Part III

Regional Economic Integration in East Asia and South America

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Beyond the Chiang Mai Initiative: Rationale and Need for a Regional Monetary Arrangement in East Asia[1]

Yung Chul Park

1 Introduction

After the financial crisis touched off in July 1997, Japan proposed the creation of an Asian monetary fund as a framework for promoting financial cooperation and policy coordination in the region. This would help Asian economies prevent and/or better manage future financial crises. Although the proposal received a positive response from a number of East Asian countries, it was shelved on the objection of the US, EU, and the IMF. The idea was revived again when the finance ministers of ASEAN countries plus China, Japan, and South Korea (ASEAN+3) agreed in May 2000 to establish a system of swap arrangements within the ASEAN+3 countries. This became known as the Chiang Mai Initiative (CMI). It involves (i) an expanded ASEAN Swap Arrangement (from five members to ten), and (ii) a network of bilateral swap arrangements among ASEAN countries, China, Japan and South Korea. The CMI swap arrangements will provide liquidity support for member countries experiencing balance of payment difficulties in order to prevent an extreme crisis or systemic failure in a country and subsequent regional contagion such as occurred in the recent Asian financial crisis.

Emergency support facilities such as the CMI, which are similar to other regional and international “lender of last resort” facilities, are primarily for systemic purposes and as such, would be used infrequently. Since the intent of the CMI is to be proactive, there is a need to define a mutually agreed framework for inter-country cooperation amongst the ASEAN and ASEAN+3 agencies, that can quickly and effectively implement emergency assistance at the required levels when a need arises. Moreover, a group approach would ensure that any conditionality associated with the financial assistance would be consistent across countries.

---

1 A revised version of a paper presented at the conference on “The Role of Regional Financial Arrangements in Crisis Prevention and Response: The Experiences of Africa, Asia, Latin America and Europe” organised by FONDAD at the Czech National Bank in Prague, 21-22 June 2001. Date of revision: May, 2002.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

As a background for the discussion on the CMI, this study begins with the question of whether regional financial arrangements, whatever forms they may take, are needed in East Asia, and if so, whether they would be effective in safeguarding the region from future financial crises. To answer these questions, I describe the basic framework of the CMI in Section 2 and recent developments in the negotiations and prospects for the CMI in Section 3. In Section 4, I discuss some of the arguments in the economics literature opposing the creation of regional financial arrangements. These arguments are then countered in Section 5 with several contrasting views which suggest that regional financial mechanisms could complement multilateral trade and financial liberalisation, and therefore promote global financial stability. I present some concluding remarks in Section 6.

2 The Chiang Mai Initiative (CMI)

On May 6, 2000 in Chiang Mai, Thailand, the finance ministers of ASEAN+3 countries agreed to establish a system of swap arrangements within the ASEAN+3 countries. This agreement is known as the Chiang Mai Initiative. Since then, deputy finance ministers of the ASEAN+3 have negotiated the details of the initiative to produce a basic framework for the ASEAN Swap Arrangement (ASA), Bilateral Swap Arrangements (BSAs) and a repurchase agreement (Repo) among the thirteen countries. The framework was approved by the meeting of the deputies on November 7, 2000 in Beijing. A progress report on the CMI was then reported to the summit meeting of the thirteen countries two weeks later.

The CMI has two components:

(i) an expanded ASEAN swap arrangement; and
(ii) a network of bilateral swap and repurchase arrangements among the thirteen countries.

In 1977, five ASEAN countries – Indonesia, Malaysia, Philippines, Singapore, and Thailand – agreed to establish an ASEAN swap arrangement (ASA) to provide liquidity support for the participating countries experiencing balance of payment difficulties. In May, 2000, the ASA was expanded to include all ten member countries under the CMI and the total amount of the facility was raised to $1 billion from the initial amount of $200 million.

The currencies available under the ASA are the US dollar, yen and euro. The euro, yen and Euro LIBOR interest rates are used as the base rate for swap transactions. Each member is allowed to draw a maximum of twice its committed amount from the facility for a period not exceeding six months, subject to an extension for another period not exceeding six months.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

The BSA is a facility designed to provide short-term liquidity assistance in the form of swaps of US dollars with the domestic currencies of a participating country. The maximum amount of drawing under each of the BSAs will be determined by bilateral negotiations. However, it is expected that disbursements to a member in need of liquidity assistance will be made in a concerted manner through consultation among the swap-providing countries. One of these swap-providing countries will then serve as the coordinator for the consulting process.

The BSA is complementary to the IMF's financial assistance in that countries drawing from the facility are required to accept an IMF programme for macroeconomic and structural adjustments. However, the BSA agreement allows an automatic disbursement of up to 10 percent of the maximum amount of drawing without any linkage to an IMF programme. Nonetheless, a number of the participating countries have expressed reservations on the linkage of the BSA with the IMF conditionality and have proposed a gradual increase of the 10 percent automatic drawdown to abolish the IMF linkage after a period of transition. Several countries have also emphasised the need for creating a surveillance mechanism for the CMI. At the fifth ASEAN finance ministers' meeting in April 2001 in Kuala Lumpur, there was consensus that the BSA would be complementary and supplementary to IMF facilities. The ASEAN ministers also agreed that "the terms and modalities of the BSA should take into account the different economic fundamentals, specific circumstances, and financing needs of individual countries". This agreement implies that the contracting parties of the BSA could deviate from the basic framework on setting terms and conditions of the swap arrangement.

Participating countries will be able to draw from the BSA for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first and first renewal drawings. Thereafter, the premium is increased by an additional 50 basis point for every two renewals, but not exceeding 300 basis points.

The Repo agreement is also established to provide short-term liquidity to a participating member through the sale and buyback of appropriate securities. The basic features of Repo agreements are to be finalised through bilateral negotiations between the contracting parties. Securities of the Repo agreement are US Treasury notes or bills with a remaining life of not more than 5 years and government securities of the counterpart country of the Repo.

The period of the Repo agreement is one week, but could be extended on the termination value date by agreement between the contracting parties. The minimum amount for each Repo transaction requested is five percent of the total amount of the Repo agreement. In each Repo transaction, the buyer will be given a margin of 102 percent for US Treasury notes or bills and 105 percent for government securities of the counterpart country.

Since the ASEAN+3 summit meeting in November 2000, Japan, China, and Korea have been negotiating BSAs with the ASEAN countries. Japan concluded its negotiations for at least eight swap arrangements during the meeting of the finance ministers of the ASEAN+3 in May 2001. Both China and Korea are reported to have made progress in their negotiations with the ASEAN participants.

3 Progress and Prospects: CMI Negotiations

Progress in Negotiations

Since the ASEAN+3 summit meeting in November 2000, Japan, China, and Korea have been negotiating BSAs with each other and with the ASEAN countries (see Table 1). Japan has been most active in the process and has concluded negotiations with both Thailand and Philippines for establishing a BSA amounting to $3 billion each. Japan and Malaysia have agreed to add $1 billion more to the initial amount of $2.5 billion of the existing BSA between the two countries.

Japan has contracted a bilateral swap of $2 billion with Korea, and Korea has been negotiating with both China and Thailand for similar arrangements. China and Thailand are expected to conclude a BSA on the order of $4 billion.

Among the ASEAN member states, Singapore and Brunei have shown little enthusiasm from the beginning for promoting the CMI, primarily because they believe the BSAs with their neighbouring countries will be one-way arrangements in which they will be asked to provide a large amount of liquidity in case of a crisis affecting the ASEAN region. However, Japan has made progress in bringing Singapore into the system by proposing a BSA that uses local currencies rather than the US dollar. In fact, Japan has proposed a similar local-currency BSA with China that is equivalent to $3 billion in its size.

Indonesia has not shown any strong interest in negotiating possible BSA arrangements with other participating countries because of its preoccupation with resolving domestic economic issues and managing its huge foreign debts – not to mention escalating political instability. Recently, however Indonesia has indicated its intention to negotiate a BSA

Table 1 Current Status of BSAs Negotiations Among the ASEAN+3

	Korea	Japan	China
Korea		– contract (7/4/01) – $2billion plus – the existing $5billion – won/dollar – one way	– agreement – $2billion – won/yuan – Two-way
Japan			– agreement – $3billion – won/yuan – Two-way
Thailand (7/4/01)	– agreement – $1billion – won/Bhat – Two-way	– contract (7/28/01) – $3billion – Bhat/dollar – one way	– contract – $2billion – Bhat/dollar – one way
Philippines	– in negotiation	– contract (8/30/01) – $3billion – peso/dollar – one way	– in negotiation
Malaysia	– in negotiation	– contract (10/5/01) – $1billion plus – the existing $2billion – Ringgit/dollar – one way	– in negotiation
Singapore		– in negotiation	

with Japan, but it does not appear to place a high priority on the CMI.

At present, the total amount of BSAs covering all 13 countries is estimated to be around $20 billion. The maximum amount of money any individual country can draw varies a great deal. In the case of Thailand, the maximum is about $6 to 7 billion, 10 percent of which can be drawn automatically ($600 to 700 million).

Given the relatively small amount of liquidity available through the CMI, could the BSA system serve as a credible and effective system of defense against speculative attacks in the future? Financial participants will continue to be unimpressed with the amount of liquidity available and will likely ignore the CMI unless the ASEAN+3 is able to increase the number of BSAs and expand the swap amount of each BSA.

