — which saw high levels of output and employment as well as short-run efficiency — was premised on active macroeconomic management under the Bretton Woods system. Post-war European reconstruction was achieved with tight capital controls. On the other hand, the recent rush to convertibility and capital control deregulation in Eastern Europe has resulted in Russia becoming a significant net capital exporter![xxv]

Some dangers associated with financial liberalization have now become quite evident, but most are not sufficiently recognized in the public discourse surrounding the subject, let alone debated and addressed. Most initiatives in this regard cannot be undertaken unilaterally without great cost[xxvi]. The very few options available for unilateral initiatives need to be carefully considered, and only implemented if deemed desirable on balance. Selectively invoking instances of bad or incompetent policy making or implementation does not justify leaving things to liberalized markets that render systematic policy-making impossible. Instead, such instances emphasize the importance of creating an environment and developing the capability for good and competent policy to be effective.

Many need to be actively pursued through multilateral initiatives, for which governments usually need the support of regional neighbours and others sympathetic. Given the power of the dominant ideology about the international financial system, it is virtually impossible to assert control over the financial system without a fundamental change in priorities and thinking by the major governments involved. The currencies of a small number of major governments — the US, Japan, Germany and the UK — were involved in over three-quarters of currency transactions in 1995. Thus, acting together, they have the capability to control capital flows.

International Reform?

Liberalization should not be allowed to frustrate the sound development of the financial system and improvements in the productivity of investment. As we have seen, sound macroeconomic fundamentals do not guarantee immunity from contagion and crisis. The scope for monetary independence partly depends on the soundness of macroeconomic management as well as political will.

Financial Liberalization Versus Development

Three closely related arguments involving liberalization and governance have been made (Jomo 1998). First, financial liberalization has undermined previously existing governance institutions and mechanisms without creating adequate alternatives in their

place. Second, domestic governance arrangements, including those involving the financial system, have been shaped or abused by those with influence for their own advantage. Third, in some instances, especially in Thailand, Malaysia and Indonesia, in the absence of adequate crisis response arrangements, official responses have been unduly influenced and compromised by vested interests as well as other considerations (e.g. see Jomo 2001).

The roots of the crisis can usefully be summed up in terms of various challenges of financial liberalization and governance, at both international and national levels. At the international level, governance issues have been raised by the transformation of financial, especially capital markets. Flexible exchange rates and other related developments have increased the scope for and activity in currency speculation. Increased international flows of investment funds have also contributed to currency volatility. Most of these funds are of a portfolio nature, and hence, are more liable to enhance volatility, while the share of foreign direct investments continues to decline.

Financial liberalization has also reduced monitoring and supervision of financial, including banking operations and transactions, including those of a prudential nature. There has also been a significant increase in lending as well as other banking transactions across borders with the proliferation of 'international off-shore financial centres' and other international banking facilities. The still growing dominance of the US dollar in the world economy, especially international finance, despite the creation of the Euro, has also skewed the nature of these developments in important ways.

Liberalization of financial services as well as of investment regulations, including liberalization of the capital account, have otherwise also reduced national oversight and management of financial flows, which created the conditions conducive to the Southeast Asian and South Korean crises. The scope for national macroeconomic — including monetary — management has been considerably reduced by various dimensions of financial liberalization. Options for developmental as well as rentier (Khan and Jomo 2000, especially Chin and Jomo) initiatives have also been significantly reduced as a consequence.

Post-Crisis International Trends

The challenge at the international level is formidable, especially with the vested interests underlying American as well as European positions on systemic reform. Yet, there have been many misgivings elsewhere too about the nature and volatility of the international financial system, with renewed attention to particular aspects with each new crisis. The developing world needs to work with others who are like-minded to draw upon the rich critiques that have developed over the years in developing reform proposals are likely to gain broad international support.

Incredibly, at the September 1997 Hong Kong annual meetings of the IMF and World Bank, the IMF's policy-making Interim Committee — which represents all 181 IMF member countries via 24 ministers — gave the IMF a mandate to alter its Articles of Association so that it would have additional 'jurisdiction' over the capital account as well as over the current account of members' balance of payments, which it has had for many decades.[xxvii]

In December 1997, the World Trade Organization also concluded its financial services agreement that basically commits member countries to scheduled accelerated

liberalization of the trade in financial services. The *Wall Street Journal* noted that the agreement would primarily benefit the United States and Europe since it is most unlikely that the South is in a position to export financial services to the North. It is therefore likely that countries of the South will face even greater problems with their balance of payments as their services, and hence current account deficits worsen. Much of the nascent financial services that have emerged under protection in these countries are unlikely to survive international competition from transnational giants enjoying economies of scale and other advantages.

IMF Reform

There has been widespread international scepticism about the IMF's role in and prescriptions for the ongoing East Asian crisis. Perhaps partly out of force of habit in dealing with situations in Latin America, Africa, Eastern Europe and elsewhere, where fiscal deficits have been part of the problem, the same prescription ('one size fits all') seemed to underlie the IMF interventions in East Asia.

Past IMF consultations with various governments have been unable to prevent major financial turmoil, with the frequency of currency and financial crises increasing, rather than decreasing with financial liberalization in the last two decades. Despite its grudging acceptance of the efficacy of capital controls in Chile, Colombia and elsewhere, the Fund has been reluctant to urge countries to control short-term inflows before a crisis occurs.

Many of its crisis response programmes were pro-cyclically contractionary in consequence, with little regard for the social and other adverse consequences of swallowing its medicine. Thus, what started of as a currency crisis led, partly due to IMF-recommended policy responses, to economic recession. For example, although all the affected East Asian economies had been running fiscal surpluses in recent years (except Indonesia which had a small deficit in 1996), the IMF forced all the governments to slash public expenditure and increase their budgetary surpluses.

