


2000

Constructing the New International Financial Architecture: What Role for the IMF?

Shalendra Sharma

University of San Francisco, sharmas@usfca.edu

Follow this and additional works at: <http://repository.usfca.edu/pols>

 Part of the [Economics Commons](#), [Law and Politics Commons](#), and the [Political Science Commons](#)

Recommended Citation

Sharma, Shalendra D. "Constructing the New International Financial Architecture: What Role for the IMF?" *Journal of World Trade : Law, Economics, Public Policy* 34.3 (2000).

This Article is brought to you for free and open access by the College of Arts and Sciences at USF Scholarship: a digital repository @ Gleeson Library | Geschke Center. It has been accepted for inclusion in Politics by an authorized administrator of USF Scholarship: a digital repository @ Gleeson Library | Geschke Center. For more information, please contact repository@usfca.edu.

Constructing the New International Financial Architecture

What Role for the IMF?

Shalendra D. SHARMA*

I. INTRODUCTION

In his celebrated *Manias, Panics and Crashes*, Charles Kindleberger predicted an historical average of at least one financial crisis per decade.¹ Yet, in Gerard Caprio's memorable phrase, the 1990s have been a period of "boom in busts".² A financial crisis every 24 months—beginning with the speculative attacks against several currencies in the Exchange Rate Mechanism (ERM) of the European Monetary System in 1992–1993,³ followed by the sudden collapse of the Mexican peso in December 1994, and the most recent and protracted: the Asian financial crisis that was set off when the Bank of Thailand devalued the baht on 2 July 1997. The unexpected meltdown of the Thai economy and the contagion (the so-called Asian flu), spread with unprecedented ferocity, and by the end of August, the currencies of three of Thailand's neighbours, Malaysia, Indonesia and the Philippines, had all been devalued substantially. During September and October, the currencies of Taiwan and Singapore came under pressure, and while both countries managed to avoid a full-blown financial crisis, both were forced to devalue their "rock-solid" currencies. Hong Kong managed to maintain its exchange rate peg to the US dollar, but its interest rates soared and its stock market plunged. By early November, the crisis had spread to South Korea (the world's eleventh largest economy), plunging it into a deep recession. Indeed, so severe was the crisis that in a matter of weeks, Asia's high-performing "tiger economies", accustomed to annual growth rates of between 6 and 10 percent, were reduced to "whimpering kittens".⁴ Indonesia's economy (measured in real GDP) contracted by almost 15 percent in 1998, Thailand's by 9.4 percent and Hong Kong, Malaysia, and South Korea each contracted

* Ph.D., Associate Professor and Director of MA program in Asia Pacific Studies, University of San Francisco, sharmas@usfca.edu.

¹ Charles Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises* (New York, Basic Books, 1989).

² Caprio, Gerard, "Safe and Sound Banking in Developing Countries: We're Not in Kansas Anymore" *Research in Financial Services: Private and Public Policy* (1997), No. 9, pp. 79–97.

³ During 1992–1993, the countries of the European Monetary System spent US\$150–200 billion on intervention in foreign exchange markets in an unsuccessful effort to stave off the devaluation of ten European currencies. The crisis brought down the ERM, and forced the United Kingdom and Italy out of the system.

⁴ Malaysian Prime Minister Mahathir Mohamed lamented that "the financial turmoil had reduced the Asian Tigers into 'whimpering kittens' and ... that the massive damage to their economies will take decades to restore": Singapore Straits Times, 3 March 1998, p. 11.

by 5 to 8 percent.⁵ Such sharp swings in GDP are of the same order of magnitude as that which occurred in the United States during the Great Depression in the 1930s.⁶

One year later the financial contagion had spread to Russia.⁷ Under pressure from the United States Treasury, the International Monetary Fund (IMF), on 20 July 1998, approved its portion (US\$ 11.2 billion) of a US\$ 22.6 billion loan package to strengthen Russia's economic programme and help stabilize the rouble.⁸ Although US\$ 4.8 billion was spent defending the rouble, it failed to bolster confidence in the financial markets.⁹ As asset prices and foreign currency reserves continued their free fall, the government finally devalued the rouble by 34 percent on 17 August 1998, and unilaterally imposed controls on capital flows and a 90-day moratorium on the repayment of Russia's foreign financial liabilities. Such arbitrary actions led to further depreciation of the rouble, Russia's loss of access to international capital markets, a virtual collapse of the banking sector and the accumulation of large external arrears.¹⁰ The speed of the Russian collapse brought home the message that no country (not even a nuclear power) was "too-big-to-fail". As investor confidence made an abrupt volte-face in perception of sovereign risk, it triggered a new round of large-scale capital outflows from emerging markets, including Brazil, the world's ninth largest economy (after the G-7 and China), and the other country earlier perceived as "too-big-to-fail".

Although Brazil's ambitious inflation stabilization programme, the Plano Real (introduced in July 1994), had made exemplary progress towards restoring price stability, productivity growth and reducing inflation between 1994–1998 (after decades of out-of-control inflation), it failed to adequately contain the fiscal deficit. The fiscal deficit estimated at 8 percent of GDP in 1998 also contributed to a widening of the external current account deficit to 4.5 percent of GDP in 1998.¹¹ These substantial fiscal and trade deficits and the structure of public debt,

⁵ For details see IMF, *IMF Annual Report: 1999* (IMF, Washington, D.C., 1999).

⁶ For an overview of the Asian crisis see Shalendra D. Sharma, *Asia's Economic Crisis and the IMF Survival*, Vol. 40, No. 2, Summer 1998, pp. 27–52.

⁷ Several factors contributed to this. As Asian banks with losses on lending at home sold their holdings in Russian high-yielding bonds to improve their liquidity position, it put much pressure on the rouble and on the bond market. Overall, roughly US\$ 2 billion invested by Southeast Asian businesses fled Russia. Other contributing factors were a sharp drop in the price of gas and oil (31 percent between January and July 1998), Russia's biggest export, an inadequate tax base, a large fiscal imbalance financed by short-term rouble denominated debt (or GKO's). Further, the failure of the authorities to come to grips with long-standing fiscal problems and to implement structural reforms intensified Russia's problems.

⁸ According to one account, "Nowhere was the US influence more evident than in the decision to bail Russia out. The Clinton administration wanted to keep President Boris Yeltsin and his so-called economic reformers in office. The IMF staff, including Michel Camdessus and Russia expert John Odling-Smee, were reluctant, because they worried they wouldn't be able to monitor how the money would be used. But with its largest donor urging it to go ahead, the IMF had little choice but to agree to pledge \$11.2 billion to a \$22.6 billion Russian rescue." Deepak Gopinath, *Slouching Towards a New Consensus*, Institutional Investor, September 1999, p. 82. Also see, Bruce Bueno de Mesquita, James D. Morrow and Hilton Root, *IMF Loans Must be Linked to Reforms*, Los Angeles Times, 9 April 1999, p. 27; and *IMF Survey*, Vol. 27, No. 17, 31 August 1998, pp. 275–276.

⁹ Some have argued that the rejection by the Duma (Russian Parliament) to accept key fiscal measures in the modified economic program worked out by the IMF and the Russian government in early July was the last straw. See Andrei Illarionov, *The Roots of the Economic Crisis*, Journal of Democracy, Vol. 10, No. 2, 1999, pp. 68–82.

¹⁰ The devaluation exposed the insolvency of the banks by leaving them with dollar obligations on forward contracts many times greater than their capital. For details see *IMF Survey*, Vol. 28, No. 15, 2 August 1999, pp. 241–243; IMF, *World Economic Outlook, 1999*, pp. 55–58 (advance copy available on the internet at www.imf.org).

which makes the government's finances extremely sensitive to changes in short-term interest rates and the exchange rate, made Brazil highly vulnerable to changes in investor sentiment—in particular, the widespread sentiment in financial markets that Brazil's crawling peg was simply not sustainable. To stem the huge outflows of US\$ 12 billion in August and another US\$ 19 billion in September 1998, the Brazilian authorities increased official interest rates to 43 percent and announced several fiscal measures, including substantial spending cuts, to stabilize the real.¹² However, this only brought temporary relief. By late September, Brazil's foreign reserves had dwindled to US\$ 45 billion, below the level of its short-term debt. As the real came under renewed pressure, the Brazilian government sought external assistance. In November the International Monetary Fund (IMF) announced a US\$ 41.5 billion multilateral loan package (with the IMF contributing US\$ 18.1 billion under a three-year Stand-By Arrangement), to sustain the value of the real and help Brazil with its balance of payments problem.¹³ However, failure to reach political agreement on the fiscal adjustment programme prevented congressional approval and further undermined investor confidence. Market concerns were immediately reflected in increased capital outflows, and spreads on Brazil's external debt rose to approximately 1,000 basis points.¹⁴ By early January 1999, Brazil had about US\$ 36 billion in reserves compared to US\$ 70 billion in August 1998. The Standard and Poor's ratings agency downgraded Brazil's foreign debt rating, and the Bovespa, Brazil's leading stock index, fell by 27 percent in a week. As reserves continued to decline, the government was forced to abandon its exchange rate policy and float the beleaguered real on 15 January 1999, just two weeks after President Cardoso's second inauguration.¹⁵

For the G-7 nations and its OECD partners, acting in concert with the IMF, the World Bank and other multilateral financial institutions, "managing" the crises has been both frustrating and extremely costly.¹⁶ If the Mexican rescue package cost an unprecedented US\$ 52 billion (with the IMF and the United States contributing US\$ 17 billion and US\$ 20 billion respectively),¹⁷ between August 1997 to December 1998, the G-7 and its partners had already pledged just over US\$ 200 billion to support Indonesia, South Korea, Thailand, Russia and Brazil, with the IMF contributing an

¹¹ See *IMF Survey*, Vol. 27, No. 23, 14 December 1998; and Rudiger Dornbusch, *Brazil's Incomplete Stabilization and Reform*, Brookings Papers on Economic Activity, Vol. 1, 1997, pp. 367–401.