Monitoring and Surveillance

From the inception of the CMI, Malaysia has opposed the idea of establishing any linkage between the IMF and CMI and has insisted on creating a regional organisation capable of conducting economic reviews of and promoting policy dialogue among the participating countries. However, other members, in particular Japan and China, have argued for a cooperative relationship with the IMF at an early stage of the CMI development in order to make it more credible. Also, it could eventually result in Malaysia's acceptance of temporarily linking the BSAs with IMF conditionality until a formal surveillance mechanism is established. Malaysia agreed to the IMF linkage providing that the participating countries establish a study group for analysing how a regional organisation for CMI surveillance and monitoring could be established and what the structure and functions of such an organisation would be.

Most participating countries agreed in principle that the CMI should be supported by a regional organisation that reviews economic developments in the region, could promote policy dialogue and coordination among the members, and could impose structural and policy reform for the countries drawing from the BSAs. The ASEAN+3 finance ministers agreed to organise a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group. The study group met in Kuala Lumpur on November 22, 2001 to discuss its report on possible modalities of surveillance prepared by Bank Negara Malaysia and the Japan's Ministry of Finance.

Prospects for Financial Cooperation in East Asia

East Asian policymakers who initially conceived the idea of the CMI would easily concede that as it is currently structured, the BSA system has a long way to go before it can be accepted as an effective mechanism of defense against financial crises in the eyes of financial market participants. One serious problem is that the thirteen countries have failed to articulate whether and how they are going to develop the CMI as a regional financial arrangement in the future. Although two years have passed since the system was established, the leaders of the CMI group have yet to produce an operational structure of the BSA, in particular a monitoring and surveillance mechanism, and it is highly unlikely they will do so any time soon.

As a result, many financial industry experts have expressed doubts as to whether any country facing an incipient crisis could draw from the BSAs that they contracted with other members, and if they could, how much liquidity would be available. Participating countries could refuse any further support exceeding the 10 percent automatic draw. In particular, if there is no effective mechanism of surveillance which could impose policy conditionality, many participating countries are not likely to activate their BSAs for fear of losing what amounts to be their short-term loans.

There is also a need to coordinate the activities of the CMI with other liquidity assistance programmes such as the Manila Framework supported by the US, Australia and New Zealand. Most of the CMI countries also participate in APEC and other regional arrangements. At some point in the future, the leaders of the ASEAN+3 may have to decide on the mode of cooperation and division of labour in promoting regional growth and stability between these institutions and the CMI.

As fear of another round of financial crisis has receded with a recovery that has been faster than previous experience would predict, the ASEAN+3 countries have become less interested in enlarging and institutionalising CMI operations. The interests of the ASEAN+3 have recently shifted to creating free trade areas in the East Asian region. The ASEAN members have already agreed to develop an ASEAN free trade area. Japan has concluded a free trade agreement with Singapore and proposed negotiations on a similar agreement with Korea.

China has indicated its interest in negotiating free trade agreements with the ASEAN and other neighbouring countries. China has made no secret about its long-run objective of establishing a Chinese Economic Area in East Asia comprising the ASEAN, Taiwan, Hong Kong and China itself. This is undoubtedly a desirable development. However, as will be discussed in subsequent sections, regional financial arrangements could facilitate trade expansion by stabilising bilateral exchange rates of regional currencies and by minimising the disruptive effects of financial market turbulence. For this very reason, it would be in the interest of East Asia to carry out the extension of the CMI parallel with negotiations on establishing free trade areas in the region. Nevertheless, the prospects for financial cooperation and policy coordination in East Asia are not very promising at this stage.

One reason for this uncertain outlook is that except for Japan, no other potential swap lender – including China – is prepared to increase the amounts of its bilateral swaps with other CMI members. China and Japan, which were expected to provide leadership in forging regional support for expanding and consolidating the BSAs as a regional institution, have not been able to agree on a number of operational issues including a surveillance mechanism. No doubt, Japan has financial resources it could make available for the swap financing for the ASEAN and Korea (China is not expected to borrow from Japan). However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are unlikely to lead the institutionalisation of the CMI. As a condition for the expansion of the CMI, Japan emphasises the need for creating an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. China feels that it cannot play second fiddle to Japan in any regional organisation in East Asia. This deadlock appears to be the most serious roadblock to the further development of the CMI.

Another reason is that China and Japan have different interests in and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN-10, with South Asian and Central Asian countries may be more important, both economically and geopolitically, than free trade with either Japan or South Korea. Given the gap in technological and industrial sophistication and size of GDP between China and Japan, Chinese policymakers may feel that neither Japan nor Korea is a good partner for free trade or financial cooperation.

China borders Russia and many of the South Asian and Central Asian countries in addition to several ASEAN members. It is natural therefore for China to seek expansion and deepening of its trade and financial relations with these neighbouring countries. To this end, China has been courting the ASEAN for a free trade agreement and in November of 2001, China joined the Bangkok agreement on a free trade area which includes Russia and the South Asian countries. China has also taken a leading role in establishing a cooperative arrangement known as the Shanghai cooperation organisation that includes Russia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan as well as China.

In contrast, Japan has not been able to articulate its strategic interests in East Asia. Japan has been in the forefront of supporting greater economic cooperation among the East Asian countries, but the geographical contiguity of East Asia from the Japanese point of view has not been altogether clear to its partners in East Asia. Japan has been promoting integration among the ASEAN+5, but surprisingly, questions remain as to the identity of the two countries added to the initial ASEAN+3. At one point, the five countries were China, Japan, Korea, Australia and New Zealand. At another, Australia and New Zealand were replaced by Taiwan and Hong Kong in defining the five-country group.

According to Wall (2002), Japan is not interested in free trade in East Asia per se; instead, Japan is engaged in the discussion of free trade agreements and other financial arrangements with other East Asian countries in order to counter China's expansion, and in so doing, maintain its leadership role as the region's largest economy.

Japan appears to be concerned with China's rise both as a military and economic power in East Asia. If the current trend continues, China could marginalise Japan's role as East Asia's leading country. Many analysts believe that Japan's active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position. Added to this suspicion, Japan is perceived to be more interested in containing China than advancing the causes of economic development and welfare. Japan is a declining power which is unwilling to resolve its wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and has been unable to restructure its economy. Combined with the absence of a strategy in East Asia, these developments have undermined Japan's ability to pull East Asian countries together for regional cooperation and integration.

What, then, is the likely course of development of the CMI and related regional financial integration in East Asia? One possible scenario is that China and Japan may reach an agreement on an institutional setting and augmentation of the existing BSAs. For instance, China may give in to Japan's demand for de facto control over the monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it sees the possibility of concluding a free trade pact with the ASEAN members in the near future. A free trade pact with the ASEAN could circumscribe Japan's influence on ASEAN affairs even if it is a major provider of financing.

Another scenario focuses on the possibility of China taking a more aggressive leadership role in regional integration by contracting larger swap arrangements with the ASEAN members. That is, China may take charge of consolidation of the CMI while negotiating a free trade pact with the ASEAN. In this case, the original CMI will become ASEAN+1. Realising that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option.

A third scenario is an enlargement of the CMI members by including Australia and New Zealand and possibly other countries from South Asia. This is the one favoured by Japan. Japan believes that it would be easier to deal with China if more countries were supporting its strategy. However, many members of the ASEAN+3 believe that forming a critical mass of the CMI, which is yet to be realised, should precede any enlargement of the BSAs. Since the enlargement is not likely to substantially increase the availability of short-term financing, the third scenario will not be taken seriously.

A fourth scenario envisions a division of East Asia as it is defined to include the ASEAN+3 between two currency blocs, a remimbi and a yen

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

bloc. Many experts believe that given the growing export market in China the ASEAN members will be driven by market forces to join in a Chinese Economic Area in the long run. Formation of a currency union among the ASEAN+1 will then naturally follow expansion of trade between ASEAN and China. Japan would then look to Korea as a potential partner for free trade and currency union.

For the next two years or so, however, the ASEAN+3 are not expected to make any major breakthroughs in enlarging the BSAs. Financial officials from the thirteen countries will continue to meet regularly to discuss ways of enhancing policy reviews of the members. In a recent meeting in Yangon, Myanmar (April 2, 2002), a proposal was put forward to restructure the informal ASEAN+3 Finance and Central Bank Deputies Meeting (AFDM+3) as Deputies Policy Review Group, which will be supported by an administrative unit and a group of eminent people (GEP). At the Yangon meeting, several alternative suggestions were made for creating a surveillance unit which included relying on the existing regional institutions such as the ADB. However, the AFDM+3 could not reach any agreement.

While the discussion on formalisation of the CMI has made little progress so far, China, Japan and Korea have launched another initiative for regional financial integration by undertaking a joint study on the feasibility of creating regional capital markets in East Asia. This proposal would be announced at the ADB meeting in May, 2002.