There has been considerable doubt as to whether the IMF actually recognized the novel elements of the crisis and their implications, especially at the outset. The apparent failures of the IMF — to anticipate the current crisis in its generally glowing recent reports on the region, and also to stem, let alone reverse the situation despite interventions in Thailand, Indonesia and Korea — have certainly not inspired much confidence. Nor has the fact that though the Philippines had long been under an IMF programme, it was not spared the contagion.[xxviii]

The Fund did not seem to be sufficiently cognizant of the subjective elements contributing to the crisis, and seemed to approach the crisis as if it were solely due to macroeconomic or other weaknesses. For instance, by closing down banks in Indonesia, the IMF undermined the remaining shreds of confidence there, inducing wholesale panic in the process. Also, while the IMF insisted on greater transparency by the affected host government and those under its jurisdiction, it continued to operate under a shroud of secrecy itself.

The IMF's double standards, as reflected by its apparent priority for protecting the interests of foreign banks and governments, has also compromised its ostensible role as an impartial party working in the interests of the host economy. The burden of IMF programmes invariably fell on the domestic financial sector and, eventually, on the public

at large — through the social costs of the public policy response, usually involving bail-outs of much of the financial sector if not the corporate sector more generally — who thus bore most of the costs of adjustment and reform, while commitments to foreign banks were invariably met, even though both foreign and domestic banks may have been equally irresponsible or imprudent in their lending practices[xxix].

Thus, foreign banks emerged from the crisis not only unscathed, but also relatively stronger. Some merchant banks and other financial institutions also made lucrative commissions from marketing sovereign debt as the short-term private borrowings — which precipitated the crisis — were converted into longer-term government-guaranteed bonds under the terms of the IMF programmes. Thus, the bail-out programmes were primarily for the foreign banks, rather than the East Asian economies or people.

The limited willingness of the USA to contribute to the IMF bailout packages to Thailand, Indonesia and South Korea also reflected new US priorities in the post-Cold War context. Despite its own unwillingness to commit more, the US administration also blocked Japanese and other regional initiatives to develop a regional facility for fear that it might enhance the Japanese role and leadership in the region and diminish the US's standing.

However, after the end-October 1997 global stock market panic and then the August 1998 Russian and LTCM crises, the US administration briefly seemed willing to take a leading role despite the limited exposure of US banks to the region. US concerns about a possible global financial meltdown, the US dollar's role as the leading reserve currency and the opportunities for US banks and other investors to take advantage of the situation seem to have influenced this change of stance.

Almost in tandem with financial liberalization, IMF intervention is generally recognized to undermine and limit national economic sovereignty.[xxx] Particularly damning is the clear abuse of imposed IMF conditionalities in the Korean aid package to resolve outstanding bilateral issues in favour of the US and Japanese interests (Chossudowsky 1998). Legislation and other new regulations enabling greater foreign ownership of as well as increased market access to the Korean economy — which have little to do with the crisis or its immediate causes — were forced upon the Korean government. Even more damaging was the further dismantling of many key institutional features that had made possible the Korean economic miracle since the 1960s. Taking advantage of Korean vulnerability, Japanese banks also insisted that the Korean government guarantee repayment as a condition for rolling over Korean short-term debt.

New International Financial Architecture[xxxi]

Governance

Current proposals for reform of international financial governance include the call for a new international institution such as a World Financial Organization (WFO) proposed by the UN's Economic and Social Committee (ECOSOC) in 1998, or a World Financial Authority (WFA) proposed by Lord Eatwell and Professor Lance Taylor. Such a proposal would need to revisit many of the underlying considerations and rationale for Keynes' original Bretton Woods proposals in 1944 as well as the many important lessons from subsequent post-war experience as well as the new challenges raised by recent and proposed measures for further international financial liberalization.

The specific implications of these proposals should be distinguished from the call to establish a permanent United Nations Conference on Finance and Development in conjunction with the 2002 UN conference on 'Financing for Development' to be held in Mexico. A compromise proposal would be to broaden the current mandate of UNCTAD to include finance issues more systematically, although UNCTAD has already been providing some logistical and other support for the increasingly ineffective and marginalized Washington-based G24 on International Monetary and Financial Issues. To be more effective, however, UNCTAD's earlier greater role and influence in advising and supporting the developing countries has to be restored. An even weaker option would be a forum on the same theme comparable to the Financial Stability Forum set up after the serious of international financial crises in 1997-8.

Related to the WFO/WFA proposal, but not necessarily under the same roof, is the need to establish a new international bankruptcy or insolvency mechanism. For guidance, most current suggestions refer to the US Bankruptcy Code for corporations, though others point to the greater appropriateness of the chapter for municipal authorities. There have also been calls for some new arbitration mechanism outside of existing institutions to resolve the range of new problems emerging. Most such calls expect these new institutions to be representative and transparent.

The capacity of the Bretton Woods institutions to respond effectively and appropriately to developmental needs and emergency financing requirements has been subject to much criticism. One important criticism has been a tendency of these institutions to adopt universalistic criteria and solutions in their dealings. Hence, there is now a greater appreciation of and desire for similar institutions at the regional and sub-regional levels. While such arrangements and institutions will undoubtedly bring about some duplication, if not ambiguity, they will also introduce some desirable competition. The IMF, in particular, seems to have resisted such plurality, e.g. the Japanese government's Asian monetary facility proposal of the third quarter of 1997.

New institutional initiatives and roles in crisis management have been increasingly discussed[xxxii]. While Article 8 (2) (b) of the IMF's Articles of Agreement is meant to offer some protection in the event of crisis, it is now widely considered to be too ambiguous for debtor governments to rely upon. Ex ante conditions[xxxiii] – such as binding arbitration procedures (used in some joint venture agreements) or collective action clauses (in the case of government bonds) – might enhance the capacities of debtors and creditors to proceed with orderly workouts. However, most debtor governments are concerned that if they invoke such clauses while other do not, their own subsequent access to international capital markets will become more expensive.

