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# East Asian Crisis - Two Years Later

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## (I)
## Instability of Global Capitalism

The East Asia financial crisis has generated wide spectrum of analysis related to its cause. During the early days of crisis, discussions had focused on macroeconomic fundamentals and structural problems of the countries in question. It was only natural because the G7 and IMF had been operating under the premise that sound macro-policies and liberalized markets were basically what were required to achieve good economic performance. Moreover, since the collapse of Soviet Union in early 1990's, structural reforms to quickly move to the open market economy had been emphasized as appropriate policies along with sound macroeconomic management. This initial reaction was derived from what John Williamson termed the Washington consensus.[1] However, subsequent research had revealed that macroeconomic indicators were generally strong among crisis-hit East Asian countries, although there was individual country variation. Neither market interest rates spreads nor rating by rating agencies gave prior indications of macroeconomic weakness. Indeed, there was structural weakness in corporate or national governance but it

[1] John Williamson, 1990, "What Washington Means by Policy Reform." in John Williamson (ed.) Latin American Adjustment: How Much Has Happened? Washington D.C., Institute for International Economics.

had been there for decades and why it became a problem all of a sudden in 1997 was hard to explain. Even the problems of the financial systems of East Asia had existed for many years and yet there are large numbers of countries that have weak banking systems which were not hit by crisis. As Barry Boswonth, rightly, pointed out, "to generates a crisis of the magnitude of East Asia there is a need to link a weak banking system to some other triggering event." "It was financial liberalization and the effort to link domestic financial markets to those of other countries. Many counties have encountered difficulties in managing this process of financial market reform."[2]

As pointed out by Radet and Sachs,[3] in all of the crisis hit countries during 1994 – 1997, from Mexico to Korea, aggregate short-term debt exceeded foreign reserves by a substantial margin. Gradual recognition of this fact along with the lack of lender of last resort in foreign currencies, in U.S. dollars, in particular, acted as the trigger to subsequent financial panic resembling the domestic bank run.[3] This gap between short-term debt, which was largely debt to nonresidents, and foreign reserves was partially the result of liberalization of capital controls.

Authorities attempted to defend the fixed or quasi-fixed exchange rates by foreign exchange intervention. There are quite a number of economists who have argued that this defense of unrealistic exchange rates was one of the major causes of the crisis. The task force of the Council on Foreign Relations on the future international financial architecture, for example, recommended not to peg the exchange rates and never to provide funds from IMF or G7 to support "unsustainable pegs."[4] It is true that

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[2] Barry Boswonth, "Asian Miracle, Crisis and Recovery." A paper presented at ADBI workshop on Development Paradigms, Dec. 10, 1999.

[3] Steven Radet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects." Brooking Papers on Economic Activity, Jan. 1998.

[4] Safeguarding Prosperity in a Global Financial System: The Future International

there were cases such as Thailand where the exchange rate was overvalued and foreign exchange intervention to support the peg led to depletion of foreign reserves triggering the crisis. However, it was also the fact that the adoption of a floating regime in the midst of, or prior to the crisis in Mexico, Thailand and Indonesia all led to the free fall of the exchange rates significantly aggravating the situation. One might argue that if these countries had floated the exchange rates much earlier, say, at the time when foreign capital had flowed in, the situation would have been different. Is that really the case? Suppose Thailand, for example, had floated the exchange rates in 1994—'95 when there was definitely euphoria about Asia. Had Thai authorities not intervened in the market, the Thai baht would have appreciated more. True, if the market were rational, capital flows to Thailand would have declined taking the exchange rates risk into consideration. My conjecture is that it would not have happened that way.

For economists, particularly those educated under the neoclassical paradigm, it comes natural to assume the rationality of market participants. In reality, it turned out to be more profitable to ride with the herd and try and skillfully manage the boom and bust cycle. Enjoy the boom but jump ship before the other market participants do. In the global economy where interdependence has become very strong and where uncertainty driven by revolutionary technological innovations is large, the assumption of one stable equilibrium is unwarranted. We are under multiple equilibria situation and once we leave the neighborhood of one equilibrium, we are likely to be thrown into a very unstable area. Too much flexibility in exchange rates, in this kind of situation, is not necessarily a blessing. Under the euphonic expectation for the future of the economy, free floating exchange rates may have accelerated, not moderated, the boom resulting in a more serious bursting of the bubble.