4 Arguments Against Regional Financial Arrangements

Ever since the proposal for creating an Asian monetary fund was made, the idea has been opposed by the US, the EU and the IMF for a variety of reasons. Although recently both the US and the IMF have lessened their opposition to regional financial arrangements, they still maintain that the arrangements should be both complementary and supplementary to the IMF financing facilities (Köhler, 2001). The opponents of a regional financial arrangement in East Asia raise two issues. First, they argue that the ASEAN+3 countries have yet to develop economic, social and political preconditions that could support a regional financial arrangement. Many of the participating countries have been embroiled in numerous territorial and economic disputes of one kind or another among themselves, animosity toward Japan because of atrocities carried out during World War II lingers on. For many years, the three countries have been mired in the controversy over historical interpretations of Japan's role in East Asia in the 19th and the early 20th centuries.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

As Eichengreen (1999) put it, East Asia lacks the tradition of integrationist thinking and the web of interlocking diplomatic agreements that could encourage monetary and financial cooperation in Europe. As a result, the opponents claim that since East Asian countries are not ready for – or capable of – creating and managing an efficient financial arrangement, their efforts at financial cooperation in an institutionalised setting could produce undesirable consequences for countries in other parts of the world. Many argue that the regional funds in particular could aggravate moral hazard problems associated with excessive borrowing and loose macroeconomic policies of participating economies.

It may be true that regional financial arrangements could pose a serious moral hazard problem. At this stage of development, East Asians may not be prepared to negotiate an international treaty that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly. This unwillingness would make it difficult for the regional fund to impose politically unpopular policies on the member countries and, hence, may pose a serious problem of policy discipline. However, moral hazard is not a problem that will beset regional arrangements alone. The IMF is not immune to this problem. The moral hazard concern is so serious that some people even question whether the IMF should continue to play the role of a quasi-lender of last resort, and for them, the creation of regional monetary funds must be an anathema. (The Meltzer Commission, 2000) The task force report of the Council on Foreign Relations (1999) advises the Fund to adhere consistently to normal lending limits in order to redress the moral hazard problem. The reasons why East Asian financial arrangements would suffer more from the moral hazard problem than the IMF or any other regional institution have not been made clear. As Sakakibara (2000) puts it, if those countries unaffected by the East Asian crisis have no political incentive for contributing their own money, they should say so instead of using the moral hazard argument as an excuse for opposing regional arrangements in East Asia.

For over a half century, European countries have worked hard to develop a wide web of political and diplomatic agreements which has served as a foundation for cooperation on monetary and financial matters. Certainly, such a web does not exist in East Asia, and as far as East Asia's limited capacity is concerned, Eichengreen and Bayoumi (1999) have a point. Indeed, if the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for finance, not to mention a monetary union.

While the importance of political preconditions for establishing an effective regional financial mechanism can not be denied, it should also be noted that the ASEAN+3 countries have participated in various regional

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

groupings. The ASEAN was established in the 1970s, and since then it has contributed to consolidating unity, promoting free trade, and providing mutual financial assistance among the member states. The ASEAN countries have more than thirty years of experience with regional cooperation. The ASEAN+3 have also been active members of APEC. Some of these countries have participated in the Manila framework; and there are other regional cooperative arrangements such as SEACEN and SEANZA which have provided informal fora for policy dialogue.

Recent economic developments in East Asia may suggest that political integration has become a less important constraint than before, largely because many of East Asia's central banks now enjoy greater independence than before and, more importantly, democratic principles are taking root in the governance of these countries. East Asia is changing and may be on the brink of an historical evolution, as Europe was half a century ago (Bergsten, 2000). It is true that there are not many political and economic issues on which all thirteen countries participating in the CMI could agree, and regional financial cooperation has been one of them. But by delegating regional financial affairs to the CMI or similar institutions, the East Asian countries could bypass political issues and disputes and work toward building regional trust.

Having suffered such a painful and costly financial crisis, the East Asian countries are prepared to set aside their differences and work together to develop a region-wide defense mechanism to the extent that it could help protect them from future crises. After three years of crisis management, East Asia has also developed a large pool of skilled and experienced people capable of managing regional financial cooperation and policy coordination.

The opponents to the CMI also argue that there may be no need for regional funds and other arrangements in a globalised world economy where a growing proportion of the trade in goods and services is increasingly conducted in cyber space. Worse yet, these regional financial mechanisms could impede multilateral trade liberalisation and global financial integration. The ongoing revolution in information and communications technology will accelerate both globalisation and virtualisation. What the world economy needs, therefore, is a new system of global governance which may include a global central bank and global regulatory authorities. In the case of the financial markets, and the financial services industries, the scope of governance could be increased to the level of the world so as to realise scale economies and to accommodate the market forces driving financial globalisation. That is, public goods, such as the services of a lender of last resort and regulatory institutions, could be better provided at a global level.

While, in theory, the creation of a system of global governance may sound reasonable, in reality it is politically unacceptable and must be dismissed as Quixotic (Eichengreen, 1999). As a second-best alternative to the global governance system, global standards and codes of conduct on banking, corporate governance, management of monetary and fiscal policies, and many others, have been proposed for adoption by emerging market economies (EMEs) and developing countries (DCs) and also enforced by the IMF. Doubts have been raised as to the effectiveness of international standards, and the legitimacy of imposing them on EMEs and DCs has been questioned.

The architects of the CMI have a more ambitious goal in developing the CMI. They plan to expand the CMI not only as a financing mechanism for the member countries experiencing balance of payment problems but also as a launching pad for creating a full-fledged regional monetary fund, eventually establishing a common currency area in the region. That is, the CMI planners are emulating the steps European countries have taken during the post-war period for regional integration in Europe.

On this longer-term issue, which is political in nature, Eichengreen (1999), Eichengreen and Bayoumi (1999), and Bayoumi, Eichengreen and Mauro (2000) argue that while a group of East Asian countries may satisfy requirements for an optimum currency area as much as the EU does, it has not developed the necessary political preconditions for a durable regional arrangement, and certainly not to the degree that Europe has. These authors argue that “any monetary arrangement that seeks to stabilise exchange rates in the absence of the necessary political preconditions will be fragile and crisis prone”.

Drawing on the European experience, one might emphasise the need for the efficient management of a relatively long period of transition to a common currency peg and ultimately to a common currency. East Asian countries would therefore have a better chance of defending themselves against crisis by focussing attention on crucial areas of structural reform and trade policy rather than wasting time and energy on a premature idea such as an East Asian EMS. In this regard, Bayoumi *et al.* are more constructive in that they suggest a number of objectives that must be achieved during the transition period along the lines of the debate underscored by the Maastricht Treaty.

These objectives include promoting wage and price flexibility, reforming and strengthening the financial sector, strengthening central bank independence, harmonising monetary policy, and creating barriers to exit. Few East Asian policymakers are naive enough to believe that they will be able to work out an agreement on creating an East Asian monetary fund or a common currency in the near future. At best, these options are

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

long-term objectives; the CMI arrangement is a first step toward achieving these goals. In this respect, it would be in the US and European interest to support expansion and consolidation of the CMI for developing a financial cooperative arrangement.

5 Rationales for Regional Financial Arrangements

Since the early 1990s, many of the East Asian countries have made sustained efforts to deregulate and open domestic markets, including financial markets, to foreign competition. As a result of trade liberalisation and market orientation, East Asia has seen a large increase in intra-regional trade and investment. In terms of the importing country data, intra-regional trade in East Asia (ASEAN+3 and Taiwan) was more than 50 percent of the region's total trade (see Table 2a and b) in 1998 when the entire region was in a deep crisis. There is every indication that this trend will continue. Financial liberalisation and market opening has also

Table 2a Exporting Country Data Unit
(in percentages)

		Importing Countries							
Exporting Countries		East Asia	(East Asian NIEs)	(ASEAN4)	(China)	(Japan)	USA	Others	World
East Asia	1990	40.0	19.7	7.3	4.4	8.6	26.6	33.4	100
	1996	48.8	20.0	10.5	9.1	9.2	22.1	29.1	100
	1998	42.6	18.4	7.8	9.1	7.4	24.5	32.9	100
East Asian NIEs (Korea, Hong Kong, Singapore, Taiwan)	1990	41.3	12.3	8.7	8.8	11.4	27.9	30.8	100
	1996	49.9	11.4	12.0	16.9	9.6	20.7	29.5	100
	1998	45.4	11.9	9.3	17.0	7.1	22.4	32.2	100
ASEAN (Indonesia, Malaysia, Thailand, Philippines, Vietnam)	1990	52.1	21.8	4.3	2.0	24.0	18.8	29.1	100
	1996	53.3	25.4	6.9	3.0	17.9	18.1	28.6	100
	1998	47.1	22.3	6.9	4.1	13.9	21.4	31.5	100
China	1990	65.2	47.6	2.9		14.6	8.5	26.4	100
	1996	55.5	31.1	3.9	–	20.4	17.7	26.8	100
	1998	48.4	28.7	3.5	–	16.2	20.7	30.9	100
Japan	1990	29.7	19.7	7.8	2.1		31.7	38.7	100
	1996	42.7	24.7	12.7	5.3	–	27.5	29.8	100
	1998	33.5	20.2	8.1	5.2	–	30.9	35.6	100

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Table 2b Importing Country Data Unit
(in percentages)