While the IMF is widely regarded as an obvious institution to be involved in many existing international monetary and financial affairs, there appears to be a number of pre-conditions for its role in these regards to be more broadly acceptable. First, it will have to reform its own governance in order to be seen as more legitimately performing this function. The IMF often has a conflict of interest, being itself a creditor, and usually privileging foreign creditors. The GFGI Working Group on Institutional Reform is considering several proposals to develop a mechanism or institution within the IMF that could be more neutral, including:

- create an affiliate in the IMF with its own governance structure (like MIGA);

- create an ombudsman within the IMF, independent of the staff, reporting to the Executive Board, with a dispute settlement capacity -- which can arbitrate impartially amongst parties -- like the WTO's Dispute Settlement Board;
- create a Committee within the IMF with its own decision-making rules, much in the same way as the (unused) Committee on Interpretation in the IMF with its one member, one vote procedure.

Governance of the IFIs needs to be altered to give equal, if not greater voice and voting rights to debtor country representatives. This is likely to be a necessary condition for many other fundamental reforms to the Bretton Woods institutions, which were originally structured by the Anglo-American alliance towards the end of the Second World War at a time when colonial empires were largely still in intact. This will be crucial for the adequate and non-onerous future provision of emergency assistance and restoring development finance flows.

When the current Managing-Director of the Fund came into the job, he voiced sympathy with developing country claims for better representation. Since then, however, the issue has received little attention. Jadhav (2000) has shown how the origins of the Bretton Woods institutions as well as the quota system as well as various historical accidents have resulted in a heavily biased system of voting rights which are unlikely to serve developing country interests unless radically restructured to, among other things, significantly increase developing country seats on the Board besides fundamental quota reform, which is likely to be very difficult to achieve.

Besides unequal voting rights, other factors have also undermined effective participation by developing countries in the IFIs. As with so many other international economic issues, developing country capacity leaves a lot to be desired. Greater demonstrated knowledge of and sympathy for developing countries should be a criterion for recruitment to and appointment of staff, especially at crucial policy-making levels. There is also an urgent need to strengthen capacity building efforts of developing country personnel, especially those involved in negotiations. Pro-active efforts must be taken to ensure greater developing country participation in all aspects of policy-making and implementation. The quality and relevance of IFI work should also benefit from greater appreciation of developing country experience, e.g. with more mid-career staff and consultant hiring, as well as workload reallocations (Evans and Finnemore 2001).

The GFGI Working Group on Institutional Reform (Woods 2001) has strongly endorsed the idea of minority shareholders within the IMF and the World Bank having the right to audit the performance of both institutions at individual country level and that such audits should be open and public[xxxiv]. Analogous to minority shareholder rights in corporate governance, developing country government members of the IFIs would enjoy the following rights:

1. to avoid conditionalities irrelevant to the immediate problems for which they have involved an international financial institution;
2. to maintain some minimum standard of social protection beyond which requirements for adjustment should not be made while adjusting during a crisis;
3. to obtain a statement from the IMF Board (and other relevant international financial institutions) when a standstill on payments is justified[xxxv].

Just before the Prague IMF-World Bank meetings in September 2000, the then new IMF Managing Director announced that countries would no longer be subject to

policy conditionalities. Instead, governments would be presented by the IMF staff with various policy options to choose from. One might add that program design should also include discussion of the likely socio-economic implications of different policy options. However, there is no evidence that this has become IMF policy and cynics suspect that this was a sop to defuse protests.

Crisis Prevention

As noted above, recent trends in the IMF and the WTO after the East Asian crises began are unlikely to make prevention of future crises any easier. By insisting on opening the capital account and allowing unrestricted freedom for trans-border movements of funds, it becomes difficult not only to have measures to prevent financial crises, but also to introduce effective financial safety nets at the national level.

Soon after the East Asian crises, there seemed to be widespread agreement that *short-term capital flows need to be regulated*. But while developing countries currently have the right to control short-term capital flows, the lack of international endorsement for such measures serves as a major deterrent for those considering their introduction.

Developing countries are currently being encouraged to either fix (through a currency board system or even dollarization[xxxvi]) or freely float their currencies, but are being discouraged from considering intermediate alternatives. However, studies have shown that a float system is associated with the same degree of volatility as a fixed system (Akyuz 2000a; 2000b), with the principal difference between the two being that of how external shocks work themselves out. Countries should be allowed to choose their own exchange rate regime, which should not be imposed as an IMF conditionality, for instance.

Since the East Asian crisis, the international discussion on international financial reform to prevent future crises has emphasized questions of transparency and greater supply of information. However, there is no evidence that having more information will be enough to prevent crises. Also, efforts seem to be directed mainly to getting more information from governments, especially from the developing countries, with little done to get information on the various financial markets, especially the most volatile and vulnerable ones such as those involving highly-leveraged institutions and offshore markets.

Also, too little attention has been paid to the policies of the developed countries, especially the major economic powers, despite their impact on exchange rates in the rest of the world, especially in developing countries. Akyuz (2000a) has noted that all emerging-market crises of the last two decades have been associated with large changes in the exchange rates of the major industrial economies. Developing countries seem generally incapable of maintaining exchange rate stability while the major currencies experience big fluctuations.

Hence, *currency co-ordination* among the US, Europe and Japan is desperately needed for the stability of their own currencies as well as other currencies in the world today. Despite frequent G7 meetings, existing arrangements leave much to be desired. Consequently, there are fluctuations of up to 20 per cent within a week. The effects of such huge swings on smaller open economies are not well understood, though they are expected to simply adjust to such changes.