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Financial Architecture, Report of an Independent Task Force Sponsored by the Council on Foreign Relations, Institute for International Economics, 1999.

This is not to say that the flexibility is necessarily bad but to assert that price flexibility alone does not, under ordinary circumstances, solve the typical boom and bust cycle that characterizes the virtualized global market. We need to recognize that it is sometimes inevitable to have boom and bust and that the proper mechanism has to be established to minimize the risk of bust developing into systemic collapse of the market. Thus, we are inevitably led to the issue of the interplay between the enormous amount of international capital flows that could reverse its direction in short periods of time in the liberalized markets of emerging economies and the workings of domestic and international financial systems including those of domestic financial authorities and international financial institutions.

It would certainly help if emerging countries strengthened banking and financial systems and corporate governance. Industrial countries should devise prudent regulations for and increase the transparency of lending institutions. International institutions such as the IMF should improve surveillance. However, we know very well that these efforts and improvements do not change the fundamental nature of globalized and virtualized international financial markets that are prone to herding, panics, contagion and boom and bust cycles. The world opinion has certainly moved from market fundamentalism or the Washington consensus of the early days of East Asian crisis to a somewhat more balanced and realistic one.

In this respect, the Finance Ministers Report to the Cologne Summit of June, 1999 was major progress. Haruhiko Kuroda, Japanese Vice Minister of Finance for International Affairs, enumerated three major improvements recommended by the report: first, the emphasis or orderly sequencing in liberalizing capital accounts allowing for the possibility of short-term capital control, second prudent regulation and disclosure of highly levered institutions and third the recognition of the need for private

sector participation. As he stated, it was quite surprising that G7 countries, particularly the U.S., who had long endorsed the Washington consensus, shifted their position dramatically to agree to these recommendations.[5] The severity and contagion of the East Asia crisis was so deep that even those who had been carrying the flag of market fundamentalism were forced to rethink their position. In this context, it is interesting that George Soros, the wizard of globalized financial markets, wrote the book entitled "*The Crisis of Global Capitalism*"[6] where he argued that global markets are inherently instable. Expounding on two basic concepts which he calls "reflexivity" and "fallibility" he leads us to the conclusion that "market fundamentalism is today a greater threat to open society than any totalitarian ideology." Many of other market players do not necessarily agree with him but, at least, they agree that appropriate public infrastructure including tough supervision and oversight of monetary authorities on both lenders' and borrowers' sides needs to effectively complement the market.

However as the immediate crisis receded in 1999 and 2000, the sense of complacency seems to be spreading particularly among private sector people. The discussions and recommendations in G7, G20 and other fora may not lead to any fundamental reforms of global markets but end up in minor interior redecoration of the system. We need to address basic and fundamental issues more seriously in this period of calm because it may very well be the calm between two storms and the next storm could well be bigger than the one we experience during 1994—'99. Due to the ability to access information instantaneously and the tele-communication revolution throughout the world, capitalism is more global and virtualized, and, thus, more unstable and vulnerable to shocks.

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[5] Haruhiko Kuroda, "The Third Way: International Financial System." In Japanese, *The Yomiuri Shinbun*, Nov. 18, and 19, 1999.

[6] George Soros, *The Crisis of Global Capitalism*, New York, Public Affairs, 1998.

In what follows, the paper provides a descriptive account of how emerging market economies, particularly those in Asia, can defend themselves, individually and/or as a group, from the inherent instability of global capitalism. It argues the case for strengthening regional cooperation in Asia, in such areas as regional liberalization/facilitation of trade and investment, development of regional debt markets, enhancement of regional currency cooperation, and creation of a regional cooperative funding mechanism.