Exporting Countries		Importing Countries: East Asia	(East Asian NIEs)	(ASEAN4)	(China)	(Japan)
East Asia	1990	43.3	66.5	51.4	51.4	26.8
	1996	49.4	67.1	52.4	53.5	35.8
	1998	50.3	74.0	55.2	65.4	35.5
East Asian NIEs (Korea, Hong Kong, Singapore)	1990	14.3	14.2	19.9	33.2	11.1
	1996	15.3	14.5	20.7	28.9	11.7
	1998	15.5	15.3	23.9	30.4	10.2
ASEAN4 (Indonesia, Malaysia, Thailand, Philippines)	1990	7.7	9.1	4.1	4.0	10.7
	1996	9.1	11.4	6.3	3.6	12.5
	1998	9.7	13.1	9.2	5.9	12.0
China	1990	7.2	15.3	2.5		5.1
	1996	10.4	18.6	2.5		11.6
	1998	12.1	23.8	3.6		13.2
Japan	1990	14.1	27.9	24.9	14.2	
	1996	14.7	22.5	22.9	21.0	
	1998	13.0	21.8	18.6	20.2	
USA	1990	18.0	21.1	13.5	12.2	22.5
	1996	16.6	18.5	13.6	11.6	22.9
	1998	16.9	19.9	15.3	12.1	24.0
Others	1990	38.7	12.4	35.0	36.3	50.7
	1996	34.0	14.4	34.0	34.9	41.4
	1998	32.8	6.1	29.6	31.5	40.5
World	1990	100	100	100	100	100
	1996	100	100	100	100	100
	1998	100	100	100	100	100

contributed to the integration of financial markets in the region and establishing a closer linkage between East Asian and international financial markets. The growing integration of intra-regional trade in goods, services and financial assets has increased the demand by the business community in the region for stabilising the exchange rates of East Asian currencies. More than anything else, the Asian crisis in 1997 has awakened the region to the need of establishing a region-wide mechanism of defense against future financial crises. There have been several other developments that have encouraged the formation of a regional financial arrangement in East

Asia. In this section, some of these developments are discussed as a background for examining whether they could maintain the momentum for enhanced regional cooperation and lead to the formation of monetary unification in East Asia in the long run.

Regional Trade and Financial Integration

Recent studies by Rose and Engel (2001) show empirically that the formation of a currency union leads to a substantial increase in trade and a lower volatility of real exchange rates among the countries joining the union. One of the major objectives of creating a regional financial arrangement in East Asia such as the CMI is to stabilise bilateral exchange rates of the regional currencies. By organising a financing mechanism that could provide some cushion for adjustment to adverse external shocks, a scheme like the CMI could alleviate some of the problems that may hinder the introduction of a regional collective exchange rate mechanism. Financial cooperation could therefore produce economic conditions favourable to establishing a free trade area in East Asia.

As Rose (1999) points out, trade is mostly regional and "the fast track to trade liberalisation of late has tended to be regional". The regional nature of trade is likely to grow in importance, as it has in East Asia. With this growing trend in regional trade integration, it is clear East Asia will lose disproportionately more from trade disruptions caused by currency crises than otherwise. This means that the East Asian countries have a collective interest in preventing the contagion of the crisis. In this regard, the CMI could be considered another regional initiative for promoting free trade. Together with the deepening of trade integration, East Asia has also witnessed a growing mobility of capital with liberalisation of capital account transactions in many countries in the region. Although the benefits of capital mobility could be substantial, capital market liberalisation has brought the danger of making financial crisis much more disruptive than otherwise along with it. Despite the series of financial crises throughout the world in recent years, the economics profession still does not fully understand the causes and prevention of financial crises. Given this lack of knowledge of crises, the second-best solution is to strengthen defenses against them. A regional financial cooperative arrangement could be such an effort.

Stumbling Blocks or Building Blocks?

Any argument for regional arrangements must begin by answering the most fundamental question: i.e. whether regional groupings, whatever forms they may take, are conducive to or likely to interfere with multilateral free trade and the orderly globalisation of financial markets. Despite many misgivings about the role of regional economic arrangements that have grown in number in recent years, the experiences of the past decade – in particular, that of the EU – suggest that they have been a complement and supplement to multilateral trade and financial liberalisation. That is, they have been building blocks to rather than stumbling blocks for a more integrated world economy. There is no evidence suggesting that an East Asian financial arrangement will be oriented toward a withdrawal from the global economy and, hence, erect barriers to global financial integration.

Six years ago, Lawrence (1996) pointed out that the forces that were driving the wave of regionalism at that time might differ fundamentally from those driving earlier moves toward regionalisation in this century and that the regional initiatives represented efforts to facilitate their members' participation in the world economy rather than their withdrawal from it. Trade and financial developments since then do not seem to challenge this observation. Many developing countries are motivated to join regional groupings as their participation could facilitate implementation of a strategy to liberalise and open their economies. Since most of the East Asian EMEs are pursuing *export cum foreign investment*-led policies, they will gain very little by forming a regional arrangement that is designed to thwart globalisation.

A New International Financial Architecture

One development that has encouraged regional cooperation in East Asia has been the slow progress of the reform of the international financial system. The urgency of reform in the G-7 countries has receded considerably with the rapid recovery of East Asia. The slow progress has been further complicated by the perception that a new architecture, as it is designed, may not be effective in sustaining global financial stability. Nor would it safeguard financial stability in the EMEs and DCs. As long as the structural problems on the supply side of capital are not addressed, the East Asian countries will remain as vulnerable to future crises as they were before. Instead of waiting until the G-7 creates a new architecture, whose effectiveness is at best questionable, it would be in the interest of East Asia to work together to create its own system of defense. For this reason alone, there has been increasing support in East Asia for developing a regional defense mechanism in the form of financial cooperation. This support has culminated in the Chiang Mai Initiative of ASEAN+3 (CMI) for creating currency swap arrangements among the thirteen countries. This agreement is widely perceived as a major step toward strengthening

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

financial cooperation among the East Asian countries. A regional financial cooperative scheme such as the CMI could be structured and managed to be complementary to the role of the IMF. For example, an East Asian regional fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. An East Asian financial arrangement could also support the work of the IMF by monitoring economic developments in the region and taking part in the IMF's global surveillance activities. An East Asian monetary fund could also be designed initially as a regional lender of the last resort while the IMF assumes the role of prescribing macroeconomic policies to the member countries of an East Asian monetary fund.

International Reserve Accumulation

Many EMEs and DCs, particularly those which have experienced a financial crisis, are taking steps to increase their foreign exchange reserves above the level that has been regarded as adequate in terms of their import requirements. Before the onset of capital account liberalisation in the 1990s, developing economies were preoccupied with the management of the current account, and as far as the adequacy of reserves was concerned, the rule of thumb was holding a reserve level equivalent to imports of three or four months. For instance, Korea had accumulated a large volume of foreign exchange reserves ($96.1 billion at the end of 2000) equivalent to 21 percent of its GDP, in part because of the increased volume of its capital account transactions, but largely because of the need to build up a war chest to stave off a speculative attack to protect the economy from financial crises. At the end of 2000, the volume of reserves as a percentage of GDP in Korea was more than three times the level of 1996. A similar development has taken place in other crisis-hit countries in East Asia (Table 3). In Indonesia, the ratio of reserves to GDP almost doubled between 1996 and 2000. In the Philippines, the ratio climbed to 27 percent at the end of 2000 from less than 9 percent three years earlier. Compared to these countries, reserve accumulation has been relatively modest in both Thailand and Malaysia. Yet, these countries have also added more than 10 percentage points to the ratios they had at the end of 1997. By any measure, this level is excessive, costly, and represents a clear case of a misallocation of resources. In a recent speech at a Tokyo conference, Stiglitz (2002) argued that the existing dollar-based reserve system benefits the US whereas developing countries bear a disproportionately heavy burden of holding large amounts of reserves to counter volatility in the currency market. He went on to say that an Asian monetary fund, which would have provided a quicker remedy to the Asian financial crisis, can be

Table 3 Foreign Exchange Reserves and Current Account Balance
(in millions of dollars and percentages)

Year	Foreign Exchange Reserves: millions of dollars	Foreign Exchange Reserves: percentage of GDP	Current Account Balance: millions of dollars	Current Account Balance: percentage of GDP
		Korea		
1996	34,037	6.5	-23,005	-4.4
1997	20,368	4.2	-8,167	-1.7
1998	51,975	16.2	40,365	12.6
1999	73,987	17.8	24,477	5.9
2000	96,131	21.0	11,040	2.4
2001(f)	105,191	23.5	6,000	1.3
2002(f)	119,323	23.9	2,000	0.4
		China		
1996	107,039	13.1	7,243	0.9
1997	142,762	15.8	36,963	4.1
1998	149,188	15.8	31,472	3.3
1999	157,728	15.9	15,667	1.6
2000(f)	168,277	15.4	12,000	1.1
2001(f)	178,387	14.9	7,000	0.6
2002(f)	188,152	14.2	4,000	0.3
		Hong Kong		
1996	63,840	41.4	-3,509	-2.3
1997	92,823	54.3	-6,159	-3.6
1998	89,625	55.0	3,891	2.4
1999	96,255	60.5	10,545	6.6
2000	107,560	65.8	8,806	5.4
2001(f)	-	-	4,000	2.3
2002(f)	-	-	1,000	0.6
		Taiwan		
1996	88,038	31.5	10,923	3.9
1997	83,502	32.7	7,051	2.8
1998	90,341	32.6	3,437	1.2
1999	106,200	35.9	8,384	2.8
2000	106,742	36.4	9,316	3.2
		Thailand		
1996	37,731	20.7	-14,691	-8.1
1997	26,179	17.3	-3,021	-2.0
1998	28,825	25.7	14,243	12.7
1999	34,063	27.5	12,428	10.0
2000	31,947	26.0	9,200	7.5
2001(f)	33,802	28.2	7,000	5.8
2002(f)	35,050	28.0	4,700	3.8