A *global system of prudential controls* should accommodate the existing diversity of national conditions as well as regional arrangements. However, the currently favored approach to prudential regulation is to formulate international standards for countries to implement and enforce. In the recent past, such standards have usually been set by the Bank of International Settlements (BIS), which serves banks in the OECD economies. There are several problems with this approach (Akyuz 2000a; 2000b).

First, such standards do not specifically take into account the risks associated with international lending. Currently, credit rating agencies are relied upon to fill the vacuum, but they have a tendency to be pro-cyclical, thus exacerbating – rather than checking -- fluctuations. Second, the standards have mainly been designed to protect creditors, not debtors, and the countries they belong to. A similar level of exposure may imply different risks to different creditors as well as debtors. Third, the one-size-fits-all approach implicit in setting standards tends to gloss over important variations, thus undermining the efficacy of this approach. Although there is currently agreement that the IMF should not set standards, it is likely to be involved in policing the enforcement of such standards, which would raise similar concerns.

Capital Controls

There are many different types of capital control measures, with different consequences, often varying with circumstances as much as the nature of the instruments. Until capital account liberalization from the eighties, most countries retained some such controls despite significant current account liberalization in the post-war period. Most such measures can only be understood historically, in terms of their original purposes, and there are no ready-made packages available for interested governments.

Economists favoring capital account liberalization have made three main arguments in favor of such a policy. It is argued that capital will tend to flow from capital-rich to capital-poor economies, or between economies with different savings rates, investment opportunities, risk profiles or even demographic patterns. Capital flows thus enable national economies to trade imports in the present for imports in the future, i.e. to engage in inter-temporal trade. Capital flows also allow national economies to offset pressures to reduce imports by borrowing from abroad or by selling assets to foreigners. Such imports and borrowings may be used to enhance national economic output capacity, i.e. a country's ability to increase production in the future. The foregoing arguments are similar to those for international trade liberalization. Foreign direct investment is also expected to involve technology transfer, which should enhance industrial capabilities. Restrictions on capital flows are considered undesirable by advocates of capital account liberalization because they prevent capital from being utilized where it is most demanded.

On the other hand, advocates of capital controls emphasize the adverse effects of free capital flows on national economic policy-making and implementation, or worse still, by undermining economic stability. Any policy intended to restrict or redirect capital account transactions can be considered a capital control. These would include taxes, price or quantity controls, including bans on trade in certain kinds of assets. Hence, there are many different kinds of capital controls, which may be introduced for various reasons. The effects of specific controls may change over time and could become quite different from what may have been intended. The major reasons advanced for the introduction of capital controls have included the following:

1. Achieve greater leeway for monetary policy, e.g. to reflate the economy.
2. Enhance macroeconomic stability by limiting potentially volatile capital inflows.
3. Secure exchange rate stability, e. g. protect a fixed exchange rate or peg.
4. Correct international payments imbalances, both deficits and surpluses.
5. Avoid inflation due to excessive inflows.
6. Avoid real currency appreciation due to monetary expansion.
7. Reduce financial instability by changing the composition of -- or limiting – capital inflows.
8. Restrict foreign ownership of domestic assets, which might cause nationalistic resentment.
9. Ensure the domestic utilization of national savings by restricting outflows.
10. Enable governments to allocate credit domestically without risking capital flight.
11. Enable domestic financial houses to attain scale economies in order to better compete internationally.
12. Facilitate revenue generation, particularly taxation of wealth and interest income; by allowing higher inflation, more revenue can be generated.

Capital controls may well be the most acceptable alternative to the destabilizing effects of capital flows on inadequately regulated financial systems characteristic of developing economies. Effective regulation may be compromised by limited capabilities and experience, inadequate personnel and other resources as well as politically or otherwise compromised regulatory capacity. When a country with a fixed exchange rate experiences a net capital outflow, it can either raise interest rates or devalue. But with a sudden large capital outflow, usually associated with easily reversible capital inflows, either option is likely to exert strong recessionary pressures due to higher interest rates or further capital flight. Monetary contraction may not only dampen economic activity with higher interest rates, but may also adversely affect the economy through the (invariably government-guaranteed) banking system, which may be exposed to foreign borrowings (Kaminsky & Reinhart 1999).

Capital controls may be used to limit capital flow volatility to achieve greater economic stability by checking outflows in the event of crisis or influencing the volume or composition of inflows. Sudden massive capital outflows -- usually attributable to herd behavior -- are more likely to occur in developing countries for various reasons. The greater likelihood of asset price changes to cause further changes in the same direction increases the likelihood of greater volatility as well as boom-bust cycles. Discouraging capital inflows would reduce the quantity of capital that might take flight at short notice. But changing the composition of capital inflows – e.g. to favor foreign direct investments as opposed to more liquid portfolio investments – may well better reduce such instability.

Different types of capital controls may be distinguished by the types of asset transactions they affect as well as by the very nature of the control measure itself, e.g. tax, limit, or ban. Capital controls are not identical with exchange controls though the two are often closely related in practice. Exchange controls mainly involve monetary assets (currency and bank deposits), and may be used to control the current account of the balance of payments rather than the capital account. While exchange controls function as 'a type of limited capital control, they are neither necessary to restrict capital movement

nor are they necessarily intended to control capital account transactions' (Neely 1999: 21-2). Some of the major differences among the types of capital controls involve:

1. *Taxes versus quantitative* controls: Taxes rely on price or market mechanisms to deter certain types of flows. Such taxes may be on certain types of transactions or returns to foreign investment, or may even involve mandatory reserve requirements, which raise the cost of the flows concerned. Quantitative controls may involve quotas, authorization requirements or even outright bans.
2. Controls on *inflows as opposed to outflows*: Limits on inflows may allow for higher interest rates, to check money supply and inflation. Checks on outflows allow lower interest rates and greater money supply than would otherwise be possible, and have often been used to postpone hard choices between devaluation and tighter monetary policy, as with Malaysia's September 1998 controls.
3. Controls on different types of inflows, especially in terms of *expected duration*: Governments may seek to encourage long-term inflows (e.g. foreign direct investment) while discouraging short-term (e.g. bank loans or money market instruments) or easily reversible (portfolio investments) inflows.