¹² *IMF World Economic Outlook*, 1999, p. 49.

¹³ For details, see *IMF Survey*, Vol. 27, No. 21, 16 November 1998; *IMF Survey*, Vol. 27, No. 23, 14 December 1998; *IMF Survey*, Vol. 28, No. 6, 22 March 1999.

¹⁴ Also, on 6 January 1999, when Itamar Franco, governor of the state of Minas Gerais, announced a moratorium on debt payments owed to the federal government (totalling US\$ 15 billion), market confidence in the success of Brazil's fiscal stabilization plan waned further. And, when a number of other Brazilian states joined the request of Minas Gerais, the net outflow of capital intensified.

¹⁵ Almost immediately, the real lost over 40 percent of its value. For details, see *IMF Survey*, Vol. 28, No. 3, 8 February 1999.

¹⁶ The G-7 (or Group of 7) countries include the United States, Great Britain, Germany, Japan, France, Canada and Italy. The OECD countries include the G-7 plus 15 other major economies of the world.

¹⁷ The US\$ 20 billion was funded through a conditional collateralized loan funded from the US Treasury's Exchange Stabilization Fund.

unprecedented US\$ 65.3 billion.¹⁸ This amount does not include the additional US\$ 30 billion pledged by Japan under the Miyazawa Initiative.¹⁹ However, despite the huge infusion of capital, the World Bank's December 1999 issue of *Global Economic Prospects* notes that "the effects of the crises of 1997–1999 from East Asia, to Russia and Brazil persist in many aspects. In most developing countries growth remains weak and well below pre-crisis levels".²⁰

The frequency and severity of the crises, the enormous size of the rescue packages, and the realization that such bailouts could not be continued indefinitely finally forced a "reality-check" on the complacent G-7 leaders. President Clinton, who in November 1997 dismissed Asia's financial woes as "a few small glitches in the road", a few months later characterized the "Asian/global crises as the greatest financial challenge facing the world in the last half century".²¹ The urgent task facing the global community, President Clinton, the other G-7 leaders, their finance ministers and senior bureaucrats now argued, was to fix the potential flaws and to create a more equitable, sustainable and stable international financial and monetary system.²² Their collective esprit de corps was lucidly captured by the self-effacing, former United States Treasury Secretary, Robert Rubin, who in his inimitable manner stated that the task before the global community was to construct a "new international financial architecture" that is "as modern as the markets".²³

Rubin's pithy epigram has generated a veritable cottage industry. An ever-growing list of "architects" have come up with proposal after proposal on how to reform the existing regime and construct a new international financial architecture. Indeed, collaborative initiatives have already been unveiled to reduce susceptibility to

¹⁸ Prior to Mexico, the largest IMF stand-by credit arrangement was the US\$ 4 billion agreement with the United Kingdom in 1977. It is important to note that while the IMF and other multilateral institutions provided the rescue packages to ailing Asian economies quickly, the amount and timing of disbursements depended on the countries' performance under IMF agreed reform programmes. Between August 1997 and October 1998, Thailand received some 60 percent of the financing committed for that period by the IMF and the World Bank. Korea received almost 90 percent of financing committed in the very early stages of the crisis. By contrast, official lending to Indonesia was held up after an initial disbursement of US\$ 3 billion in early November 1997, owing to the slow implementation of reforms. IMF disbursements resumed only in May 1998 and were stepped up during the summer after major political reforms took place in the country. For details on IMF lending see *IMF Survey*, Vol. 28, No. 5, 8 March 1999.

¹⁹ The Miyazawa Initiative, announced in October 1998, aimed to aid affected countries restructure corporate debt, reform financial systems, strengthen the social safety net, increase employment and ease business' financial constraints. While the massive injection of capital has slowed the downward spiral, and while there are signs of recovery in some of the hard-hit economies, it is premature to pronounce the crisis over. As of mid-1999, a third of the world's economies were either in recession or experiencing markedly slow growth, and unlike the Mexican peso crisis, recovery this time will most likely be slow and incremental. For an excellent overview see IMF *World Economic Outlook: May 1999* (IMF, Washington, D.C., 1999).

²⁰ World Bank, *Global Economic Prospects and the Developing Countries: 2000* (World Bank, Washington, D.C., 1999) pp. 1–2.

²¹ Quotes cited in CPER Conference Report, No. 6. *Financial Crises in Asia* (London, Centre for Economic Policy Research, 1998) p. 2; and Report of an Independent Task Force sponsored by the Council on Foreign Relations, *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* (New York, Council on Foreign Relations, 1999) p. 23.

²² At the Birmingham summit in May 1998, the G-7 leaders and finance ministers stressed the need for reforming the international monetary system.

²³ Robert Rubin, "Strengthening the Architecture of the International Financial System", public statement delivered at the Brookings Institution, 14 April 1998.

financial crisis, and to deal with it more effectively when and where it occurs. While there is broad consensus on the “motherhood and apple-pie” issues, such as the need to strengthen the global financial system via more intensive surveillance and monitoring of capital markets and country financial sectors (in particular, the banking system), timely dissemination of financial information under internationally agreed standards, and greater transparency in both public and private sector activity (including greater private sector burden-sharing in order to eliminate, or at least keep within permissible limits, the problems associated with “asymmetric information” and “moral hazard”), there is also much disagreement.²⁴ Currently, policy-makers, financial analysts, academic economists and others are engaged in intense debates regarding the merits of capital controls, fixed versus floating exchange rate regimes, and “dollarization”, amongst other issues. Without doubt, the most contentious issue has to do with the role of the IMF. This article provides an overview and critically analyses the debates. Contrary to its many critics, it argues that the IMF’s role must be enhanced. Given its institutional resources, administrative capacity, worldwide membership, broad experience and technical and policy competence, the IMF can play an important role in co-ordinating global economic integration and crisis management.

II. THE IMF AND ITS CRITICS

To critics, the IMF is a Bretton Woods relic incapable of playing a constructive role in the building of the new international financial architecture.²⁵ While its harshest critics want the IMF altogether abolished, others are prepared to live with a severely restricted institution with limited powers and resources. Still, some others have proposed alternatives to the IMF. Among those calling for the IMF’s immediate shutdown is the former US Secretary of State, George Schultz, former Treasury secretary, William Simon, and the former chairman and CEO of Citicorp/Citibank, Walter Wriston. The trio argue that “the IMF’s promise of massive intervention has spurred global meltdown of financial markets [and that] the IMF is ineffective, unnecessary and obsolete and should be abolished”. Similarly, Robert Barro argues that “the IMF can best help the global economy by declaring itself insolvent and going out of business” and Nobel laureate Milton Friedman blames the IMF’s huge

²⁴ Moral hazard refers to a situation where someone can reap the rewards from their actions when things go well, but does not suffer the full consequences when things go badly. Hence, investors do not have to exercise due diligence since they would expect a bailout in the case of default, or for that matter, debtor countries can choose to pursue risky economic policies with the expectation that they will not have to pay the full costs of their debts and investors will not lose the full amount invested if a financial crisis occurs. In the case of the Mexican peso crisis, it was argued, the IMF, by cushioning the losses of imprudent lenders and borrowers with generous “bailout” packages, only encourages reckless behaviour in the future. Asymmetric information emerges when one party to a financial contract does not have the same information as the other party.