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Table 3 (continued)

		Indonesia		
1996	24,024	10.6	-8,532	-3.8
1997	20,609	9.6	-5,790	-2.7
1998	22,713	23.0	4,102	4.2
1999	23,540	16.2	578.3	4.1
2000(f)	27,464	18.5	8,400	5.7
2001(f)	31,164	19.2	7,000	4.3
		Malaysia		
1996	27,009	26.7	-4,462	-4.4
1997	20,788	20.8	-5,936	-5.6
1998	25,559	35.0	9,529	13.1
1999	30,588	37.7	12,606	15.9
2000	29,075	32.6	8,850	9.9
2000(f)	30,632	32.6	7,300	7.7
2002(f)	32,640	32.0	5,000	4.9
		Philippines		
1996	10,030	12.1	-3,949	-4.8
1997	7,266	8.8	-4,353	-5.3
1998	9,226	14.9	-1,546	2.4
1999	13,242	17.3	7,911	10.3
2000	13,048	27.4	9,349	19.7
2001(f)	14,452	19.1	8,400	11.1
2002(f)	15,971	20.3	8,000	10.2
		Singapore		
1996	76,976	83.7	13,898	15.1
1997	71,392	85.2	16,912	20.2
1998	75,028	99.9	21,025	23.3
1999	77,176	89.3	21,254	24.0
2000	80,362	82.2	21,715	22.2

Note:
(f) estimates by the Institute of International Finance.
Sources: Institute of International Finance, and the central bank websites.

an alternative model, providing a good basis for a new global regime.

In theory, floating rates and capital account liberalisation are supposed to reduce the need for holding a large amount of reserves. In the aftermath of the 1997 crisis, East Asian crisis countries – except for Malaysia – have moved to a flexible exchange rate system and deregulated their capital account transactions to a considerable degree. However, as far as reserve holdings are concerned, experiences with floating rates and participation in international financial markets in these countries for the past three years has not strengthened the belief that a flexible exchange rate system and opening domestic financial markets would substantially lessen their vulnerability to future crises.

In fact, liberalisation of capital account transactions has increased the demand for reserves largely because capital flows have been unstable and unpredictable in these countries. Furthermore, access to international capital markets has been rather uncertain for many EMEs. For these reasons, adequacy of reserve holdings is often gauged by the amount of short-term foreign loans and a good benchmark is that the ratio of reserves to short-term foreign debts should be equal to one or even a little higher. Even when this high benchmark is adopted, reserve holdings of the crisis-hit countries in East Asia are excessive. In both Korea and Thailand, the ratios have been greater than 2, and even in Indonesia, it has fluctuated between 1.3 and 1.45 (see Table 4). This requirement raises a number of questions as to whether the EMEs should borrow at all from the short end of international capital market and whether it would be advisable to ask these countries to open their financial markets.

If the EMEs have to maintain an amount of reserves equal to their short-term foreign indebtedness, this means that they must secure long-term foreign loans or accumulate current account surpluses in order to meet the reserve requirement. Commercial banks hold a small fraction of their deposit liabilities which are mostly short-term, and they can do so because, among other things, they have access to the domestic lender of last resort. Except for the IMF, there is no international lender of last resort for EMEs to turn to. The IMF as a quasi-lender of last resort could provide an additional issuance of SDRs, but at this stage of international financial reform, it is not altogether clear whether the institution could play the role of a crisis-lender. Could the EMEs then make arrangements with international banking institutions to establish private contingent lines of credits they could draw from in case they come under speculative attack? The Mexican experience is instructive in that the availability of contingent credit lines does not increase liquidity once a financial crisis breaks out because the banks which provide contingent credit lines to the central bank withdraw other credits extended to firms and financial institutions in order to reduce their country exposure (Carstens, 2001).

One could argue that restructuring ailing corporations and unsound

Table 4 Foreign Reserves/Short-Term Debt

	Indonesia	Korea	Thailand	Taiwan	China	Chile
1998. IV	0.89	1.31	1.15	5.24	4.37	1.68
1999. II	1.45	1.43	1.53	6.46	5.75	1.52
1999. IV	1.33	1.69	2.23	6.24	7.75	2.06
2000. I	1.38	2.19	2.21	6.53	7.45	1.67
2000. II	1.32	2.06	2.32	7.43	7.28	1.63
2000. III	1.35	2.14	2.72	7.33	7.63	1.41

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

financial institutions together with institutional reform of accounting, auditing, and corporate governance should take precedence over regional cooperation in East Asia since it would strengthen the foundation of stable and sustainable growth and hence help fend off speculative attacks in the future. While it is true that the crisis-hit countries have a long way to go before cleaning up their financial institutions and improving profitability and balance sheets of their corporations, there is little evidence suggesting that economic restructuring alone could safeguard these economies against speculative attack. This is because international financial markets are prone to panic, herding, and contagion of crisis.

In the absence of a global or regional lender of last resort, and given the limited availability of private contingent lines of credit, EMEs may therefore have to hold a larger amount of reserves than otherwise would be needed, and to do so they may have to run a sizeable surplus on the current account as the East Asian crisis countries have done since the crisis broke out in 1997. Thus, the reserves accumulation in EMEs suggests an undesirable implication for the future trade relations between developing and developed countries and for growth of the world economy. Developing countries that liberalise their current and capital account regimes and participate in international financial markets will attempt to generate surpluses on their current accounts. As the number of these countries increases, trade relations between developing and developed countries are likely to deteriorate. Therefore, both developing and developed countries will find it in their best interest to search for other schemes that could reduce holdings of foreign exchange reserves. For example, a group of countries, not necessarily from the same region, may decide to pool a certain percentage of their reserves to create new credit facilities for themselves. An individual country belonging to the arrangement would not have to hold as much reserves as it would otherwise have to hold if it can borrow from the credit facility. The group of thirteen East Asian countries (ASEAN+3) has command over a large amount of foreign currency reserves estimated to be almost $800 billion. Depending on how these reserves are pooled and managed, a mere *ten* percent of the total amount will be sufficient to provide a first and second line of defense against any speculative attack. If the East Asian countries had been able to cooperate to use part of their reserves to supply short-term liquidity to Thailand, East Asia could have been spared the misery of recession and social dislocation.

An East Asian Common Currency Area

Many studies have shown that a nominal exchange rate fixed at an untenable rate was invariably one of the major causes of financial crises as in the cases of Mexico, East Asia and Russia. For a while, after the eruption of the East Asian crisis, the flexible exchange system was the accepted norm in the new international financial architecture. For some EMEs, currency unions and currency boards were an alternative regime, but usually only under unusual circumstances. The new consensus, however, did not last very long. Williamson (2000) and Frankel (1999) argue that intermediate regimes such as the BBC system are more likely to be appropriate than the corner solutions for many EMEs. In particular, Williamson advocates several intermediate regimes with soft margins. Fischer (2001) suggests that developing countries which are not exposed to capital flows could choose from a wide range of intermediate regimes and that flexible exchange rate systems suitable for EMEs could include crawling bands with wide ranges.

If indeed East Asian countries find it desirable to be on some type of intermediate regimes, then one can make a stronger case for creating regional financial cooperative arrangements. In the long run, the East Asian countries could work together to develop an East Asian common currency area after a transition period during which a mechanism of coordination of exchange rate policies is established. An East Asian financial arrangement could therefore serve as a forum for articulating and preparing for these monetary options.

In the short run, the adoption of intermediate regimes will raise the question of which currency or set of currencies should serve as a reference rate to which exchange rates of East Asian currencies will be stabilised. East Asian countries have diversified their export markets over the last two decades with the result of reducing their dependence on the US market. As the regional market grows in East Asia, the linkage with the US dollar has complicated their exchange rate policies. Furthermore, the bilateral exchange rates of the dollar, euro and yen have exhibited substantial swings in recent years and instability of these major currencies has exerted negative effects on growth in EMEs (Reinhart and Reinhart, 2001).

Emerging market economies, individually or as a group, can exercise little influence on the movements of the bilateral exchange rates of these major currencies. EMEs therefore may be able to reduce adverse effects on EMEs of higher volatility of the three currencies by linking their currencies to a currency basket consisting of the US dollar, euro and yen currencies. Linking to the US dollar, East Asian countries risk the danger of aggravating volatility of their nominal effective exchange rates. In recent months, the Japanese yen has declined in value relative to the US dollar and euro. With the yen depreciation, other East Asian currencies have also depreciated much more than warranted vis-à-vis the US dollar due to expectations that these countries will suffer the loss of competitiveness of their exports, in particular when they compete with Japan in exports markets in the US and Europe, although there has been little visible change in their economic fundamentals.

If linking to the US dollar is not a viable option, then East Asian countries may have to consider identifying a basket of currencies for a reference rate for their nominal exchange rates. To the extent that stabilising nominal effective exchange rates of regional currencies in East Asia is an important policy concern, then it follows that East Asian countries may be better off with a common basket of currencies. A regional financial arrangement could serve as a body for managing a common peg system in East Asia.

6 Concluding Remarks

It is certainly true that one cannot overemphasise the importance of restructuring the economy of East Asia into one possessing strong economic fundamentals. However, it is also important to prepare for regional financial arrangements that could greatly contribute to the stability of the financial system in the region, unless the architectural deficiencies of the global financial system are satisfactorily rectified.