It is important to establish at the outset what particular controls seek to achieve. With the benefit of hindsight, it is crucial to determine to what they extent the measures actually achieve their declared objectives as well as their other consequences, intended or otherwise. For instance, it is important to know whether specific controls are meant to avert crisis or to assist recovery. In its *1998 Trade and Development Report*, the United Nations Conference on Trade and Development (UNCTAD) recommended capital controls as means to avoid financial crises. Almost as if endorsing the 1st September 1998 Malaysian measures, Paul Krugman recommended capital controls in his *Fortune* magazine column to create a window of opportunity to facilitate economic recovery — which is a different objective, though some of the mechanisms or processes involved may not be altogether different. On the other hand, Montes (1998) has argued that capital controls and other efforts to prop up a currency under attack are largely ineffective and may actually serve to subsidize further speculative actions.

Jomo (2001) has argued that while too late to prevent the massive capital flight for 14 months from the outbreak of the crisis, i.e. from July 1997 to August 1998, the September 1998 Malaysian currency and capital control measures were probably necessary to check the possibility of further flight with the dollar peg, then intended to raise the ringgit's value and restore monetary stability and greater monetary policy independence. Various analysts suggest that subsequent measures were biased towards 'crony' corporate interests closely connected to the political leadership (Johnson and Mitton, 2001; Aslam 2001). Kaplan and Rodrik (2001) have argued that the September 1998 Malaysian controls averted a looming crisis which they claim had been building up in mid-1998. As they emphasize, the Malaysian policy package was certainly superior to the IMF alternative[xxxvii] -- as imposed in Thailand, Indonesia and South Korea.

International co-operation and co-ordination have often been the best response during such episodes, but are also important for effective prudential and regulatory initiatives as well as to reduce 'policy arbitrage'. Measures to insulate the domestic banking system from short-term volatility through regulatory measures and capital controls as well as stricter prudential regulation for the region.

James Tobin has called for a tax on foreign exchange spot transactions to enable more independent national monetary policy, discourage speculative capital movements, and increase the relative weight of long-term economic fundamentals against more short-termist and speculative considerations. As a bonus, the tax collected would also more than adequately fund the United Nations system and programmes, not leaving it hostage to the whims of US leadership, as has long been the case. Another Nobel Laureate, Lawrence Klein has mentioned two other options to be considered besides the *Tobin tax*, namely *regional monetary arrangements* as well as the introduction of '*circuit-breakers*' into the system — a suggestion also made by the World Bank's then Senior Vice President and Chief Economist, Joseph Stiglitz.

Crisis Management

In managing crises, the recent East Asian experiences highlight the crucial importance of ensuring international liquidity by quickly providing foreign funds to economies experiencing crisis. Currently, such *international liquidity provision* is being frustrated because:

- Multilateral institutions generally do not have the necessary finances readily at their disposal. Although the IMF nominally has the requisite facilities, it lacks the required funds, which have to be raised with the approval and active support of its principal shareholders. Unlike the World Bank, it does not go to financial markets to raise funds. This de facto requirement subjects the process to undue political influence, as was clear in the international financial community's changing responses to the East Asian crises as it unfolded from mid-1997.
- The IMF-imposed policy conditionalities accompanying the provision of such emergency liquidity have also been onerous. The East Asian experiences suggest that these conditionalities actually exacerbated the macroeconomic crises.
- Such funds should be used to support a currency against speculation, but instead, currencies have been allowed to collapse first, with emergency funds going to pay off creditors.

Recent experiences underline the crucial importance of facilitating *fair and orderly debt workouts* to restructure debt payments due. Existing arrangements tend to treat debtor counties as if they are bankrupt without providing the protection and facilities of normal bankruptcy procedures[xxxviii]. With such an internationally credible bankruptcy procedure institutionalized, a debtor would have certain rights, including getting a *temporary standstill* on debt payments, *continued financing* for on-going operations, and *orderly debt restructuring*.

While the IMF's Articles of Agreement allow for such temporary standstills, this has not actually occurred. Despite the IMF's Articles of Agreement providing for a *temporary standstill*, in the recent South Korean case, the creditors got together and struck an agreement with the government after a private meeting, raising three problems:

- The government was thus coerced to take over responsibility for private debt.
- The creditors thus got better debt restructuring terms, whereas debtors would be more likely to get better terms in a bankruptcy court.
- The new finance went to the creditors, instead of supporting the debtor.

Unlike the seventies, when developing country solidarity ensured effective voice and a number of reforms which promised to advance their interests such as the New

International Economic Order, the Global Common Funds and so on, their increasingly divergent interests – real as well as imagined – have been a major stumbling block to more effective collective action to reprioritize development and its implications for the international financial architecture debate. Some major sources of divisions include:
- conditionalities: middle-income countries have been much less willing to accept and more able to resist onerous conditions than lower income countries;
- debt standstills: countries with access to the capital market have different interests from those reliant on official debt.
- the heavily indebted poor countries (HIPC) initiative: middle-income countries have been opposing G7 efforts to deploy net income from borrowing charges paid by them for IFI loans for HIPC debt relief as the richer countries try to minimize their own contributions.