²⁵ The IMF, along with the World Bank, was established at Bretton Woods in 1944 to supervise the operation of the system of fixed exchange rates. This system ended in 1971.

bailout packages for “helping to exacerbate the Asian crisis” and calls for its dissolution.²⁶

To these critics the IMF’s most egregious fault is that its policies (in particular, its large rescue packages) undermine market discipline by promoting moral hazard. It is true that bailout packages have allowed errant private creditors (especially big commercial banks) to escape from bad lending decisions at relatively little cost.²⁷ It is also true that financial intermediaries in Asia enjoyed both explicit and implicit government guarantees in case of default (and therefore undertook excessively risky ventures based on the highest possible return rather than expected values), just as creditors ignored information about weak supervisory structures in debtor countries. Yet, the widespread perception that the IMF bailed out all foreign and domestic investors is incorrect. Private creditors (mostly European and Japanese banks) have taken large losses and have had to lengthen the maturities of their claims, and bondholders and equity investors have sustained huge losses in Asia. One recent study has estimated that foreign equity investors as a group suffered potential losses of roughly US\$ 240 billion from the Asian and Russian crises, and the corresponding figures for foreign banks and bondholders were US\$ 60 billion and US\$ 50 billion respectively. Between June 1997 and January 1998, US investors are estimated to have lost about US\$ 30 billion on Asian equities alone.²⁸ Moreover, the moral hazard risk must be balanced against a more deadly financial implosion of the monetary system and systemic spill-over risks and meltdown, and the heavy socio-economic costs of inaction.²⁹ By providing emergency assistance to illiquid but not insolvent borrowers, the IMF prevented costly defaults by avoiding driving previously solvent institutions into bankruptcy and thereby limiting risk to the financial system as a whole. After all, we know from the hands-off strategy during the 1980s debt crisis (where creditors and debtors were left to sort out their problems) that inaction can greatly aggravate the problem. Finally, the assumption that only IMF policies create moral hazard is simplistic. Financial crises, more often than not, reflect misjudgments or “irrational exuberance” and, as Mishkin carefully argues, “asymmetric information problems” that lead investors and banks to underestimate the risks in emerging markets and then to overreact when sentiment begins to change.³⁰ Given these contexts, calls to abolish the IMF is akin to declaring that the US Federal Reserve “should no longer be

²⁶ See George P. Schultz, William Simon and Walter Wriston, *Who Needs the IMF*, Hoover Digest, 1998, No. 2, pp. 7–9; Milton Friedman, *How Asia Fell*, Hoover Digest, No. 2, 1999, pp. 1–4; and Robert J. Barro, *How the IMF Starts Fires it's Supposed to Put Out*, Hoover Digest, 1999, No. 3, pp. 1–4. See also Anna Schwartz, *Time to Terminate the ESF and the IMF*, CATO Institute Foreign Policy Briefing, No. 48, 26 August 1998 (Washington, CATO Institute, 1998).

²⁷ For example, the Mexican rescue package allowed holders of Mexican government securities (*tesobonos*) to get out with little cost.

²⁸ Institute of International Finance, *Report of the Working Group on Financial Crises in Emerging Markets* (Washington, D.C., January 1999). Also Bong-Chan Kho and Rene Stulz, *Banks, the IMF and the Asian Crisis*, National Bureau of Economic Research, Working Paper Series, No. 7361, September 1999.

²⁹ The collapse of a relatively small US hedge fund, Long-Term Capital Management, in August 1998, and the threat of it bringing down a much wider circle of financial institutions, is illustrative. The Federal Reserve moved in time to prevent the contagion.

³⁰ F.S. Mishkin, *The Causes and Propagation of Financial Instability: Lessons for Policymakers* in C. Hakkio (ed.), *Maintaining Financial Stability in a Global Economy* (Federal Reserve Bank of Kansas City, 1997), pp. 55–96.

allowed to lend money during bank runs”—an idea that is “irresponsible” and has serious implications for the global economy.³¹

Sebastian Edwards also wants to abolish the IMF.³² He argues that the Asian financial crisis revealed that the Fund is a secretive, top-down, meddlesome, highly bureaucratized, profligate behemoth that has great difficulty in responding quickly to crises and implementing even the most modest reforms. To Edwards, “what is needed is a set of new, small and efficient multilateral institutions” that can “provide information and act quickly to avert crises”. Edwards proposes the creation of three new small and efficient entities with defined responsibilities to replace the IMF. First, a Global Information Agency to provide timely and uncensored information on each country’s financial health, including the publishing of public ratings of domestic financial systems and the issue of red alerts when countries fail to provide adequate information. Second, a Contingent Global Financial Facility to provide contingent credit lines to countries that, although solvent, face temporary liquidity problems. To be eligible, these countries would have to meet some minimum standards of disclosure and transparency. And third, a Global Restructuring Agency to provide conditional lending and policy advice to crisis countries. However, Edwards’ proposal has the potential to create an even larger bureaucracy with co-ordination and duplication problems. Imagine a scenario where the relatively autonomous agencies, one setting standards for transparency and disclosure and one with little say over the nature of these standards, conditioning its lending on them. This would make the current co-ordination problems between the IMF, the World Bank and other multilateral agencies seem minor.

In his provocative book, financier George Soros has argued that the international financial markets are “coming apart at the seams” creating “a crisis of global capitalism”.³³ He claims that since the private sector has proven to be ill-suited to allocate international credit, it is time to create a publicly funded “international credit insurance corporation”. Under this system, borrowing countries would underwrite the cost of insurance by paying a fee when floating loans, and lenders could buy insurance against default. The idea is that “good” borrowers (those with transparent financial systems), would be able to borrow at lower rates. The Fund would set limits on how much each country could borrow and insure investors against debt default, while shielding solvent borrowers from insolvency contagions (since the Asian contagion wreaked havoc on solid borrowers). It is not clear how the IMF would determine limits on how much could be loaned, or what the appropriate insurance fee would be. Soros will have to provide more specifics for his global central bank (although he does

³¹ Paul Krugman, *The Indispensable IMF* in Lawrence J. McQuillan and Peter C. Montgomery, *The International Monetary Fund: Financial Medic to the World* (Stanford University, Hoover Institution Press, 1999) pp. 200–202. Suffice it to note, the moral hazard argument can be applied on a variety of levels, including the IMF, governments and companies. That is, if we do not need the IMF internationally, should we then not have lenders of last resort domestically. More specifically, should we abolish our national deposit insurance schemes?

³² Sebastian Edwards, *Abolish the IMF*, *Financial Times*, 13 November 1998, p. A1.

³³ George Soros, *The Crisis of Global Capitalism* (Boston, Little Brown, 1998).

not use the term). As it stands now, Soros' idea of an international public insurance corporation seems to be a non-starter.

Jeffrey Garten, Dean of the Yale School of Management, advocates the creation of a global central bank with responsibility for overseeing a new global currency and with wide-ranging powers to engage in market operations by purchasing the government securities of its members when they get into financial difficulties. Its operations would be financed by credit lines from national central banks or drawn from a modest tax on international merchandise transactions and/or selected global financial transactions. Moreover, it would enjoy oversight powers over banks and other financial institutions, establish uniform standards for lending, and be accountable to a committee of governors drawn from the G-7 and eight rotating emerging-market members. Garten writes:

"A global central bank could provide more money to the world economy when it is rapidly losing steam. For example, it could buy the bonds of the Central Bank of Brazil, thereby injecting hard currency into that country when it most needs the help (like right now). It would have the ability to buy a country's debt at steep discounts, a crucial need now because in countries like Thailand and Venezuela debts are piling up and preventing new lending and new investment."³⁴

Garten's global central bank faces two difficult challenges. First, it is not clear if the credits extended by national central banks would be sufficient, and second, the question of how much authority national central banks would cede (or whether they will be willing at all) to a global central bank, and how this political and economic obstacle would be overcome, remains unresolved.

Finally, Henry Kaufman has proposed the creation of a single super-regulator—an "international credit-rating agency"—with broad supervisory and regulatory powers over financial markets and institutions, including the capacity to enforce common prudential standards on financial institutions, and monitor the performance of financial institutions and markets.³⁵ Like Garten's proposal, Kaufman's is short on specifics. It does not spell out the standards or specify how greater transparency and risk management would be enforced. What is clear is that no national government will be willing to cede so much power and sovereignty to international regulators or supervisors. As Barry Eichengreen has aptly noted, at a time when there is little interest in creating new supranational bodies with the power to usurp the traditional prerogatives of nation states, what "such proposals have in common is their impracticality. They have not a snowball's chance in hell of being implemented."³⁶

Surprisingly, one of the IMF's sternest critics, Harvard economist Jeffrey Sachs, prefers reforming the Fund, rather than abolishing it. Sachs asserts that the IMF's

³⁴ Jeffrey Garten, *In This Economic Chaos, a Global Bank can Help*, International Herald Tribune, 25 September 1998, p. 8.

³⁵ Henry Kaufman, *Preventing the Next Financial Global Crisis*, Washington Post, 28 January 1998, p. A17.