Until recently, it appeared that the CMI was losing momentum, and because of the slow progress in BSA negotiations among the ASEAN+3 and most of all, a relatively small amount of liquidity that is likely to be available to the participating countries in case they face speculative attacks, the international financial markets have ignored the existence of the CMI. However, there has been an emerging consensus that East Asians must join forces to establish regional financial arrangements which will help them fend off speculative attacks and, in so doing, stabilise East Asian financial markets. Given the different interests of the various countries with respect to regional financial cooperation, it is not altogether clear whether the East Asians will be able to successfully negotiate the creation of such arrangements. Details of the swap arrangement mechanism among the ASEAN+3 countries will have to be worked out, and it is too early to tell whether the thirteen countries will be able to design a scheme acceptable not only to ASEAN member states but also to China, Japan and Korea.

Now that China is joining the WTO, Chinese policymakers realise that they may have to liberalise and open their financial markets and financial services industries sooner than expected. They also realise that as the country with the largest market, they must contribute to, and cooperate with, other countries in order to sustain financial stability in East Asia.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

However, China will find it very difficult to support any regional arrangements dominated by Japan.

Japan has an important role to play, as the second largest economy in the world and as a member of the G-7, in promoting regional cooperation in East Asia. While Japan and the other East Asian countries cannot, and should not, ignore the wishes of the US and the European Union, the East Asian countries must decide whether a regional cooperative mechanism will help restore the dynamism and vitality the region was accustomed to before the crisis. In recent months, Japan has once again become more active in advocating the creation of East Asian monetary and financial arrangements, at least informally. In order to attract wider support from other East Asian countries, Japan must tell them what its national interests are and what they are prepared to do to support the establishment of East Asian financial arrangements. Japan must find ways in which it could collaborate with China on resolving regional economic issues.

East Asia has a long way to go before formalising and implementing the Chiang Mai Initiative and launching other types of cooperative mechanisms. In this regard, Japan should be able to provide leadership in papering over the differences that are likely to emerge among the East Asian countries in the negotiation process. In addition, most of all, Japan should be prepared to provide a large share of the resources needed to facilitate regional financial cooperation without dominating the other countries.

Finally, but most importantly, Asian regional institutions should contribute to the stability of the international financial system, as the Asian Development Bank has done in global development finance for over 30 years. A first requirement for achieving cooperative evolution with the rest of the world is for East Asians and outsiders to consult actively and candidly, perhaps with the United States in APEC and with Europe in ASEM (the Asia-Europe Meetings). East Asians need to tell the international community clearly what they are motivated to do, how they developed their action plan, and how they believe it fits in with global systems. Outsiders also need to listen carefully and support them, if possible, in an outward-looking direction (Bergsten, 2000).

References

Bergsten, C. Fred (2000), "Toward a Tripartite World", In: *Economist*, July 15.

Bayoumi, Tamim, Barry Eichengreen and Paolo Mauro (1999), "On Regional Monetary Arrangements for ASEAN", In: Yung Chul Park

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

and Yunjong Wang (eds.), *Exchange Rate Regimes in Emerging Market Economies*, KIEP-ADBI-CEPII, Tokyo, December.

Carstens, Agustin (2001), "Use of Contingent Lines of Credit: The Mexico Experience", a presentation at International Reserves: Policy Issues Forum at the IMF, April

Eichengreen, Barry (1999), "Strengthening the International Financial Architecture: Where Do We Stand?", a paper presented for the East-West Center Workshop on International Monetary and Financial Reform, October 1-2.

Eichengreen, Barry, Tamim Bayoumi (1999), "Is Asia an Optimum Currency Area? Can It Become One? - Regional, global, and historical perspectives on Asian monetary relations", In: Stefan Collignon, Jean Pisani-Ferry and Yung Chul Park (eds.), *Exchange Rate Policies in Emerging Asian Countries*, Routledge, New York.

Council on Foreign Relations (1999), *Safeguarding Prosperity in a Globally Financial System: The Future International Financial Architecture*, Institute for International Economics, Washington D.C.

Fischer, Stanley (2001), "Exchange Rate Regimes: Is the Bipolar View Correct?", a paper presented at the Meeting of the American Economic Association, New Orleans, January 6.

Frankel, Jeffrey A. (1999), "No Single Currency Regime is Right for All Countries or At All Times", Essays in International Finance No. 215, International Finance Section, Princeton University, August.

International Monetary Fund (1999), "External Evaluation of IMF Surveillance", Report of a Group of Independent Experts, Washington D.C., September.

International Monetary Fund (2000), *Review of Fund Facilities: Preliminary Considerations*, Washington D.C., March.

Köhler, Horst (2001), "New Challenges for Exchange Rate Policy", Remarks prepared for the Asia-Europe Meeting of Finance Ministers (ASEM), Kobe, January 13.

Lawrence, Robert Z. (1996), *Regionalism, Multilateralism, and Deeper Integration*, The Brookings Institution, Washington D.C.

Reinhart, Carmen, Vince Reinhart (2001), "What Hurts Most: G-3 Exchange or Interest Rate Volatility?", a paper presented at the NBER Conference on Management of Currency Crises, Monterrey, California, March 28-31.

Sakakibara, Eisuke (2000), "Is Asian Recovery Sustainable?", a paper presented at the Asian Development Bank 33rd Annual Meeting Seminar, Chiang Mai, Thailand, May.

Rose, Andrew K. (1999), "Is There a Case for an Asian Monetary Fund?", In: *Economic Letter*, Vol. 99, No. 37, Federal Reserve Bank of San

Francisco, December 17.
Rose, Andrew K. and Charles Engel (2001), "Currency Unions and International Integration", In: *Journal of Money*, *Credit*, *and Banking*, Vol. 34, No. 3, The Ohio State University, August.
Stiglitz, Joseph (2002), "Asian Economic Integration - Current Status and Future Prospects", Opening remarks at the RIETI Symposium, Research Institute of Economy, Trade and Industry, Tokyo, April 22-23.
Williamson, John (2000), *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option*, Institute for International Economics, Washington D.C., September.

Comment on "Beyond the Chiang Mai Initiative: Rationale and Need for a Regional Monetary Arrangement in East Asia", by Yung Chul Park

Leslie Lipschitz

The topic of this paper looks innocuously narrow. But the paper is not very precise on what is meant by a "regional monetary arrangement" and it covers a range of issues: regional financing arrangements, the appropriate exchange rate regime for east Asia and for emerging market economies more generally, moral hazard, regionalism versus globalism, and the new international financial architecture.

I am reminded a bit of Douglas Adams' book *The Hitchhikers' Guide to the Universe* in which the super computer Deep Thought is asked to answer the ultimate question of "Life, the Universe and everything". If I recall correctly, after generations of pondering it comes up with the answer 42. At which point the disappointed sages realise that the question had not been formulated properly.

To try and avoid this problem I will start with some delineations:

- What ought we to think about regional financing arrangements like the Chiang Mai Initiative (CMI) or the broader swap arrangements under study by the Manila Framework Group (MFG)?
- This question is quite distinct from what we ought to think about exchange rate regimes in Asia (and more generally for emerging market countries) and the viability of a common peg or even a common currency.
- And, thirdly, how, if at all, does all this relate to the new international financial architecture?

Regional Financing Arrangements

It is important to understand the context. These financing initiatives did not occur in a vacuum, but rather in the context of much more vigorous regional peer surveillance in the aftermath of the Asian crisis. Regular meetings of the MFG and APEC provide an opportunity for intense discussion of developments in Asia and developments in the rest of the world that impinge on Asian countries. For the IMF (the "Fund") these meetings have been highly informative – they have helped us understand

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

regional and domestic policy priorities and constraints. We gather from the participants that they have found Fund and World Bank participation useful because we have brought to the meeting a frank assessment of downside risks in the global environment that could have implications for domestic policies.

The dangers of regional finance – the problems one might have with an Asian Monetary Fund – are outlined in Yung Chul's paper. Clearly, regional financing arrangements should be supplementary to, not substitutes for, global financing arrangements. This is a simple matter of diversifying risk – no sensible insurance company would offer flood insurance only to a group of homes all in the same valley. Second, it is appropriate to be wary of any large pool of unconditional finance that could skew the balance between adjustment and financing. If a country needs to adjust, it needs to adjust – a certain amount of conditional finance may ease the adjustment path, but financing cannot, in the end, substitute for adjustment. Finally, of course, a large pool of relatively unconditional financing – especially if coupled with a quasi-fixed exchange rate – could exacerbate moral hazard.

I do not see any of those problems with the current move toward regional financing arrangements – the CMI and the ongoing discussions under the umbrella of the MFG. Among the participants there are now much more candid surveillance discussions focused on vulnerabilities in individual countries and on the appropriate policies to reduce them. There is certainly a growing consensus on appropriate priorities in adjustment programmes – witness recent discussions on Indonesia. As Yung Chul points out, activation of the major swaps under the CMI requires a Fund-supported programme. This notion of parallel financing with the Fund was not inserted at the behest of the Fund, but at the insistence of the major (potential) creditor countries in the Initiative. The Fund has not sought to be actively involved in the ASEAN+3 process or the particulars of the design of the CMI, but participant countries have consulted the Fund at various stages of the discussions.

I think that the CMI, and the regional financing discussions within the MFG, represent a marriage of the considerations governing regional financial arrangements with those governing global financial arrangements. At their best they will exert peer pressure for strong policies, and, at times of need, they will provide reliable parallel financing. The Fund's view of these developments is wholly positive.