Conclusion

Drawing from the experiences of the 1997-8 East Asian crises, six major lessons for international financial reform can be drawn. First, existing mechanisms and institutions for financial crisis prevention are grossly inadequate. Recent trends in financial liberalization are likely to increase – rather than decrease – the likelihood, frequency and severity of currency and financial crises, as recent experiences suggest. There has been too little done to discourage short-term capital flows and too much emphasis on the expected protection from international adherence to codes and standards[xxxix] (Rodrik 1999). Financial liberalization has also reduced the macroeconomic instruments available to government for crisis aversion, and instead left governments with little choice but to react pro-cyclically, which tends to exacerbate economic downturns. National macroeconomic policy autonomy needs to be assured to enable governments to be able to intervene counter-cyclically to avoid crises, which have had much more devastating consequences in developing countries than elsewhere. Recognition of the exaggerated effects of currency movements at the international level should also lead to greater surveillance and coordination among the three major international currency issuers.

Second, existing mechanisms and institutions for financial crisis management are also grossly inadequate. The greater likelihood, frequency and severity of currency and financial crises in middle-income developing countries in recent times – with devastating consequences for the real economy and also for 'innocent bystanders in the neighbourhood', as in the East Asian crises – makes speedy crisis resolution imperative. There is an urgent need to increase emergency financing during crises and to establish adequate new procedures for timely and orderly debt standstills and workouts[xl]. IFIs, including regional institutions, should be able to provide adequate counter-cyclical financing, e.g. for social safety nets during crises[xli] (Ocampo 2000). Instead of current arrangements which tend to privilege foreign creditors, new procedures and mechanisms are needed to ensure that they too share responsibility for the consequences of their lending practices.

Third, the agenda for international financial reform needs to go beyond the recent preoccupation with crisis prevention and resolution to address the declining availability and provision of development finance, especially to small and poor countries (Mosley 2001; Ocampo 2000) which have very limited and expensive access to capital markets. There is growing pressure on the IMF, in particular, to return to its supposedly 'core

function' of providing emergency credit and 'core competencies (*sic*)' of crisis prevention and mitigation[xlii]. Furthermore, the World Bank and other multilateral development banks have either abandoned or sharply reduced industrial financing, for example, further limiting the likelihood of developing countries securing funding to develop new manufacturing capacities and capabilities. It is now clear that the recent United Nations Conference on 'Financing for Development' in Mexico in March 2002 did not adequately address this challenge despite the promise of the Monterrey Consensus after the modest proposals of the Zedillo group report commissioned by the UN Secretary-General.

Fourth, inertia and vested interests stand in the way of urgently needed international institutional reforms. There is a need to reform the governance of existing international financial institutions to ensure greater and more equitable developing country participation and decision-making -- and hence, ownership – in operations, research and decision-making at all levels in various tasks – old and new – which the new international financial system must begin to address more adequately. There is also a related need to reduce the concentration of power in, and of, some peak institutions, such as the IMF, by delegating authority to other agencies (e.g. WFO or WFA), as well as encouraging decentralization, devolution, complementarity and competition[xliii] (with other IFIs including regional IFIs). The G7 must consult developing countries more seriously in matters of international economic governance to avoid insensitive and potentially disastrous oversights as well as further loss of policy legitimacy (Rodrik 1999).

Fifthly, the reforms should restore and ensure national economic authority and autonomy -- which have been greatly undermined by international liberalization as well as regulation -- which is essential for more effective macroeconomic management and developmental initiative. Policy conditionalities[xliv] accompanying IMF financing must be minimized, if not eliminated altogether. It is now clear that 'one size does not fit all' and imposed policies have not contributed much to either economic recovery or growth (Weisbrot *et al.* 2000), let alone sustainable development. Such ownership will ensure greater legitimacy for public policies and must include regulation of the capital account as well as choice of exchange rate regime[xlv]. Since it is unlikely that international financial reforms in the foreseeable future will adequately provide the 'global public goods' and other international financial services needed by most developing countries, it is imperative that while reforming the international system to more adequately serve their needs, national policy independence is also assured to better address regulatory and interventionist functions beyond global and regional purview.

Finally, there is growing appreciation of the desirability of regional monetary cooperation in the face of growing capital mobility and the increasing frequency of currency and related financial crises, often with devastating consequences for the real economy. It has been argued, for instance, that growing European monetary integration in recent decades arose out of governments' recognition of their declining sovereignty in the face of growing capital mobility, especially as their capital accounts were liberalized (Baines 2002). Instead of trying to assert greater national control, with likely limited efficacy, cooperation among governments in a region is more likely to be effective in the face of the larger magnitude and velocity of capital flows. However, there is no single formula or trajectory for fostering such cooperation, and it is unlikely that such

cooperation can be successfully promoted independently of economic cooperation on other fronts. The existence of such regional arrangements also offers an intermediate alternative between national and global levels of action and intervention, and reduces the likely monopolistic powers of global authorities. To be successful and effective, such regional arrangements must be flexible, but credible, and capable of effective counter-cyclical initiative for crisis prevention as well as management. In East Asia, the Japanese proposal for an Asian monetary facility soon after the outbreak of the Southeast Asian currency crises could have made a big difference in checking and managing the crises, but was blocked by Western opposition. With the growing reluctance in the West – especially the USA -- to allow the IMF to serve as a 'lender of last resort' (as in the recent Argentinian crisis), there should at least be a growing tolerance of regional cooperative arrangements as alternatives.

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Endnotes

[i] In Kaminsky and Reinhart's (1996) study of 71 balance of payments (BoP) crises and 25 banking crises during the period 1970-95, there were only three banking crises associated with the 25 balance of payments crises during 1970-79. However, there were 22 banking crises -- which coincided with 46 payments crises – over 1980-95, which they attribute to financial liberalization from the 1980s, with private lending booms culminating in banking crises and then currency crises.

[ii] In the face of limited information and a novel, rapidly changing situation, such behavior is often considered rational by market players, even if unfortunate.

[iii] Hedge funds may, however, go in different directions, for instance, when one fund's currency sell-off provokes another fund to snap up bargain equities, e.g. foreigners were often persistent net buyers of Japanese stocks throughout the bursting of the bubble there in the 1990s.