³⁶ Barry Eichengreen, *Towards A New International Financial Architecture: A Practical Post-Asia Agenda* (Washington, D.C., Institute for International Economics, 1999) p. 9.

unimaginative “one model fits all prescriptions actually made Asia’s financial turmoil worse”.³⁷ He argues that the problems in Asian economies were “far from fatal”. To the contrary, the economies had deep strengths, such as high rates of savings, budget surpluses, flexible labour markets and low taxation. Hence, “there is no fundamental reason for Asia’s financial calamity except financial panic itself”. In effect, “the crisis is a testament to the shortcomings of international capital markets and their vulnerability to sudden reversals of market confidence”. This problem was made worse by the Fund’s callous overdose of unnecessary conditions: notably, pressing beleaguered governments to raise their existing budget surpluses still higher and to tighten domestic bank credit by increasing interest rates, including the imprudent closing down of several weak (but viable) banks. To Sachs, such ill-advised policies only served to prolong asset-price deflation in real estate and further erode investor confidence. This resulted in the “stampede mentality” with further capital flight and economic contraction.

While there is truth in some of Sachs’ criticism, especially in the context of South Korea,³⁸ the reality is too complex for such generalized criticisms. We now know that these “miracle” Asian economies were not simply mere victims of the sharp shifts in capital flows, but suffered from serious financial sector weaknesses and external-imbalance problems, not to mention non-existent prudential supervision and regulation—a direct result of pervasive crony capitalism. Also, to set the record straight, when Thailand, South Korea and Indonesia approached the IMF, they already had perilously low reserves, and the Indonesian rupiah was excessively depreciated. Under these circumstances the first order of business was to restore confidence in the currencies. To achieve this, interest rates had to be temporarily increased, even if higher interest costs complicate the situation of weak banks and corporations. Once confidence is restored, interest rates can return to more normal levels. Yet, as Sachs asks, why not operate with lower interest rates and a greater devaluation? The answer is simple—the level of devaluations was already excessive.

Reinforcing Sachs’ critique, Martin Feldstein has argued that the IMF’s intrusive policies greatly aggravated the Asian crisis.³⁹ Instead of focusing on balance-of-payments adjustment, the IMF stepped out of bounds (since its charter provides no such mandate) when it began to arbitrarily meddle in the domestic economic affairs of sovereign countries. Insisting on structural reforms which lie beyond its traditional competence in macroeconomic adjustment, the Fund’s misguided domestic structural and institutional reforms measures had adverse consequences, turning a temporary liquidity problem into a country-wide and later region-wide financial meltdown.

³⁷ Quotes are from Jeffrey Sachs, *The Wrong Medicine for Asia*, New York Times, 3 November 1997; *The IMF: Power Unto Itself*, Financial Times, 11 December 1997; and Steven Radelet and Jeffrey Sachs, *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, Brookings Papers on Economic Activity, No. 1, 1998, pp. 1–74.

³⁸ There is agreement that South Korea got into trouble in mid-1997 because its financial sector had incurred short-term foreign debts that far exceeded its foreign exchange reserves. Korea’s problem was one of unsustainable corporate debt and the resultant temporary illiquidity rather than insolvency. In such a context the IMF’s demand for a fundamental restructuring of the Korean economy was not very prudent.

³⁹ Martin Feldstein, *Refocusing the IMF*, Foreign Affairs, Vol. 77, No. 2, March/April 1998, pp. 20–33.

Feldstein notes that Asian economies had prospered for decades despite the structural problems in their economies, and the IMF's intrusive measures (which included among other things "specifying in minute detail such things as the price of gasoline and the manner of selling plywood"), were not a prerequisite to economic recovery. It is not difficult to argue that the IMF went overboard in its demands, especially in Indonesia where the Fund's demands skyrocketed from 15 bullet points in November 1997 to 50 bullet points by the time the second deal was signed on 14 January 1998, to 115 bullet points by the third deal in April 1998.

However, there were equally compelling reasons as to why the IMF opted for the so-called radical surgery. The prevalent view within the Fund was that in this era of high capital mobility and market integration, it was impossible to fix the international financial system without simultaneously fixing the domestic microeconomic structures of crisis-affected countries. Hence, stabilizing a country's financial system necessitated institutional reforms that extended well beyond the traditional monetary, fiscal and exchange rate policies. There was also concern that since the market now knew about the pervasive structural problems, would market confidence be regained without the affected countries agreeing to implement transparent auditing and accounting practices, improve corporate governance and reform (if not dismantle) their shaky banks, finance companies and government monopolies? Suffice it to note, without the IMF's determined intervention, it was highly unlikely that Thailand and Indonesia would close their insolvent banks and finance companies or that South Korea would rein in its greatly over-leveraged and out of control chaebols, or for Indonesia to dismantle the corruption-ridden and inefficient government monopolies in plywood and clove.

The criticism that the IMF's unduly contractionary macroeconomic policies (i.e. its insistence on reduced spending, high taxes and higher interest rates to limit currency depreciation, together with the closure of banks and finance companies) were directly responsible for the bankruptcy of otherwise viable firms, inflation and overall economic slowdown, is debatable. The failure of the currency and equity markets to make the expected quick recovery seems to indicate that the Fund's policies may have made the contraction deeper than necessary. Also, there is some evidence that the bank closures were carried out in an *ad hoc* manner, ignoring issues such as deposit insurance, thereby leading to panic withdrawals of funds and undermining investor confidence. However, the banking problem provided no easy solutions and the Fund had a tough call on its hands. The Asian economies needed to avoid further devaluations and sustain capital inflows to finance their current-account deficits and their large stock of short-term debt (much of it denominated in foreign currency). It is well known that once the market loses confidence in a currency, raising interest rates is the only way to support the currency. In regard to bank closure, Sachs' claim that the IMF's "ill-conceived" closure of banks worsened the crisis is simply wrong. For example, prior to the crisis, Indonesia had anywhere between 270 to 300 banks and finance companies. The evidence indicates that the IMF closed only 16 banks. In hindsight, a compelling

argument can be made that it should have closed even more.⁴⁰ Further, the IMF cannot be placed in a position of providing large-scale funds without ensuring that banks have prudent policies in place. Such open-ended commitments are neither credible nor desirable.

In the light of this complex and difficult background, what grade the Fund gets in dealing with the Asian crisis depends much on the analytical and normative biases of the observer. However, if the real measure of success is based on the actual performance, namely, did the IMF-led rescue packages help restart plummeting economies, then the IMF should be awarded a B+. A recent comprehensive study shows that South Korea and Thailand, which have on the whole been rather successful in implementing the IMF-led programmes, have made favourable economic recovery.⁴¹ Large parts of the economy have stabilized, inflation has fallen sharply and their external position has greatly improved. On the other hand, Indonesia, in part due to the political uncertainty and failure to implement the IMF-sponsored reforms, still faces significant hurdles.

III. THE IMF: BUILDING CAPACITY

While there is broad consensus that the world needs some sort of an institution to mitigate recurrent financial crises, it is not necessary to reinvent the wheel to achieve this goal. Instead of abolishing the IMF, or creating entirely new superstructures, the most prudent is to strengthen the IMF. Thankfully, this fact has not been lost. The United States, the G-7 Executive Directors of the IMF, and the G-22 group of nations (the G-7 and G-22 are the major shareholders of the IMF and World Bank),⁴² acknowledge that the IMF is an important partner and want the institution to play a central role in constructing the global financial architecture. In October 1998, the United States Congress finally approved some \$ 18 billion in much-needed new funding for the IMF. As US Treasury Secretary, Larry Summers recently noted, “events have reaffirmed that the IMF is indispensable. All of us involved with global finance would be breathing less easily this holiday season if the IMF had not taken the steps that it did in response to the crises in Asia and elsewhere.”⁴³

⁴⁰ Lest we forget, Thai banks were permitted to wait for up to two years before reporting non-performing loans, while the Indonesian banks did not have to do any such reporting at all.

⁴¹ See Timothy Lane, Atish R. Ghosh, *et al.*, *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment* (Washington, D.C., International Monetary Fund, Preliminary Copy, 1999).

⁴² The IMF's purpose is to promote international monetary co-operation, exchange rate stability and the expansion of international trade by serving as a short-term lender, providing liquidity for member countries with short-term balance of payment problems. On the other hand, the World Bank role is to provide longer-term development finance. Although the total size of the IMF's quotas increased from about US\$ 9 billion at its creation in 1944 to nearly US\$ 200 billion in 1997, it has declined relative to almost all relevant global economic indicators, whether the size of world trade, international reserves, or international financial flows.

⁴³ Lawrence Summers, “The Right Kind of IMF for a Stable Financial System”, presentation at the London School of Business, UK, 14 December 1999 (www.ustreas.gov/press/release/ps294.htm). The US is the one of the IMF's major financial backers with a quota or “membership fee” that accounts for roughly 18 percent of the total IMF funds. The quota also determines its “drawings” or voting power and borrowing capacity.