Exchange Rate Regimes

On the topic of exchange rate regimes I must point out that I am speaking personally, not for the IMF – the matter is far from settled and there is no

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

clear IMF view.

We are all familiar with the menu of options – BBC (bands, baskets and crawl), soft pegs, hard pegs, dollarisation, dirty floats, pure floats, and corner solutions (i.e. either a very hard credible peg or a clean float) – and with the arguments of the various advocates for each.

I was struck in Yung Chul's discussion of exchange rate regimes by his deep distrust of the market. Japan is depreciating, therefore Thailand, Indonesia, and Korea follow suit. The markets get it wrong, it is time for Asia to think about something other than floating exchange rates.

Unlike Yung Chul, I think the evidence of the recent past (crisis in the Czech Republic, Russia, Asia, Brazil, Turkey, etc.) overwhelmingly favours floating – albeit floating with a strong anti-inflationary commitment by an independent central bank. Any type of government exchange rate guidance increases the likelihood of private agents getting into trouble by taking large uncovered forex positions. Moreover, explicit, or even implicit, exchange rate limits are a bit like drawing a line in the sand and daring the markets to cross it; this is a crazy game that countries tend to lose. It is worth noting how well New Zealand and Australia weathered the Asian crisis, and the degree of private hedging in response to a true float.

The notion of a common currency for East Asia or even a common peg is, I believe, quite premature. And I have problems with much of the literature on this issue.

First, it is argued that for a fixed rate or a common currency cycles should be correlated. Clearly, this makes sense in some respects: increasing trade within a common currency area will increase cyclical correlation, and to the extent that cycles are correlated there is less need for independent monetary policy. But surely correlated cycles in any area increase the amplitude of these cycles. Much better is to have uncorrelated cycles; in the US, the north-east is subject to influences different from those in energy-rich Texas-Louisiana or those on the west coast. This however requires an ability to have (a) significantly different fiscal positions and some transfer mechanisms, (b) wage and price flexibility, and (c) labour mobility. Perhaps one of these three safety valves is in place in Asia.

Second, if Asian emerging market countries are buffered by dollar-yen-euro swings, it is not clear why some common peg will be more effective than a float – particularly if relative sensitivities to different major currencies differ between, say, Korea and Thailand.

Third, I think that Charles Wyplosz was probably correct at the beginning of our discussions: If you really do want more fixity you have to think about capital controls. And here I think there are reversibility problems. It will be difficult to get the genie back into the bottle, particularly in places like Indonesia and the Philippines.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Finally, the experience of fixed exchange rate regimes in emerging market Asia has been less than comforting; and one cannot help but be concerned about new financing mechanisms that would make available vast sums to defend an exchange rate against market forces that, in the end, could prove overwhelming.

In sum, I think it is far too early to think of a regional currency arrangement.

The New International Financial Architecture

If there is any one theme in the new architecture, it is this: everything possible should be done to reduce vulnerabilities and to anticipate and forestall crises. This is the context of the CCL, of the new-style IMF surveillance, of FSAPs and ROSCs.

Yung Chul laments the cost of the very high reserve holdings that may be required under the Greenspan-Giudotti rule that suggests 100 percent reserve cover of maturing debt. But this rule of thumb is, I think, misinterpreted. The point is not that a country should necessarily hold huge reserves, but rather that it should have a reasonably well-managed debt and reserve profile. Clearly it should avoid some of the problems of the past – e.g. capital account regulations that create incentives for short-term bank borrowing in foreign exchange rather than for foreign direct investment, or the issuance by government agencies of long-term bonds with put options that effectively convert them into short-term bonds when spreads widen.

In new-style IMF surveillance we spend an awful lot of time trying to assess vulnerabilities. The various Early Warning System (EWS) models tend to find significant empirical weight in variables like reserve cover of short-term debt. But these models are as often wrong as they are right – with a high incidence of type 2 errors – and they are only a starting point. On the particular question of reserve cover, a specific case may help to clarify the general issue.

New Zealand in 1999 showed very high vulnerability on the basis of some EWS models – not surprisingly in that its reserve cover of short-term debt was only about 17 percent. Our assessment, however, was that it was not very vulnerable at all. This rested on a number of observations:

- There was ready private sector access to foreign financing at reasonable spreads (50-75 basis points).
- Banks were robust.
- There was a true floating exchange rate.
- The private sector was highly hedged against foreign exchange risk.
- Much of the foreign debt was intra-corporate and much in local currency; etc., etc.

Hence our assessment was that this was a well-managed country that was not particularly vulnerable – despite the low reserves and despite the mechanical model results.

The bottom line is that (a) there is no mechanical foolproof way of assessing and minimising vulnerability – it takes judgment; and (b) there is, ultimately, no substitute for good macroeconomic policies and robust domestic institutional arrangements. I believe that the development of the various Asian regional economic fora is a positive aspect of the new international financial architecture – a force for beneficial peer pressure that will improve our assessment of vulnerabilities and our appreciation of the macroeconomic and structural policy changes needed to safeguard against them.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Regional Interdependencies and Macroeconomic Crises in Mercosur

Daniel Heymann[1]

1 Introduction

In the relatively short history of Mercosur, the countries of the region have gone through wide macroeconomic fluctuations. Macroeconomic turbulence is not a novelty for Argentina, Brazil and their partners, but it has shown different features in recent years, particularly concerning the strength and nature of regional spillovers. Regional macroeconomic interdependencies became more visible with rapid growth of intra-regional commerce, and the feeling of a "Mercosur component" in the international demand for each country's assets, despite the unequal size of the Mercosur economies and the low starting levels of trade. However, there was little movement in establishing concrete forms of macroeconomic cooperation. On the contrary, recent macroeconomic disturbances, particularly the Brazilian currency crisis of 1999 and the deep recession and financing difficulties of Argentina, set in action strong centrifugal forces. By 2001, the prospects of Mercosur were in doubt. Member countries reconsidered their trade strategies and there was much public scepticism about the benefits of the integration project. The collapse of the convertibility regime deepened the Argentine crisis to an extreme of serious economic disorganisation, while the Brazilian concern was mostly to limit contagion. In such circumstances, regional macroeconomic cooperation was hardly a possibility. Still, regional effects will continue to play a part in the macroeconomic performance and policies of the Mercosur countries. In this chapter, I will briefly comment on the macroeconomic experience of Mercosur, and reflect on the possibilities for concerted regional action.

2 The Macroeconomic Experience Until 2001

The integration process in the Mercosur area started in a period of macroeconomic instability throughout the region. Between the start with

1 Comments by J. Martin, F. Navajas, A. Ramos and J.J. Teunissen are acknowledged. The opinions are those of the author.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

bilateral agreements in 1985 and the formal creation of Mercosur in 1991, Argentina and Brazil strongly felt the effects of the debt crisis of the early eighties. The lack of effective stabilisation strategies resulted in very high inflation in Brazil and hyperinflationary outbreaks in Argentina. The macroeconomic volatility did not prevent governments from engaging in negotiations to promote intra-regional trade, but it made public and private agents concentrate on the short-run swings. The Mercosur project did not become at this point an important factor in economic decisions.

During the nineties, the economies of the area went through drastic changes. The period was marked by an international environment quite different from that of the eighties, and by reforms in policies and economic institutions.[2] Argentina and Brazil liberalised their trade regimes, as Uruguay did before. The members decided that Mercosur would move towards a customs union, to be established (with some sector exceptions) after a few years of transition. Large-scale privatisations took place, especially in Argentina, where most of the state enterprises were quickly transferred to the private sector. The concern for reducing fiscal deficits and ending high inflation was widespread throughout the region. However, in every country the stabilisation policies had different timings and features. Substantial differences remained in macroeconomic policies, in aspects as crucial as exchange rate regimes.

The scarce degrees of freedom of economic policies and the low levels of initial trade[3] strongly limited the willingness and the ability of governments to cooperate effectively in macroeconomic matters. Official pronouncements stated the intention to coordinate fiscal, monetary and exchange rate policies, but did not specify concrete actions, although macroeconomic matters were to be periodically reviewed by groups of country officials. On the other hand, the initial Mercosur agreements were quite specific and detailed regarding the timetable of trade integration.

In the first part of the nineties, macroeconomic performance within Mercosur varied widely. The output level fluctuated in Brazil, while inflation remained very high. Argentina established in 1991 its convertibility system, with a fixed exchange rate to the dollar, when the stabilisation programme urgently needed credibility and any form of monetary management was regarded with deep distrust. This strict regime strongly conditioned policy choices later on. The immediate effect was a rapid disinflation, associated with a recovery in the supply of credit and

2 A general discussion of the reform processes in Latin America can be found in CEPAL (2001) and Stallings and Peres (2000). The cases of Brazil and Argentina are studied, respectively, in Baumann (2000), and Heymann and Kosacoff, eds. (2000).

3 As an example, Argentine imports from Brazil were less than 650 million dollars in 1990. Four years later, those flows had risen to over 4 billion dollars.

more optimistic expectations, which fuelled a sharp increase in output and domestic demand. The trade balance quickly shifted from large surpluses to sizeable deficits, due to a surge in imports. The rapid rise in the value of imports from Brazil became a point of public attention. At the end of 1992, Argentina raised a fee applied on imports, including those from the Mercosur region, from 3 to 10%. This measure generated discussions with the partners, but did not cause at that moment strong objections from Brazil. The use of tariffs for macroeconomic purposes indicated the limited range of the available instruments, and suggested the types of tensions the integration project may be subject to.