## (II)
## Alternative Solutions: An International Lender of Last Resort versus Capital Controls

As has been pointed out by Mervyn King, Deputy Governor of the Bank of England, the two "purist" or logically clean solutions are the creation of an international lender of last resort with free movement of capital or reinstatement of permanent capital controls.[7] He, then, proceeds to conclude that neither one is feasible nor desirable under current international political regime and advocates the muddling through or "middle way." He brushes off the possibility for the creation of international lender of last resort by saying "The basic reason is the maxim: 'it's the politics, stupid.'" Unfortunately, he is right. However, it is probably useful particularly for the countries at the periphery to analyze the very nature of international politics. Since Japan is a little more far removed from the center than the U.K., I may be in a better position than Deputy Governor King in performing this task.

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[7] Mervyn King, "Reforming the International Financial System: The Middle Way." speech delivered to a session of the Money Marketeers at the Federal Reserve Bank of New York on Sept. 9, 1999.

According to Alan Meltzer, the definition of lender of last resort is as follows: "The central bank is called the lender of last resort because it is capable of lending --- and to prevent failure of solvent banks must lend --- in periods when no other lender is either capable or willing to lend in sufficient volume to prevent or end a financial panic."[8]

In the domestic context, it is the central bank as an institution which is the lender of last resort. In the current international context, the IMF or IMF and World Bank combined is not the international lender of last resort. However, if all the G7 countries and IMF are "willing to lend in sufficient volume to prevent or end a financial panic,"[8] they could perform the function of international lender of last resort. Thus, without necessarily creating a world government or a world central bank, we could, if we are willing, form a mechanism around the G7 that could play the role of international lender of last resort. The proper question to ask, then, is why couldn't we, or more precisely, why were we not willing to formalize this mechanism during the East Asian crisis period.

The answer, to me, is very clear. Financial panic for a country or a region is not necessarily the crisis for other countries. True, there is a possibility of contagion. During the 1997 –'99 crisis, the contagion fear became real for the United States after the Russian crisis of August 1998. Until then, though, the East Asia crisis had been an "Asian" crisis which had not affected the countries at the center of global capitalism. As long as the crisis remains country specific, or regional, there is not an urgent political need for unaffected counties to pay the significant cost associated with the playing the function of international lender of last resort. Realism not altruism dictates policy decisions in the G7 and other countries.

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[8] Alan Meltzer, "Financial Failures and Financial Policies." in G.G. Kaufman and R.C. Kormendia(ed.), Deregulating Financial Services: Public Policy Flux, Cambridge, Mass. Ballinger, 1986.
[8] Alan Meltzer, ibid.

Moreover, the crisis of a country or a region may be the opportunity for financial institutions including mutual and hedge funds of countries at the center to increase their profits. In fact, except for the brief period of August 1998 to early 1999, U.S. financial institutions and the U.S. economy have gained significantly from the crisis.

Goerge Soros describes the global system that we currently have as follows: " The global capitalist system is purely functional in nature and the function it serves is (not surprisingly) economic: the production, consumption and exchange of goods and services." "Despite its non-territorial nature, the system does have a center and periphery. The center is the provider of capital; periphery is the user of capital: the rules of the game are skewed in favor of the center."[9]

It is this skewed system or bias toward the center that is the real issue for the countries at the periphery. Being at the periphery, they do not, even collectively, have the political leverage to persuade the countries at the center. They can wait for the next crisis which may really hit the center for countries at the center to come around. Or, they can adopt some defensive mechanism to protect themselves from recurrent crises in this globalized and virtualized world market. There are basically two types of defense, imposition of emergency or permanent capital controls and creation of what King[10] called the do-it- yourself lender of last resort. Both are defensive measures and as such involve efficiency loss in forsaking benefits of a free capital market. However, given the fact that the globalized market, today, is far from perfect and potential damage, both economic and social, from the next crisis may be huge, such defensive measures may be the politically right choices. If it is the politics in countries at the center that hamper purist solutions, countries at the periphery have to opt for the economically second-best and politically clever solutions.

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[9] Goerge Soros, ibid

[10] Mervyn King, ibid.