While enhancing the IMF capacities will be incremental, over the past several months progress has been made in strengthening the Fund and addressing some of the problem areas identified by the critics. First, the Fund, along with the World Bank, the regional development banks and the Basle Committee on Banking Supervision, are to work on all aspects of improving the banking system, including the carrying out of more intensive surveillance of the financial sectors of member countries and helping members develop the supervisory and regulatory frameworks in conformity with international standards.⁴⁴ Top priority is to be given to reforming the banking sector in emerging market economies by developing standards (in line with the international standards outlined in the Basle Committee's Core Principles for Banking Supervision) in banking supervision, accounting and disclosure, auditing and valuation of bank assets, and in corporate governance.

Second, there is now agreement that the IMF, in collaboration with other institutions such as the World Bank and the Bank for International Settlements,⁴⁵ should closely monitor developments in the global capital markets by keeping a watchful eye on: the risks of potential large reversals of capital flows and the contagion effects; the rapid accumulation of short-term debts; unhedged exposure to currency fluctuations; and the impact of selective capital account liberalization. Moreover, in order to prevent a private debt problem rapidly turning into a sovereign debt problem, measures are to be devised to make capital flows less volatile, the exchange rate regimes more realistic, and domestic asset prices better at reflecting the actual underlying returns and risks.⁴⁶

Third, the Fund is to actively encourage member countries to adopt the IMF's *Code of Good Practices on Fiscal Transparency*, and disseminate reliable, timely and comprehensive fiscal and monetary data, both to the IMF and market participants, by subscribing to the Fund's General Data Dissemination System (GDDS) and the Special Data Dissemination Standard (SDDS). The SDDS has already been amended to include data on reserve-related contingent liabilities, and to provide better coverage of the foreign liquidity position of the corporate and government sectors. Countries subscribing to the SDDS will need to be in full compliance by March 2000.

Fourth, in response to the charges that the IMF's policies encourage moral hazard, the Fund is to consider ways to increase private sector involvement in crisis prevention and especially in burden-sharing, thereby limiting the "exit-option" that removes private sector credit from a distressed economy at the very time the official

⁴⁴ It was recognized that the Basle Committee on Banking Supervision will continue to take responsibility for formulating banking and supervision standards, while the IMF's primary role will be to monitor the adoption and implementation of these standards during its regular Article IV surveillance work.

⁴⁵ The Bank for International Settlements, an international institution based in Basle, Switzerland, acts as a kind of central bankers' bank.

⁴⁶ There was recognition that the monitoring of international capital flows had to be improved. This meant that much better data had to be made available. The Bank for International Settlements (BIS) data, which provided some of the best data on short-term international capital flows, was available only twice a year with a six-month lag. Hence, a foreign exchange crisis could arrive and depart well before these data could even provide a warning sign. It was agreed that the BIS move towards a quarterly data system, with a one-month lag.

governmental and multilateral financial community (e.g. the IMF) are being called upon to inject large doses of public resources.

Fifth, in April 1999, the IMF's Executive Board agreed to provide Contingent Credit Lines (CCL) to member countries. The CCL is an addition to another financial instrument, the Supplemental Reserve Facility (SRF), established at the end of 1997. The SRF is intended for use by member countries already in crisis or facing exceptional balance-of-payments outflow due to short-run speculative attacks. The CCL is intended as a precautionary measure for countries with fundamentally strong policies, but which are at risk of possible contagion.

Sixth, the IMF and other multilateral financial institutions, in consultation with donor and recipient country members, are to design programmes that take better account of the broader structural and institutional environment within which they are implemented. There is to be a greater focus on reforms to reduce trade barriers and unproductive or "market-distorting" expenditures, promote core labour standards and to mitigate the social costs of economic adjustments.

Seventh, there is broad consensus that the IMF—an institution with tremendous clout in the global economy that is underwritten by the world's taxpayers—should not operate behind a wall of secrecy. The IMF has been instructed to move "significantly" towards openness and transparency by the G-7. Specifically, the Fund is now to release a broad array of information on its policies, programmes and objectives, including a more comprehensive summary of countries' accounts with the Fund and all outstanding loans. The establishment of the IMF website (www.imf.org) has already increased accessibility. Currently, users can access a wealth of institutional information and data, including members' financial positions *vis-à-vis* the Fund, numerous letters of intent, Policy Framework papers, speeches by management, the IMF publications database and full texts of hundreds of IMF publications. All of these developments augur well for the future of the international financial and monetary system.

IV. THE IMF: AN INTERNATIONAL LENDER OF LAST RESORT?

More than a century ago, Walter Bagehot explained that a financial system requires a lender of last resort to assist financial institutions in a liquidity crisis.⁴⁷ Bagehot distinguished between liquidity and solvency and provided rules that separated the two. He argued that in a crisis, the lender of last resort should lend freely, at a penalty rate, on the basis of collateral that is marketable in the ordinary course of business when there is no panic.⁴⁸ The collateral requirement separates insolvent from illiquid financial institutions. Banks, in particular, are vulnerable to runs because they

⁴⁷ Walter Bagehot, *Lombard Street: A Description of the Money Market* (New York, Wiley, 1999) (originally published in 1873). Bagehot, of course, was thinking of the Bank of England to act as the lender of last resort to avert the liquidity crises afflicting the city of London in the early nineteenth century. Bagehot argued that the lender of last resort should provide cash without limit to solvent borrowers at a penal rate of interest.

⁴⁸ That is, the collateral should be valued at pre-panic prices.

issue highly liquid short-term liabilities. The penalty rate eliminates subsidies, reduces moral hazard, and reduces reliance on the lender. In a national setting, governments (usually a central bank), generally opt for providing lender-of-last-resort facilities because the public costs of a banking panic are large and because the private sector is unable to fulfil this role since lenders cannot quickly determine how a given shock will affect individual institutions. To limit moral hazard and the use of these facilities, the authorities impose supervisory and regulatory standards and require, through partial deposit insurance and capital adequacy standards, that the private sector shares the cost of risk-taking. Moreover, since a domestic lender of last resort usually has regulatory authority over the commercial banks to which it lends, it can actually increase the supply of domestic money through its operations (e.g., by emitting additional currency to buy government securities). Analysts credit the development of lender-of-last-resort facilities for reducing the frequency and severity of national banking crises.⁴⁹

If a lender of last resort is necessary in a domestic context, isn't an analogous institution necessary at the international level to resolve collective action problems? Despite quota increases and the creation of instruments such as the New Arrangements to Borrow (i.e. the SRF and CCL), the Fund's resources are still minuscule when compared to the sheer volume of private global capital flows. Moreover, the IMF still cannot lend freely (since it cannot create hard currencies) nor quickly (since it must get member approval of, and borrower agreement to, its conditional loan programmes). Given these constraints, some prefer that the IMF should stop pretending to be a lender of last resort and get out of the lending business, allowing private markets to distribute liquidity to solvent financial institutions.⁵⁰ However, most observers agree that the world needs an international lender of last resort, although there is less agreement on who the lender should be and how the lender should operate.

Allan Meltzer has argued that the IMF should be replaced by a "true lender of last resort".⁵¹ He claims that unlike the IMF, a true lender of last resort must employ Bagehot's classic rule: never to subsidize borrowers. Rather, a lender of last resort must lend freely, to temporarily illiquid but solvent financial institutions, at penalty rates and matched by the borrower's best collateral. Deepak Lal argues that the IMF should not serve as a lender of last resort because it cannot distinguish between an illiquid bank and an insolvent bank. Lal notes:

"The IMF can lend only after lengthy negotiations with a country's government and with the approval of its board. It has no way of sorting out the 'good' from 'bad' loans, for instance made by foreign banks to residents in the country, and to liquidate the latter. The lender of last resort function for the money center banks involved in foreign lending must therefore continue to be provided by their parent central bank."⁵²

⁴⁹ Still, episodes like the US savings and loan crisis indicate that good supervision and regulation do not eliminate the need for a lender of last resort.

⁵⁰ Anna J. Schwartz, *Is there a Need for an International Lender of Last Resort*, *The Cato Journal*, Vol. 19, No. 1, Spring/Summer 1999, pp. 1-6.

⁵¹ Allan H. Meltzer, *Asian Problems and the IMF*, *The Cato Journal*, Vol. 17, No. 3, 1998.

⁵² Deepak Lal, *Don't Bank on It, Mr Blair*, *The Spectator*, 26 September 1998, pp. 17-19.