[iv] Rather than as part of some grand conspiracy.

[v] Of course, the very existence of that choice may encourage them to stick around in certain circumstances.

[vi] Short-termism — encouraged by financial liberalization — has also accentuated the bias against longer-term productive investments.

[vii] Rapid growth, on the basis of export-oriented industrialization from the late 1980s, gave rise to unregulated financial expansion, which contributed to a property boom and asset price bubbles, both in the more market-oriented or 'Anglo-Saxon' Malaysia as well as the more bank-oriented Thailand.

[viii] As in Chile in the early 1980s.

[ix] These can involve savers being encouraged with tax policies that do not punish them for putting money away. While banks should still make lending decisions based on economic criteria alone, systemic biases towards short-termism need to be mitigated. The government can prioritize and favor certain types of investments by subsidizing them through taxes or loan guarantees for those sectors or activities it deems important.

[x] Since the debt crises of the early and mid-eighties, the cutting of government fiscal deficits had gained top priority at the behest of the Bretton Woods institutions and others.

[xi] Malaysia was less vulnerable thanks to pre-crisis restrictions on foreign borrowings as well as stricter central bank regulation. However, it was more vulnerable due to the greater role of its capital market unlike the other three economies with more bank-based financial systems.

[xii] While the low productivity growth critique popularized by Krugman (1994) may be theoretically and methodologically faulted, there is little doubt that East Asian growth has been helped by high savings and investment rates. While this might give the impression of 'all perspiration, no inspiration', as suggested by total factor productivity (TFP) critics, the dominance of FDI in the internationally competitive export-oriented industries suggests the transfer or import of 'inspiration' embodied in new plant and equipment as well as the necessary technological learning to get the jobs done.

[xiii] Paul Krugman's (1998a) attempt at theoretical catch-up is particularly worthy of consideration in light of his own previous attempts at understanding related international economic phenomena as well as East Asian economic growth. As the crisis is still unfolding, such an attempt can hardly be definitive, especially since we do not even have the advantage of complete hindsight. Yet, as policy is very much being made on the hoof, his attempt to highlight certain relationships may well be illuminating. Hence, Krugman argued that:
'it is necessary to adopt an approach quite different from that of traditional currency crisis theory. Of course Asian economies did experience currency crises, and the usual channels of speculation were operative here as always. However, the currency crises were only part of a broader financial crisis, which had very little to do with currencies or even monetary issues *per se*. Nor did the crisis have much to do with traditional fiscal issues. Instead, to make sense of what went wrong we need to focus on two issues normally neglected in currency crisis analysis: the role of financial intermediaries (and

of the moral hazard associated with such intermediaries when they are poorly regulated), and the prices of real assets such as capital and land.'

[xiv] None of the fundamentals usually emphasized seem to have been important in the affected economies: all the governments had fiscal surpluses and none were involved in excessive monetary expansion, while inflation rates were generally low.

[xv] For Krugman, the crisis was mainly about bad banking and its consequences, and only incidentally about currencies. Krugman (1998a) argued:
The boom-bust cycle created by financial excess preceded the currency crises because the financial crisis was the real driver of the whole process, with the currency fluctuations more a symptom than a cause. And the ability of the crisis to spread without big exogenous shocks or strong economic linkages can be explained by the fact that the afflicted Asian economies were … highly vulnerable to self-fulfilling pessimism, which could and did generate a downward spiral of asset deflation and dis-intermediation.

[xvi] Since trade-related currency trading is greatly exceeded by 'investment'-related currency trading, it is not surprising that the volume of currency trading is so large. One key question is how much of those investment-related trades are 'healthy', 'appropriate', or 'desirable', which is hard to determine. International investors want to hedge their personal income and wealth by spreading their investments across many countries and adjusting them quite frequently as conditions change, thus contributing to market volatility.

[xvii] For most of human history, including that of capitalism, it has not been 'integral to global trade in goods and services', as claimed by then US Treasury Secretary Robert Rubin. In fact, as is well known, various critics have offered various alternatives to the present system such as returning to fixed exchange rates, the gold standard and so on.

[xviii] Recent results show that national savings tend to equate national investment, suggesting that flows of capital to 'the best possible use' are far from universal and much smaller than simple theories predict. Lack of information or other risks and uncertainties tend to reduce cross border capital flows.

[xix] Eatwell suggests a negative correlation between dependence on 'foreign savings' and economic performance. This is true if we do not break down the nature of foreign savings. The numbers are strongly biased by the inclusion of short term money market flows, which may include efforts by governments to prop up their currencies with high interest rates which temporarily suck in money from overseas. Mexico, Brazil, and especially Venezuela typified this a few years ago. If only long term direct investment or equity investment was considered, a lot of poorly performing Latin American economies would be screened out. Southeast Asian countries, especially Singapore and Malaysia, would then rank high on both foreign savings (measured 'appropriately') and economic performance.

[xx] High interest rates have slowed economic growth in the region. They have been intended, in part, to prop up the currencies to maintain confidence but, perhaps more importantly, to allow local companies to pay off their foreign debts. The cost has been slower growth. Liberalization is generally associated with higher interest rates. Lower interest rates could be due to a combination of pegged exchange rates, capital controls, and effective deployment of funds in such economies.

[xxi] One could argue that some of this is the result of greed, stupidity, and lack of education or regulation. If used carefully, derivatives are ultimately insurance contracts.

[xxii] There is evidence of a strong positive correlation between financial openness, foreign investment, GDP growth, and per capita income driven by the performance of the Asian countries.

[xxiii] Due to the separation of ownership and management of portfolio investments, though it may be in the interest of investors to 'buy and hold', it is difficult to write contracts to motivate pension managers, mutual funds, and other intermediaries to stay put.