Malaysian capital control imposed on September 2 of 1998 is, perhaps, a good example of such a defensive measure taken by a country at the periphery that succeeded. Economists trained in the neo–classical paradigm have a built–in bias against capital controls but even those at the IMF had to admit "that controls gave the Malaysian authority some breathing space to address the macroeconomic imbalances and implement banking system reforms."[11] It is true that Malaysia had the national economic rehabilitation plan compiled by National Economic Action Council in early August 1998, a month prior to the imposition of capital controls combined with exchange controls of September 2. The key elements of the plan included the stabilization of the value of the ringgit, recovery of market credibility, maintenance of the stabilization of the financial market, improvement of the economic infrastructure, placing priority on social security policies and rehabilitation of each economic sector. The plan aimed to establish a social safety net and increase the transparency of the nation's economic system–while fending off criticism of cronyism–and to achieve economic efficiency and a healthy recovery of the financial system.

The plans were different from the orthodox IMF prescriptions in two respects. First, they were different from shock therapy à la IMF but took international criticism seriously regarding less cronyism and more transparency. Second, they were quite Keynesian in fiscal and monetary policies as opposed to the monetarist bias of the IMF recommendations. In the midst of strong deflationary pressure coming from the East Asian financial crisis, the adoption of Keynesian policies were quite appropriate. Structural reforms of the financial system that were realistic but implemented aggressively helped, as well. Also, as rightly pointed out by the IMF report, the success of Malaysian policy crucially depended on the

[11] IMF, Staff Report, Country Experiences with the Use and Liberalization of Capital Controls, Jan. 2000.

effectiveness of controls. The competence of the central bank, the Bank Negara, and existence of necessary monitoring mechanisms were necessary conditions to ensure effective control. “The controls were wide–ranging and combined capital controls with exchange controls, but without restricting payments and transfers for current international transactions and foreign direct investment.” “Practically all legal channels for a possible build up of ringgit funds offshore were eliminated. Offshore ringgit were required to return onshore, limits were imposed on imports and exports of ringgit currency, the use of ringgit currency in trade payments and offshore trading of ringgit assets were prohibited, and transfers between external accounts of nonresidents and ringgit credit facility between residents an nonresidents were prohibited.” Also with other supplementary measures, the ringgit was effectively insulated from the rest of the world and the exchange rate was fixed at 3.8 ringgit per U.S. dollar. The IMF noted “Since the introduction of controls, there have been no signs of speculative pressures on the exchange rates despite the marked relaxation of fiscal and monetary policies to support weak economic activity. Nor have there been signs that a parallel or non-deliverable forward market is emerging; and no significant circumvention efforts have been reported.”[12]

Not all the countries at the periphery have the necessary infrastructure to erect effective capital and exchange controls without the spread of corruption. Malaysia did have it but also the global financial crisis ended in 1999, and improving international conditions helped Malaysia. However, it is a fact that defensive capital and exchange controls in the mist of financial crisis worked successfully. In addition to Malaysia, Singapore has maintained a policy of insulating it domestic currency from the rest of the world for many years. And as can be evidenced from Singaporean experience and the most recent Malaysian reality, this does not imply the country has to completely close its doors to the rest of the world. Trade, direct investment and portfolio investment in those countries

[12] IMF, ibid.

have taken place extensively and it is not accurate to call Singapore and Malaysia closed economies.

Of course, this is just one of many defensive policies that could be implemented by small "open" economies but what this example shows us is that in the absence of a true international lender of last resort, the countries at the periphery could opt to insulate their economies in some selected areas and still reap the benefit of free flows of goods and services. Believers in market fundamentalism often preach that it is an all or nothing situation. That is not certainly the case. Countries could or, perhaps, should opt for partial liberalization depending upon their size, development stage, and their social and political environment. In his respect, Dani Rodik is right in arguing against capital account convertibility.

"One wonders which of the ills of international capital markets the proposed medicine (capital account convertibility) will remedy. Will the African countries get the foreign capital they need if they remove capital controls? Will "emerging markets" be less at risk of being flooded with foreign capital when such flows conflict with the domestic goals of inflation control or of maintaining a competitive exchange rates? Will sudden reversals become less likely than before? Will contagion across countries be less severe? Will more of the inflows take the form of long–term physical investments rather than short–term flows?"[13]

"It is not that capital controls are necessarily the answer to these problems; they are not. But capital–account liberalization fits the bill less." To use the King's term, defensive 'middle–way' policy vis-à-vis capital and exchange controls is perhaps the appropriate second best solution for many emerging countries.