Challenging these assertions, Stanley Fischer, the first deputy-managing director of the IMF, argues that the Fund's powers must be enhanced so it can function as a "true international lender of last resort".⁵³ Fischer argues "that the IMF, although it is not an international central bank, has already undertaken important lender of last resort functions", such as using its own funds to design financial stabilization programmes and organizing international rescue packages (including the prevention of panic-induced declines in the aggregate money supply and contagious spill-overs). While the IMF lacks the powers of a central bank, and does not have the resources to cover all potential foreign exchange obligations, it nevertheless has the capacity to act as a lender to individual countries in specified circumstances. Fischer convincingly argues that the major function of the lender of last resort in modern economies is that of a "crisis manager", a role that does not require large amounts of capital. Indeed, "the lender of last resort need not have the power to create money as long as it can provide credit to the market or to institutions in trouble".⁵⁴ He correctly notes that "panics caused by a demand for currency are rare". More generally, panics takes the form of a bank run (possibly enhanced by contagion), in which deposits shift from those banks and financial institutions deemed unsound to those thought to be healthy. In these cases, creating additional money may be unnecessary. At least in principle, the liquidity can simply re-circulate from the institutions gaining money back to those losing it.

Fischer provocatively adds that more than anything, it is the IMF's inability to act as a reliable lender of last resort that increases moral hazard and investor volatility. In this era of globalization, where adjustment occurs rapidly through the capital account, crises tend to be more systemic and localized. These crises require a lender of last resort because, although lending may have caused the crises, lending is also required to end them. Without a body like the IMF, an *ad hoc* consortium of countries led by the G-7 would have to be pulled together during times of crisis. If past experience is any guide, this consortium would neither act in a timely manner, nor as effectively as the IMF. No doubt, leading the consortium would be the leader of last resort, the United States. The idea that the US act as the world's central banker would hardly be acceptable at home or abroad. Currently, the IMF is the only institution that can co-ordinate large and rapid injections of credit when fast-moving global financial panics hit sovereign nations. Yet, if the IMF is to continue to serve as an informal lender of last resort, its ability to provide liquidity in times of crisis must be strengthened. The Fund, on its part, must make certain that its prescribed standards on improving financial disclosure, supervision and regulation are implemented in both the public and private sectors. Indeed, the new provision that only countries that meet specified standards will be eligible to borrow IMF funds under the CCL, provides incentives for countries to

⁵³ Stanley Fischer, "On the Need for an International Lender of Last Resort", available via www.imf.org/external.no/speeches/1999/010399.htm.

⁵⁴ In theory, the IMF has the means to create unlimited resources through the allocation of special assets, known as special drawing rights (SDRs). Members could vote it the power to create such liquidity in an emergency, although they have not done so to date.

adopt the necessary international standards. Equally important, the IMF must become more selective in its lending, providing funds only when there is a liquidity crisis, that is, when private lenders are unwilling to lend. Already, the Fund's lending under the SRF incorporates Bagehot's classic prescription that crisis lending should be at a penalty rate. The fact that SRF short-term loans made to Korea, Russia and Brazil were subject to penalty rates, and the strict but necessary policy conditionality (which serves as a further element of the penalty), is a welcome sign that the days of moral hazard-free lunches may soon be over.

V. CAPITAL ACCOUNT LIBERALIZATION OR CAPITAL CONTROLS?

Dramatic changes in information and communication technology have transformed the financial services industry and made highly mobile capital a fact of life. Today, private capital which flows to emerging markets comprises a wide range of instruments, including bank deposits, equities, direct investments, corporate bonds and government securities, among others. In recognition of this, over the past two decades the IMF has steadfastly promoted the liberalization of cross-border capital flows.⁵⁵ Just before the outbreak of the financial crisis in Asia, the Interim Committee of the IMF (at its semi-annual meeting in April 1997) proposed that the organization's Articles of Agreement (the basic constitution of international financial relations among the 182 member nations), be amended to include currency convertibility for capital transactions. This view was reiterated in the following months by senior Fund officials, including managing director Michel Camdessus, who stated that capital account liberalization should become one of the IMF's fundamental objectives.⁵⁶

The Asian countries hardest hit by the crisis had all pursued diverse approaches to opening up their capital accounts. Indonesia liberalized outflows in the 1980s and inflows only gradually. In 1989 it eliminated controls on foreign borrowing by banks (but reintroduced them two years later because of concerns of excessive borrowing). Indonesia continued, however, to liberalize inflows to corporations, allowing borrowing for trade finance, sales of securities to non-residents and foreign investment in the domestic stock market. South Korea took a more gradualist approach. It liberalized outflows in the early 1980s, and inflows into its securities markets in the early 1990s. In 1992, for example, non-residents were given limited access to the Korean stock market, and the types of securities that resident firms could issue abroad were expanded. Thailand attracted foreign inflows by offering tax incentives to foreign investors, including the setting up of a special facility in 1992, the Bangkok International Banking Facility (BIBF), in order to enable domestic banks and financial

⁵⁵ Earlier, the maintenance of capital controls was not viewed as inconsistent with the objective of the elimination of foreign exchange restrictions, partly because capital controls were considered necessary for supporting the system of fixed exchange rates.

⁵⁶ Michel Camdessus, "Capital Account Liberalization and the role of the Fund"; text available on www.imf.org/publications.

institutions to borrow from abroad to finance local investment projects and allow foreign investment in Thai securities markets.⁵⁷ By the mid-1990s, Malaysia was home to one of the world's most highly capitalized stock and open financial markets. Not surprisingly, in 1996, almost 60 percent (or US\$ 100 billion) of total capital flows to developing countries went to Asia.⁵⁸

In a dramatic move on 2 September 1998, the Malaysian government abruptly imposed controls on capital outflows in an effort to stop (to use Prime Minister Mahathir Mohamed's words) "rogue foreign speculators" from trying to destroy the Malaysian economy. A series of measures were hastily introduced for containing ringgit speculation and the outflow of capital by eliminating the offshore ringgit market. Also, a temporary (one-year) prohibition was instituted against repatriation of earnings by foreign investors on portfolio investments held in the country for less than one year.⁵⁹ In addition, exporters were required to turn in foreign currency earnings to the central bank in exchange for ringgit at the new pegged exchange rate (3.80 to the US dollar), and citizens were prohibited from taking as little as US\$ 100 out of the country, with the law enforced by random searches at the airport and other exit points.⁶⁰

Malaysia's radical policy response to the crisis, besides bringing sharp rebuke from the Fund and the United States Treasury, also re-ignited an old debate on the appropriate sequencing of reforms, and specifically, on the appropriate timing for liberalizing the capital account. No doubt, economic theory has long recognized the negative effects of exchange and capital controls. By taxing foreign money required to purchase foreign-made goods and services, exchange controls cut the quantity imported and/or raise the domestic relative price of imports. Moreover, exchange and capital controls raise transaction and other trade-related costs, and give rise to negative market perceptions, which in turn makes it costlier and more difficult for the country to access foreign funds. Costs associated with international transactions increase because exchange controls tend to undermine the development of liquid (and efficient) foreign exchange markets, besides postponing necessary adjustments in policies or hampering private-sector adaptation of modern financial instruments. Both types of controls foster evasion and rent-seeking and reduce trade by limiting the transfer of technology, portfolio diversification, managerial expertise and skills through direct foreign investment. Moreover, controls on repatriation of profits and dividends discourages

⁵⁷ In hindsight, the BIBF ended up unintentionally serving as a conduit for local firms to vastly expand their loans from foreign banks. Much of this money went into the real estate sector, creating over-supply. When these investments went sour, bad loans proliferated. The worst part was that most of these loans were denominated in foreign currency, usually with no hedging against currency depreciation. The results were disastrous.

⁵⁸ IMF, *World Economic Outlook: 1999*, note 10 above.

⁵⁹ In February 1999, a system of taxes on outflows replaced the prohibition on repatriation of capital.

⁶⁰ The Malaysian case is quite different from controls on capital inflows as implemented in Chile between 1991 and 1998. Specifically, Chile imposed various restrictions on inflows, including a requirement that a portion of any money borrowed abroad be deposited for a year at the central bank, without interest. In the case of Malaysia, on 4 February 1999, the 12-month holding restriction on repatriation of portfolio capital was replaced with a declining scale of exit levies.

direct foreign investment, reduces inter-temporal trade and limits domestic business opportunities. In the presence of capital controls, financial inter-mediation is less efficient, as savings are not allocated to the most efficient uses and the range of available financial products and services tends to be narrow and of poorer quality.