[xxiv] Of course, liquidity is one of the features that induces otherwise risk averse investors to buy into a situation. Furthermore, in any transaction, there is a buyer for every seller.

[xxv] Of course, capital flight is not an inevitable consequence of financial liberalization, but may reflect the fears and consequent hedging behavior of locals.

[xxvi] As market and other reactions to Malaysian Prime Minister Mahathir's critical remarks about the international financial system made clear.

[xxvii] I am grateful to Anthony Rowley for confirming these details with Kunio Saito, director of the IMF's new Tokyo regional representative office on 17 December 1997.

The executive board of the Fund is currently holding a series of meetings to discuss the detailed implementation of this mandate and will report again to the Interim Committee on the *modus operandi* at the spring meeting. Thereafter, individual member governments have to ratify the change, but a simple majority will be sufficient. In other words, a unanimous vote is not needed to approve the change in the Fund's articles.

However, other colleagues — including Professor Gerald Helleiner of the University of Toronto and Dr Yilmaz Akyuz of UNCTAD — suggest that the situation is not as dire as the above account suggests because the approval process is much more complicated.

[xxviii] Arguably, the Philippines currency has not taken quite as hard a hit, in part because their (colonial-inherited) banking and accounting standards are considered relatively better, but also because short-term capital inflows have been relatively less, given the recentness of its economic recovery.

[xxix] As the Bank of International Settlements (BIS) noted in its January 1998 *Report on the Maturity and Nationality of International Bank Lending* (Raghavan 1998; Vadarajan, 1998), 'In spite of growing strains in Southeast Asia, overall bank lending to Asian developing countries showed no evidence of abating in the first half of 1997.' In the year from mid-1996 to mid-1997, South Korea received US$15 billion in new loans, while Indonesia received US$9 billion. Short-term lending continued to dominate, with 70 per cent of lending due within a year, while the share of lending to private non-bank borrowers rose to 45 per cent at the end of June 1997. The banks were also actively acquiring 'non-traditional assets' in the region, e.g. in higher yielding local money markets and other debt securities. Most of this lending was by Japanese and continental European banks.

[xxx] However, invoking 'national economic sovereignty' may become very dubious when it is clearly hijacked by special interests.

[xxxi] This section draws heavily on Akyuz (2000a; 2000b).

[xxxii] This paragraph draws heavily from my experience in the GFGI working group on Institutional Reform (see Woods 2001).

[xxxiii] Opponents argue that ex ante rules are likely to increase moral hazard and cannot possibly anticipate all aspects of specific situations.

[xxxiv] As noted by the GFGI Working Group (Woods 2001), several existing mechanisms have the potential for development along these lines such as:
- the newly-formed Office of Independent Evaluation (OIE) at the IMF and its potential to play an auditing role;

- a Sub-Committee of the Development Committee of the IMF and World Bank could make a six monthly statement to the Executive Boards;
- the provision for special majorities within the institutions already provides a veto right for groups such as developing countries, e.g. in the IMF, an increase in charges requires a 70% majority. For example, a 'super-majority' could be required for all decisions having significant impact on minority shareholders or on disputes involving over-intrusiveness.
- the development of a transparent procedure for the selection of all senior management positions (since these have a particularly significant impact on borrowing countries).

[xxxv] When the IMF (and other IFIs) does not provide a country in distress with the requisite funds, then 'bailing-in' the international private financial sector becomes unavoidable.

[xxxvi] While acknowledging that money is not just another commodity, the *Wall Street Journal*, for example, continues to promote dollarization and currency boards (instead of central banks), while giving lip service to free floats, as the only viable 'corner solutions', while attacking other international monetary alternatives. Needless to say, it has not acknowledged the advantages that dollar pegs have given to the US, such as having the rest of the world finance its huge deficits.

[xxxvii] Jomo (2001) has argued that while the contractionary December 1997 policy package associated with then Finance Minister Anwar Ibrahim and influenced by IMF advisers undoubtedly exacerbated the subsequent Malaysian recession, Anwar later sought to reverse these policies through expansionary fiscal and monetary measures from mid-1998 before he was sacked for seemingly challenging Prime Minister Mahathir's leadership.

[xxxviii] Henderson (1999) has argued that rather than invoke US bankruptcy procedures for private firms (Chapter 11) (see Cui 1996), the more relevant and appropriate reference point for developing country governments are the provisions for municipal authorities (Chapter 14).

[xxxix] Pistor (2000) has demonstrated that international legal standards are unlikely to have the desired outcomes.

[xl] There is a growing consensus on the need to set up standstill and other procedures for international debt akin to US bankruptcy provisions for corporations and municipal authorities.

[xli] Social safety nets should not be seen as a substitute for social policy, which should be adequate to ensure a decent standard of living within a government's means besides developing human resources for development.

[xlii] Then US Treasury Secretary and former World Bank Vice President and Chief Economist Lawrence Summers is a prominent proponent of this view, e.g. see his speech at the London Business School on 14 December 1999, reported in the *Financial Times* the next day. The full text is available at www.lbs.ac.uk/news-events/scripts/summers.

[xliii] As Ocampo (2000) put it, 'The required financial architecture should in some cases have the nature of a network of institutions that provide the services required in a complementary fashion (in the areas of emergency financing, surveillance of macroeconomic policies, prudential regulation and supervision of domestic financial systems, etc.), and in others (particularly in development finance) should exhibit the characteristics of a system of competitive organizations'.

[xliv] They have been shown to be ill informed, erroneous and irrelevant to the problems at hand, besides exacerbating the crises in East Asia.

[xlv] Interestingly, IMF Senior Deputy Managing Director Stanley Fischer (2001) admits that '*willingly or otherwise*, a growing number of countries have come to accept [the belief that intermediate regimes

between hard pegs and free floating are unsustainable]…. Proponents of the bipolar view – myself included – have perhaps exaggerated their argument for dramatic effect'.