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[13] Dani Rodik, " Who Needs Capital-Account Convertibility " Feb. 1998, to be published in Peter Kenen (ed.), Essay in International Finance, Princeton.

## (III)

## Regional Capital Markets Development and Currency Arrangement

In his recent speech, Lawrence Summers, U.S. Treasury Secretary, rightly argued for "a greater focus on the strength of national balance sheets."[14] I agree in view of our experience from the East Asian crisis. He states: " The IMF should actively promote a more fully integrated assessment of a country's liquidity and balance sheet. Governments need to think long and hard about their approach to financial liberalization -- and, in particular, the danger of opening up to short-term capital in the presence of too many domestic guarantees. And they need to manage the government's own debt in a way that best insures them against future risks. The most sophisticated debt managers are not those who achieve the lowest possible cost of borrowing." It is quite interesting that U.S. Treasury Secretary came around to the reference to the "danger of opening up to short-term capital," but he is right that national debt management or asset, liability management including short-term capital is one of the crucial elements of the East Asian crisis. As a matter of fact, Donald Tsang, Hong Kong's Financial Secretary wrote in the midst the crisis, December, 1997 as follows; " The Asian currency problem is essentially one of funding mismatch compounded by ineffective intermediations."[15] It was, indeed, the currency and maturity mismatch that led to the deterioration of balance sheet of crisis countries. In the case of Thailand and Korea, short-term bank or non-bank financial institutions' borrowings denominated in U.S. dollars were the problem while it was short-term corporate U.S. dollar borrowing in Indonesia. As Summers suggests, IMF surveillance of countries liquidity and balance sheet is useful but the question is whether

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[14] Lawrence Summers, " The Right Kind of IMF for a Stable Global Financial System." Speech at the London School of Business, London, Dec. 14th, 1999.
[15] Donald Tsang, " The Asian Debt Market." Asiaweek, Dec. 19, 1997.

a satisfactory compilation of private sector balance sheets including their off-shore and off balance transactions is possible or not. If capital and exchange controls are effectively implemented, these statistics will be collected and scrutinized. Or if there are legal reporting requirements with penalties, the compilation of statistics is theoretically possible. Short of such controls and reporting requirements, however, the role of authorities would be more indirect.

As has been pointed out by Donald Tsang "Despite generally strong economic fundamentals, high savings and prudential fiscal policy among its economies, Asia traditionally invests most of its savings outside the region, mainly in OECD markets. Funds flow back to Asia in the form of foreign direct investment and portfolio investment. Indeed, most of Asian's official foreign reserves are invested overseas in long-term instruments, while coming into Asia are bank loans, direct and portfolio investment, which are largely short-term."[15] This is because there are no deep and resilient debt markets in Asia and because the U.S. and other OECD countries are the center of global capital markets. Moreover, most of Asian investments overseas are in U.S. dollars or lately some of them in euro and yen and a substantial part of re-flow is denominated in U.S. dollars. This is because the U.S. dollar is the key currency.

Indeed, during the years preceding the crisis, inflow of funds to crisis hit countries far exceeded outflow. For the five Asian countries, South Korea, Indonesia, Malaysia, Thailand and Philippines, inflows of capital increased from U.S. $47.4billion in 1994 to $92.8 in 1996 outflows. Foreign reserves increased from $22.9 in 1994 only to $37.9 in 1996. In 1996, the inflow through commercial banks and non-bank private corporations which are mostly short-term amounted to $74.0 out of total of $92.8.

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[15] Donald Tsang, ibid.

However, looking at the post crisis situation, it remains the structural characteristic of East Asia that the region supplies a substantial amount of liquidity to the world. Thus, it becomes incumbent for the region, first, to avoid excessive swings in capital flows that generate boom and bust cycles and to use abundant regional liquidity to smoothly provide necessary capital needs of the region. One obvious solution to this situation is to create a well functioning capital market or more specifically debt markets in the region. During the crisis Tsang advocated the use of International Financial Institutions such as the World Bank and Asian Development Bank. He argued that high quality debt paper by them in Asian markets be used to supplement liquidity to crisis hit countries. The Japanese government in the second phase of the New Miyazawa Initiative provided Japanese government funds and funds through the Japan Fund in the Asian Development Bank to partially guarantee sovereign debts issued by Asian countries.[16] Both of these initiatives were intended to use limited public funds to kick-start private markets for debt in the region.