Yet, a number of distinguished economists (who on principle are supportive of the idea of free capital mobility) have, nevertheless, cautioned that controls help limit volatile short-term capital flows and thereby avoid balance-of-payments crises and limit exchange rate volatility, as well as providing governments with greater independence in determining the interest rate policy. In 1978, Nobel laureate James Tobin proposed “throwing sand in the wheels of short-run capital flows” by imposing a uniform tax (dubbed the “Tobin tax”) on all foreign exchange transactions to reduce the destabilizing speculation in international financial markets.⁶¹ Similarly, MIT’s Rudiger Dornbusch notes that since financial markets are very liquid and react quickly to shocks (while the real economy is slow to react due to price and wage rigidities and investment irreversibility), this “differential speed of adjustment” may induce excess exchange rate volatility (over-shooting, bubbles, etc.), with negative effects on real economic activity. Dornbusch proposes the adoption of measures such as dual exchange rate systems to protect the real economy from the fluctuations in the financial markets. More recently, angered by the “destruction” caused by the Asian financial crisis, Columbia University economist Jagdish Bhagwati (an uncompromising advocate of free trade) accused the “Wall Street-Treasury Department Complex” (which commands tremendous influence over the IMF and the World Bank) of preaching the virtues of unfettered capital flows without highlighting the costs associated with “the inherently crisis-prone nature of freer capital movements”. He noted in particular, that a large influx of capital can lead to over-capacity and speculative bubbles. Bhagwati notes that there is a “difference between trade in widgets and dollars ... many assumed that free capital mobility among all nations was exactly like free trade in their goods and services ... that the gains might be problematic because of the costs of crises was not considered ... [and it is this] original version of the myth which has steadily propelled the IMF into its complacent and dangerous moves toward the goal of capital account convertibility”.⁶² While Bhagwati cautions that countries should “not jump to capital controls”, he notes that “it has become apparent that crises attendant on capital mobility cannot be ignored”. His advice includes:

“For many developing countries today, including India and China, the question is not whether to impose capital controls but whether to drop them. To them, I say: Cease moving towards free capital flows until you have political stability, sustained prosperity and substantial

⁶¹ The Tobin tax would be a small percentage levy (in the order of about 0.1 to 0.5 percent) on all foreign exchange transactions. Tobin argued that such a tax would greatly lessen the profit margins on short-term currency trading (so called “round-tripping”), while having minimal effects on the returns to long-term international investments. For details, see James Tobin, *A Proposal for International Monetary Reform*, (1978) 4 *Eastern Economic Journal* 153.

⁶² Jagdish Bhagwati, *The Capital Myth*, *Foreign Affairs*, Vol. 77, No. 3, May/June 1998, pp. 7–12.

macroeconomic expertise. Concentrate instead on internal reforms such as privatization and external reforms such as freer trade. Allow 'targeted' convertibility for dividends, profits and invested capital for direct foreign investment. It brings capital and skills and is more stable than short-term capital flows. For the countries that had already freed capital flows substantially and are currently afflicted by panic-driven outflows, my advice is the opposite: Do not jump into capital controls."⁶³

On 28 September 1998 (just three days before Malaysia imposed controls) the iconoclastic MIT economist, Paul Krugman posted on his webpage a provocative article justifying the use of controls on capital outflows to combat speculative attacks. While some viewed Krugman's piece as providing intellectual cover for Malaysia's use of controls, Krugman clarified his position a week later in an article aptly titled, "Saving Asia: It's Time to Get Radical".⁶⁴ He argued that since earlier prescriptions, in particular, protecting the currency through sharp rises in interest rates ("the IMF model"), or allowing a sharp depreciation of the exchange rate (advocated by Sachs and others), have not worked, "temporary controls on capital" is the least bad choice, if not the only choice, left to a country desperately trying to halt a financial meltdown.

To Krugman such temporary and "curative" controls should be dismantled once the economy recovers. A host of other distinguished analysts have echoed similar sentiments. Harvard's Dani Rodrik issued an indictment of the IMF's push for unconditional capital market liberalization, arguing that since asymmetric information problems are endemic to financial markets it is time for "the IMF to accept temporary capital controls in the countries that are otherwise following its recipes, so that they, too, can revive their economies".⁶⁵ Princeton University's Alan Blinder (also a former vice-chairman of the Federal Reserve), suggested that emerging economies should not "rush to open capital markets [since] unfettered international financial mobility is not the best system for all countries".⁶⁶ Berkeley's Barry Eichengreen advocated Chilean-style controls on capital inflows to stop the "boom and bust" cycles associated with volatile short-term capital flows, and Joseph Stiglitz, the World Bank's Chief Economist, noted that "volatile markets are an inescapable reality. Developing countries need to manage them. They will have to consider policies that help stabilize the economy ... These could include sound bankruptcy laws and Chilean-style policies that put some limits on capital flows."⁶⁷

It is difficult to gauge to what extent (if any) these criticisms and suggestions forced the IMF to re-evaluate its policies on capital liberalization and capital controls.

⁶³ Jagdish Bhagwati, *Yes to Free Trade, Maybe to Capital Controls*, *The Wall Street Journal*, 16 November 1998, p. A-38.

⁶⁴ Paul Krugman, *Saving Asia: It's Time to Get Radical*, *Fortune*, 7 September 1998, pp. 74-80. In a later article he argued that "sooner or later we will have to turn the clock at least part of the way back to limit capital flows for countries that are unsuitable for either currency unions or free floating". Paul Krugman, *The Return of Depression Economics*, *Foreign Affairs*, Vol. 78, No. 1, January/February 1999, pp. 56-74.

⁶⁵ Dani Rodrik, *The Global Fix*, *The New Republic*, 2 November 1998.

⁶⁶ Alan Blinder, *Eight Steps to a New Financial Order*, *Foreign Affairs*, Vol. 78, No. 5, September/October 1999, pp. 50-63.

⁶⁷ Joseph Stiglitz, *Bleak Growth Prospects for the Developing World*, *International Herald Tribune*, 10-11 April 1999, p. 6.

Based on my interviews with senior Fund officials, two broad perspectives can be discerned. To some, full financial liberalization is still the least bad alternative, because imposing capital controls and limiting capital mobility is no solution to the structural problems underlying many emerging economies. Hence there should not be any retreat from current levels of capital account liberalization and that, if there is, then the Fund should have authority to approve it in advance. Also, some correctly pointed out that the restoration of capital inflows will be crucial in ensuring an early recovery. After all, one reason why Mexico recovered so quickly from the peso crisis was the large foreign investor participation in its export sector. Moreover, capital controls may insulate economies, thereby eroding the incentive to reform. However, others believe in a more gradualist approach. They argue that in order to compensate for financial market imperfections and the reality that adequate domestic regulation in emerging markets will take many years at best, some controls on volatile short-term capital could be permitted to allow “some temporary breathing space in which to adopt and implement sound economic policies and reforms”.⁶⁸ They add that the Fund should allow for a transitional arrangement during which countries would be urged (via a carrot and stick approach) to take concrete steps to strengthen their banking and financial systems. The Fund now appears to favour sequenced capital account liberalization so that long-term flows (such as FDI and term loans) are favoured over short-term equity flows. Also, the IMF’s position of control on capital inflows is neutral, but it remains opposed to controls on outflows. The fund is quick to point out that this policy flexibility “in no way negates the IMF’s position that free capital flows are good for everyone in the long run”.⁶⁹ The new policy position is summed up by deputy-managing director Stanley Fischer:

“Malaysia’s decision to impose controls on capital outflows—and support for the idea among some academics—raises the question of whether such controls will once again become widespread. The IMF’s position has long been that capital account liberalization should proceed in an orderly way: countries should lift controls on outflows only gradually as the balance of payments strengthens; liberalization of inflows should start at the long end and move to the short end only as banking and financial systems are strengthened. We have not opposed Chilean-style, market-based measures to regulate capital inflows at the short end, but they must be considered case-by-case (Chile has recently eased its controls).”⁷⁰

The Fund’s policy position means neither a return to pervasive capital controls nor a rush towards unconditional capital liberalization. Rather, it adopts a prudent policy that recognizes that controls over inflows, particularly those designed to influence their composition, might be justified, but only in countries with appropriate prudential policies. An important lesson of the Asian financial crisis is that capital market liberalization must be undertaken with care. The problem in Asia was

⁶⁸ *IMF Survey*, Vol. 29, No. 2, 24 January 2000, p. 32.

⁶⁹ *IMF Survey*, Vol. 29, No. 2, 24 January 2000, p. 31.

⁷⁰ Stanley Fischer, *Reforming World Finance: Lessons from a Crisis*, *IMF Survey*, 19 October 1998, (special supplement) pp. iii–iv.

not that they liberalized their capital accounts but that the sequencing was wrong and that liberalization was only partial. Most of these countries liberalized short-term capital inflows before foreign direct investment, when they should have done it the other way around. Also, if the domestic financial systems are weak, poorly regulated and subject to institutional distortions, rapid capital account liberalization can lead to excessive short-term borrowing and lending and a build-up of excessive debt burdens, quickly turning liquidity problems into solvency problems. Hence, an orderly and sequenced liberalization until the requisite regulatory institutions are in place is critical. Seen in this context, the Malaysian controls have been a missed opportunity. Rather than utilizing the so-called “breathing space” to make fundamental reforms to its fragile and highly leveraged financial sector, the Malaysian government has done the opposite. Prime Minister Mahathir, besides sacking reform-oriented policy-makers (such as Anwar Ibrahim), has followed policies, including further loosening of non-performing loan classification regulation and the setting of minimum lending targets for banks, that will only serve to exacerbate the underlying structural problems.