One result of the failure to develop well-functioning capital markets is that mobilization of Asia's enormous savings has been left to domestic and foreign banks, supervision of which has not necessarily been adequate. Bank managers and supervisors have been given responsibility for monitoring the asset management of these resources, but in the absence of sufficient market checks, the quality of this monitoring has turned out to be poor. Maturity transformation and the currency composition of assets and liabilities have been especially problematic. Development of medium-to long-term debt markets denominated in domestic or non-U.S.-dollar currencies would have contributed much to avoiding excessive exposure to short-term U.S. dollar liabilities.

The crucial question that arises, then, concerns the impediments to

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[16] See the Appendix, " Resource Mobilization Plan for Asia --- The Second Stage of the New Miyazawa Initiative ---."

establishing medium-to long-term debt markets in Asia. Let me use the example of Japan in examining this important issue. Japan is probably the country with the most fully developed government debt market in the region, but it lags substantially behind London and New York in terms of infrastructure. As of fiscal 1999, tax barriers, such as the withholding tax and securities transaction tax, was eliminated, at least for Japanese government bonds, or JGBs.

Nevertheless, quite a number of issues still need to be pursued further. First, competitive auctioning of 10-years JGBs, the core product of the JGB market, still accounts for only 60% of the total. Full-scale competitive auctioning needs to be implemented quickly. In addition, we are starting to issue a five-year note to serve as a benchmark medium-term note –something which has not been done in the past because of the conflict with the financial debentures of the long-term credit banks. More importantly, the reopening of various issues to increase the volume of one issue is badly needed to give greater depth to the market.

Another issue requiring quick resolution involves settlement and clearance. Real-time settlement is a necessary ingredient in truly global transactions. The Bank of Japan's settlement system needs to be made compatible with Euroclear, for example, and a regional clearance system connecting Tokyo, Hong Kong, Singapore, Sydney and other Asian markets needs to be quickly established. Needless to say, repo and futures market development should also be encouraged, both in Japan and elsewhere in the region.

Financial intermediation in the Asian countries, including Japan, has characteristically been dominated by banks, a situation that has tended to delay the development of bond markets, essentially because bonds are a close substitute for bank lending. Thus, the creation and nurturing of well-functioning capital markets would imply some

fundamental restructuring of the banking operations in these countries. Rather than adhering to their traditional lending business, the banks should be encouraged to increase their participation in fee businesses and market-oriented operations. The securitization of loans and dealing and trading by banks in government as well as private securities markets and foreign exchange markets should also be encouraged and promoted. Market making by the principal dealers, including banks, is a crucial element in the development of efficient securities and foreign exchange markets.

Although I have been brief and have limited my comments primarily to the Japanese situation, many of the same things can be said of other Asian countries. I might add that the capital markets, whether in Tokyo, Hong Kong, or Kuala Lumpur, should be closely linked, and should deal not only in national but also in regional and global issues, with transactions conducted based on a standardized legal and financial infrastructure.

Another issue which is closely related to this challenge of debt market creation is that of currency mismatch or excessive dollarization. It has been rightly pointed out that excessive dollarization or rigid pegging to the U.S. dollar, with short-term borrowing denominated in U.S. dollars, was one of the major causes of the crises in Asia. This has led us to contemplate various alternative exchange rate systems in this region. The current thinking of academia seems to be inclined toward two extreme solutions: an absolutely fixed regime, such as a currency board or complete dollarization à la Panama, on the one hand, or free floatation, on the other. Jeffry Sachs, for one, strongly supports a floating system, or full flexibility, while Rudiger Dornbusch argues for a currency a board connected with the U.S. dollar for the Central and Latin American countries.

Two doubts might be raised with respect to these extreme solutions. First, as discussed in the first section, it would seem difficult for relatively small open economies to float their currencies freely amidst vast cross-border flows of capital which could suddenly reverse directions, without risking too wide a swing in exchange rates.

Second, as concerns a currency board, it is true that Argentine and Hong Kong have handled the most recent crisis fairly well. However, not only has Hong Kong paid an enormous price for defending the system, but the characteristics of the Hong Kong economy are not necessarily shared by those of other countries. It is also undeniable that excessive rigidity, whether in the form of fixed rates or a currency board, was at the root of the crisis in the first place. Thus, it can be argued that even such regimes as fixed currencies or a currency board system must be managed carefully to allow flexibility when necessary, unless a country or region completely abandons sovereignty over its monetary and other policies.

Having said this, I might add that full or partial currency unification and common or partially shared monetary and other policies represent one viable solution to the exchange rates regime question. And this may be the direction many countries will be heading in the medium term. If this proves to be the case, Europe and regions under strong European influence will eventually gather together in a Euro zone, while countries with close ties to the United States will be bound together in a U.S. dollar zone.

What, then, would become of Japan and the other countries of Asia? They would, of course, have the option of eventual participation in either the Euro or U.S. dollar zone. Another option would be to develop a third currency zone in Asia. In view of the diversity of cultures, races, histories and developmental stages of Asian countries, however, it would clearly be extremely difficult to achieve unification on the European model

in this region. Nor would it be possible for Japan to play the type of role the U.S. may potentially fulfill in the Americas. One possible alternative is to develop relatively pliant regional cooperation in the areas of trade, investment and foreign exchange rate systems. The latter might involve formation of a basket of regional currencies, such as an, Asian currency unit (ACU), and to attempt to use this unit as the denominator for trade and exchange transactions. The nations of the region could then eventually develop a scheme resembling the European currency unit, or ECU.

## (IV)
## Asian Monetary Fund

As defensive measures in addition to partial capital and exchange controls, countries at the periphery could create regional debt markets and regional currency cooperation. This is not to deny the global "middle-way" that Mervyn King recommends. Nor would it block efforts by Lawrence Summers and others to make the IMF closer to the genuine international lender of last resort by narrowing its function to the provision of necessary liquidity to countries concerned. However, my point is that because of the asymmetry in the current global capitalism, countries at the center are less likely to devote their resources to potentially regional crises and the current calm may strengthen their complacency.

In the context of examining defensive regional policies, we need to now focus on what Mervyn King called the creation of do-it-yourself lender of last resort.

> Create a do-it-yourself (DIY) Lender of Last Resort (LOLR), with the aim of providing self-insurance against a liquidity crisis. There are several ways of providing such insurance. One is simply to build up large foreign currency reserves. This has already been taken to heart by emerging markets. China has substantial foreign exchange reserves ($147

> billion at the end of June). And Korea, perhaps the best example of a country suffering a liquidity run on it banking system in terms of foreign currency, has raised its reserves from a low point of $7.3 billion in November 1997 to current high of $64.8 billion in August. It is unfortunate that the absence of more efficient solutions to the risk of crises means that scarce capital might be deployed in this inefficient way. Building up net reserves—via current account surpluses—will reduce world demand at a time when the US economy is unlikely to provide as large a stimulus as over the past five years. An alternative is to create gross reserves by borrowing from abroad and investing the proceeds in liquid international securities. Both methods involve costs. A second approach to DIY LOLR is for emerging markets to create contingent credit facilities with international banks, as Argentina has done with its contingent repo facility, or try to set up collateralized loan facilities along the lines suggested by Martin Feldstein[19]. A final approach to the DIY- LOLR, in the absence of an effective multilateral ILOLR, is the creation of regional self-insurance funds. All of these approaches are likely to be pursued, to a greater or lesser extent, in the wake of recent financial crises.