While the Fund has appropriately criticized the Malaysian controls, its admittedly neutral stance towards the Chilean controls on capital inflows should not be seen as an endorsement of that approach. As noted earlier, the Chilean controls, or the *encaje*, in effect between May 1992 and May 1998, required anyone borrowing abroad to pay a premium of between 20 and 30 percent of the loan which was to be held at the central bank without interest, for one year. The penalty rate for early withdrawal was 3 percent. The rationale for the Chilean tax was threefold: (1) to prevent overvaluation of the peso, which would have negatively affected the country’s export-oriented growth; (2) to encourage more long-term capital inflows for developmental purposes; and (3) to discourage residents from relying too heavily on short-term borrowing, thereby reducing the problem of maturity mismatch (that is heavy short-term borrowing and long-term lending). When short-term flows dried up in 1998, the premium was reduced to zero. However, what is important to note is that Chile’s unremunerated reserve requirement (URR) on most capital flows was a market-based and non-discriminatory form of capital control with many desirable macroeconomic effects. Therefore, the Chilean controls worked because they were comprehensive and an integral part of broader macroeconomic reforms. Specifically, the Chilean authorities closed all possible loopholes, even to the extent that domestic banks were prevented from writing offshore derivative swap contracts with foreign holders of long-term Chilean debt. Most importantly, Chile could do this because of its strong macroeconomic fundamentals. Its regulation of the financial sector is well developed. It has in place a modern system of prudential banking regulation, effective loan recovery mechanisms and high transparency, disclosure and accountability standards, and a strong and autonomous central bank. Suffice it to note, these preconditions are sadly absent in most emerging economies.

VI. EXCHANGE RATE REGIMES

Countries can choose from among three basic regimes in linking their economies to the international system. (1) They can have a flexible or “floating” exchange rate where governments let their currency float freely in the exchange markets against all other currencies. Even when the exchange rate is flexible in this sense, the government may (usually through the central bank) buy foreign exchange to push up the value of the foreign currency and depreciate the home currency, or sell foreign exchange to push down its value and appreciate the home currency in order to smooth short-term fluctuations in demand and supply, and thus in short-term exchange-rate changes. Such intervention is referred to as a “dirty float”, while the “managed float” means the absence of a specific target for the exchange rate. (2) They can have an intermediate regime or “pegged exchange rate” that can be adjusted or changed through such mechanisms as “adjustable peg” (or fixing the exchange rate, but without any open-ended commitment, to resist devaluation or revaluation in the presence of a large balance of payments deficit or surplus), or pursuant to some pre-determined parameters such as “target zones” (a margin of fluctuation around some central rate) or “crawling bands” (a pre-announced policy of devaluing a bit each week) and other hybrid systems. (3) Countries may also choose a rigidly fixed exchange rate where governments can fix the price of their currency against a specific foreign currency or a basket of foreign currencies. Fixed rates can be managed by currency boards. Unlike a central bank, a currency board issues funds that are fully backed (100 percent) by reserves of hard currency like the US dollar, whereby the domestic currency is freely convertible into hard currency. The exchange rate is fixed by law, not just by a currency market intervention, and monetary policy is targeted strictly on maintaining balance of payments equilibrium with the fixed exchange rate. An extreme form of a fixed exchange rate is the abandonment of a national currency and the adoption of a powerful foreign currency such as the US dollar for domestic use—hence, the term “dollarization”. A country that has official dollarization (such as Panama), besides adopting the US dollar as legal tender, has also eliminated the monetary policy-making role of its central bank. Without a national currency to manage, the country’s monetary policy, is in effect, put into the hands of the United States Federal Reserve.⁷¹

The choice has important consequences for an economy, since the exchange rate is one of the most important price signals. While all three regimes have their strengths and weaknesses, an important lesson of the financial crises of the 1990s is that the fixed but adjustable exchange rate pegs tend to crumble too easily under speculative attacks. Specifically, although adhering to a pegged exchange rate regime can be a successful strategy for controlling inflation, it also has fatal flaws. As Mishkin notes, “under a

⁷¹ Limited dollarization occurs when US dollars circulate alongside a country’s national currency. In this arrangement, the domestic currency continues to serve to some degree as a medium of exchange, store of value and unit of account. Limited dollarization exists in many countries throughout the world, notably in Latin America.

pegged exchange rate regime, when a successful speculative attack occurs, the decline in the value of the domestic currency is usually larger, more rapid and more unanticipated than when a depreciation occurs under a floating exchange rate regime".⁷² In the recent financial crises involving Mexico, Asia, Russia and Brazil, the defence of an exchange rate pegged at untenable levels was at the heart of the problem. Moreover, the worst hit country, Indonesia, saw its currency decline to less than one-quarter of its pre-crisis value in a matter of weeks. Why don't pegs work as well as they used to, and why don't countries abandon them? Most analysts agree that financial globalization and high capital mobility have rendered the operation of intermediate arrangements (in particular, the adjustable peg regime) problematic because rapid flows of large and liquid international capital markets make it exceedingly difficult for authorities to support a peg. Even the most competent central bank finds it difficult to know when to abandon the defence of its currency, or when to call the speculators' bluff. In any case, both strategies carry enormous costs. As Eichengreen aptly notes, "pegged rates create one-way bets for speculators, making sitting ducks of the central banks and governments seeking to operate them".⁷³

What should be done next? It seems that there are two credible choices left: a country can either let its exchange rate float freely or adopt a truly fixed arrangement. However, what is appropriate is difficult to say, because no single currency regime is right for all countries or at all times. Suffice it to note that both options have their pros and cons. While floating rates allow a country to pursue an independent monetary policy, they nevertheless remain at the mercy of the markets. Rapid capital movements can quickly overwhelm emerging markets with limited absorptive capacities. Floating rates can be subject to sharp fluctuations, forcing currencies to "overshoot" the economic fundamentals—thereby pushing a currency far below its underlying economic value—leaving rising inflation, trade deficits, and eroding export competitiveness in its wake. On the other hand, a fixed rate can provide a useful anchor for price stability by linking weak and emerging economies to the large, powerful economies, including reductions in the transaction costs of international trade and investment. However, private capital flows can overwhelm, forcing costly devaluations and re-valuations. A "successful" defence of a fixed rate can often be costly, requiring a country to raise interest rates and/or slow its economy to avoid speculative attacks. The experiences of Hong Kong and Argentina illustrate that even the currency board arrangements are not free from speculative attacks or banking collapse. Currency board pressures in both these countries (especially Argentina) has extracted very high costs in terms of economic growth. While total dollarization almost eliminates the possibility of a currency devaluation and transaction costs associated with international trade and finance with the United States, dollarized economies face similar problems associated with currency board systems. Besides losing

⁷² F.S. Mishkin, "Lessons from the Asian Crisis", NBER Working Paper Series, No. 7102, p. 19.

⁷³ Eichengreen, *Towards a New International Architecture*, see note 36 above, p. 104.

several important policy instruments over policy (for example, no domestic institution can act as the lender of last resort), there is also complete loss of seigniorage.⁷⁴ Moreover, dollarization may be feasible only for small, open economies highly vulnerable to international shocks, and with strong international trade and financial ties to the United States.⁷⁵ Finally, a dollarized economy with a weak banking system may not be able to efficiently channel the capital inflow that inevitably accompanies dollarization, leading to unsustainable lending booms and financial dis-intermediation.

The IMF does not have an official position on its member countries' exchange rate regimes, maintaining that it sees advantages in both fixed and flexible exchange rate systems, depending on a country's economic circumstances. However, if the IMF is to play an important role in shaping the new international financial architecture and build a financial and monetary system with fewer vulnerabilities, it will have to effectively guide countries in adopting exchange rate regimes that are right for them.

⁷⁴ Seigniorage is the revenue (or the profit) a country earns by issuing currency. For example, when the US Federal Reserve issues dollars it buys US Treasury securities in exchange. So when the Treasury makes payments on these securities they go to the Federal Reserve. In turn, the Federal Reserve uses a small portion of these payments to help finance its operations and sends the rest back to the Treasury Department.

⁷⁵ Both the US Federal Reserve and the Treasury have stated that the policies of the United States will not be altered to adapt to the economic considerations of countries that choose to dollarize. So foreign governments considering full dollarization must do so with the understanding that US monetary policy will remain focused on domestic issues.