The last approach King briefly mentions is the creation of a regional fund, a variant of which was proposed by the Japanese Government in August and September of 1997 as the Asian Monetary Fund. The idea was essentially the pooling of a part of foreign reserves of countries in the region. If Japan, China, Korea and other South-East Asian countries provide, say, a half of their reserves to the fund with specific arrangements for the activation of the fund, it should serve as an effective regional lender of last resort for the next liquidity crisis. The Asian Monetary Fund proposal was strongly opposed by the U.S. and European countries on the ground that it would undermine the discipline imposed by IMF and may pose a serous moral hazard problem. However, if the function of AMF is very narrowly defined as provision of necessary liquidity at the time of crisis with specific formula for private sector participation, for example, à la Korean model, it could complement the existing function of the IMF. If

[19] Martin Feldstein, "A Self-Help Guide for Emerging Markets." Foreign Affairs, March/April, 1999.

Lawrence Summers' proposal to restructure the IMF really goes through, significant overlapping may occur but even then, AMF's role could be restricted to the provision of liquidity with conditions for private sector participation and surveillance and the macro-policy recommendation function could be played by IMF. As I repeatedly stated throughout the paper, the amount of liquidity that countries wish to provide for the crisis may differ depending upon the degree of possible contagion and it is only natural for countries in the region to try to contain the crisis which could easily become regional by providing necessary liquidity. Indeed, this could be done by collection of bilateral aid and Japan did exactly that by the New Miyazawa Plan after the AMF proposal had been shot down. However, it is probably appropriate to formalize such bilateral aid as a permanent mechanism and develop it into a regional agreement.

The moral hazard argument should not be used to detract our attention from the need of an international lender of last resort with freely moving international capital. Moral hazard is a serious problem but the issue should be used to secure proper private sector participation both by borrowers and lenders. The existence of a Central Bank, alone, does not pose any moral hazard problem in itself. It is the conditions under which the Bank provides liquidity at the time of crisis which may cause moral hazard. The general rule à la Bagehot[21] of lending with good collateral at a penal rates could be modified adding some general scheme for private sector participation with some substantial discretion left to deal with individual cases. The agreement may be easier on a regional basis then global one because of similarities of countries in the region.

There are some economists who have used the moral hazard argument as a way to defend market fundamentalism. If the market were perfect and would equilibrate demand and supply stability, there would be

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Mervyn King, ibid.

[21] Walter Bagehot, Lombard Street: A Description of the Money Market, London, 1873.

no need for the Central Bank. But once we agree to the existence of the Central Bank on the domestic scene, the need for an international lender of last resort of some sort with free movement of capital cannot be theoretically denied. Then, it should become an issue of what conditions the lender of last resort impose rather than eliminating or reducing infusion of public money. Provided it is the liquidity crisis, the amount of public money to be infused may be very large even with appropriate private sector participation. The moral hazard issue should not be used politically by countries unaffected by the crisis to avoid the responsibility. If unaffected countries do not have a political incentive to contribute to their own fund, they should say so instead of using the moral hazard argument as an excuse.

The establishment of regional fund as a mechanism for creating do-it-yourself lender of last resort can be combined with other regional cooperation. It could, for example, be combined with a regional arrangement for exchange rates. The formation of a regional currency unit such as ACU discussed in the previous section with some mechanism of defending a certain range of exchange rates can be related to the fund. Of course, the fund should not be used to defend unrealistically appreciated exchange rates. However, the existence of the common fund would make joint intervention more plausible and in a certain circumstances the amount of the fund could be augmented by the joint intervention. In order to do that, we need to formulate a common exchange rate policy in the region. Given heavy interdependence among the countries of the region, this formation of a common exchange rate policy may be quite useful.

As in the case of European experience, monetary or international financial cooperation should go in tandem with cooperation in the real sector. A free trade area agreement or an agreement on direct investment should probably precede or, at least, simultaneously, be pursued with cooperation in exchange rates and the fund. If cooperation in trade and

direct investment proceeds with the creation of regional debt market discussed in section II, the creation of a common fund with exchange rate cooperation may develop into the creation of an Asian currency independent of the Euro zone or U.S. dollar zone. I remain somewhat hesitant to recommend aggressively pursuing this option of creating an Asian currency zone in the short term, since to do so promises to be an extremely difficult, enormously challenging undertaking. However, short of the creation of an international lender of last resort on the global context, this is an option worth while considering and debating within and outside this region as we look to the twenty first century.