The issue of macroeconomic coordination was widely discussed since the early period of Mercosur. According to some opinions, some type of regional agreement on macroeconomic policies was a condition for progress in trade integration. However, the governments had few incentives to make regional commitments, since these would further restrict their choices in macroeconomic management, or put existing policy institutions – like the Argentine monetary system – into question. There were suggestions to moderate the fluctuations of inter-country relative prices and trade flows, like the application of safeguard clauses involving tariffs on imports from within the region, or the use of tax-subsidy instruments to manage bilateral effective real exchange rates. In 1993, the Brazilian authorities proposed the definition of real exchange rate bands; in the case of divergence due to a devaluation in one country, the others would be authorised to raise tariffs on its goods.[4] The Argentine government rejected the idea, and in turn offered its own proposal that in practice would have made the Mercosur partners peg their currencies to the dollar as Argentina had done unilaterally.

This disagreement reflected different views about macroeconomic policies. In Brazil, it was argued that the Argentine fixed exchange rate would induce an unsustainable real appreciation of the peso, leading to a devaluation in the near future. From the Argentine side, the main macroeconomic problem of the area was often perceived to be the instability in Brazil, manifested in rapid inflation and a high real exchange rate.

The divergences in macroeconomic policies and performance did not prevent a very large growth in intra-regional trade, while the operation of Mercosur seemed to become an increasingly important consideration in private investment decisions. Moreover, the governments were able to

4 The proposal included a regional intervention fund, although it was recognised that the resources would be limited, and the fund would be relevant mainly for the smaller countries in the region.

define comprehensive agreements on trade policies. Although there was some discussion (especially in Argentina) about the convenience of establishing a free trade area, rather than a customs union, it was decided that, since the beginning of 1995, a common external tariff would apply for a wide range of goods, and that national tariffs for the remaining items (like capital goods) would converge after a transition period.[5]

In the mid-nineties, the macroeconomic behaviour of the region still varied substantially. Brazil implemented its stabilisation programme in 1994 and Argentina went through a financial crisis and a deep recession in 1995. At the same time, the evolution of trade flows reflected an increase of regional interdependencies.

The Brazilian stabilisation package initially used a fixed exchange rate as an anchor, but this was meant as a short-term instrument. While measures were taken to discourage capital inflows, no major reforms were introduced in monetary institutions. Such clear differences with Argentina's convertibility system signalled the reluctance of the Brazilian government to give up monetary and exchange rate flexibility. The specific design of the Real programme did not cause much discussion in the other Mercosur countries. The much lower inflation and the demand expansion in Brazil created positive spillovers for its partners, precisely at a time when Argentina was showing a downturn in real economic activity.

The behaviour of the Argentine economy generated different interpretations. Some analysts expressed concern about the current account deficits, particularly given the low levels of domestic savings. The pension reform (implemented in 1994) caused an immediate fall in government cash revenues and raised fiscal borrowing requirements. The authorities maintained that the fiscal situation was under control. Regarding the current account deficits, they stressed the productivity gains in various sectors of the economy, and argued that the large increases in domestic absorption could be viewed as an appropriate response to expectation of higher incomes. However, it was clear that a continued expansion of spending and output required a fluid supply of international credit. The raise in the US interest rates in 1994 slowed down spending and the turmoil caused by the Mexican devaluation at the end of that year triggered a deep financial crisis and a sharp recession.

The crisis in Mexico and its repercussions on Argentina came as a shock for the public and the authorities. Preventing a crisis like the one that

5 The name itself of the trade area (Mercosur: Common Market of the South) already indicated that the ultimate aim of the participants was to achieve tight forms of integration (however, neither Brazil nor Argentina showed interest in establishing regional entities). It may be noted here that in its origin Mercosur had not only economic purposes, but was also intended to end the political rivalries from the past.

occurred in 1995 had not been a policy issue. There was a drastic fall in the demand for Argentine assets, soon followed by strong doubts about the solidity of banks, which resulted in a large decline in deposits and a drastic contraction of credit. This triggered an abrupt recession, while unemployment rose by 6 percentage points in about half a year.

Argentina's convertibility system was endangered, as reserves dropped and the authorities were required to sustain the liquidity of the banking system under attack. It soon became clear that the Argentine authorities were determined to defend the fixed exchange rate, and that they had widespread public support.[6] A large package of loans arranged by multilateral organisations eased tensions in the financial markets, precisely at a moment when the run on the banks was speeding up. Demand for assets started to revive, and domestic spending recovered. The rapid increase in exports to Brazil also had an important macroeconomic impact,[7] and clearly contributed to the output recovery that was under way by the end of 1995. From the Argentine perspective, it was as if an "implicit" (and, certainly, fortuitous) coordination had operated, with Brazil expanding its purchases when Argentina was absorbing a negative shock.

The crisis of 1995 showed the sensitivity of the Argentine economy to the moods of international financial markets. It also revealed the importance attached by the public to the fixed exchange rate. The policy responses to the fragility of the banking system consisted mainly of the reinforcement of prudential regulations. The crisis generated a definitely positive perception about the consequences of Mercosur integration. This view persisted in the following years, as the economies of the region went through a phase of expansion with rapidly raising intra-Mercosur trade, and a convergence in macroeconomic performance, featuring especially the drastic reduction of inflation in Brazil.

This behaviour diluted worries about the macroeconomic functioning of the region. For Brazil, the spillovers from its partners lost visibility in the face of the improvement in its own economy, while the impulses transmitted by Brazil to the other countries were clearly favourable. In these circumstances, the parties of Mercosur felt no urgency in contemplating scenarios of regional economic disturbance. Some attention was given,

6 The argument that the incumbent government was willing and able to guarantee the maintenance of the parity with the dollar probably played an important part in voting decisions in the 1995 presidential elections, particularly for the large number of individuals who had taken debts denominated in dollars.

7 Between 1993 and 1995, Argentine exports to Brazil nearly doubled; those additional sales represented approximately 1% of Argentina's GDP. Although very large, the increase in Argentine exports to Brazil was proportionally smaller than the aggregate growth in Brazilian imports, which suggests that the driving effect came from the demand side.

however, to the issues of macroeconomic coordination over the long run, with an active discussion of the possibility of moving towards the constitution of a regional currency area. Still, it was clear that such a process could hardly be started in the immediate future, given the well rooted differences in monetary institutions and prevailing opinions about the regimes best suited for each country. For the longer-term perspective, much would depend on the evolution of the real economic aspects of the integration project.

After the Asian crisis of 1997, the region again experienced macroeconomic instability. Interdependencies had increased with the rising trade flows and the perception of investors that there are common elements in the performance of the Mercosur countries. The volatility of international financial markets could have induced the search for a common regional response. However, this did not happen. After the Russian crisis of 1998, which strongly affected the region, the concerns of Brazilian policymakers were centred on the fragility of its own financial situation, with very high interest rates, pressures in the exchange market and reduced levels of economic activity. Meanwhile, the Argentine authorities made efforts to convince asset holders that they should "differentiate" the Argentine economy from that of Brazil, pointing to the preventive measures to strengthen the banking system, and to their fiscal prudence (although the fiscal situation was showing weaknesses). Thus, once again, the macroeconomic evolution of Brazil was typically seen in Argentina as a source of instability. In turn, Brazil dealt with its domestic matters without showing much preoccupation with the effects on its neighbours. In Brazil, the position of the Argentine authorities was often interpreted as non-cooperative, and especially unwelcome in difficult times.

Mercosur experienced strong tensions after the attack on the Brazilian currency and its sharp depreciation at the beginning of 1999. The Brazilian shock immediately induced a rise in the "country risk" indices for Argentine bonds, even if it was less sharp than in the Russian episode. Initially, there was much concern in Argentina about the possibility that Brazil would enter a phase of large financial instability and low economic activity. In fact, inflation in Brazil did not rise much and real output did not fall as feared, while interest rates gradually came down from very high levels. Argentine exports to Brazil dropped, thus contributing to a deepening of the recession and a worsening of the fiscal situation in Argentina, both directly and through its effects in asset markets. The drop in exports to Brazil, the competition from lower priced Brazilian products, and worries that investments would shift to Brazil, led in Argentina to the call for restrictions to Mercosur trade. Brazil flatly rejected trade measures by its partners in response to its devaluation. Notwithstanding the statements of the authorities that progress of Mercosur remained a policy priority, the episode raised questions about the prospects of macroeconomic coordination within Mercosur, but also about the future of trade and investment policies.

In Brazil the mood was different. The Brazilian economy recovered in 1999, and continued to expand in 2000, with a moderate inflation and declining interest rates. This was widely interpreted as indicating that the Brazilian depreciation, although a traumatic event, had had favourable consequences. Inflation could be kept well under control with a monetary policy that allowed for exchange rate flexibility. Many Brazilian analysts saw the economic difficulties of Argentina mainly as the result of a stubborn insistence in maintaining the inflexible currency regime.

The Argentine government chose to continue the fixed parity to the dollar while the main trading partner had sharply devaluated, the dollar was strong, export prices had fallen and foreign financing was much less fluid. It feared that a devaluation would result in very high costs, given the general denomination of their financial contracts in foreign currencies. To completely rule out the possibility of a devaluation it was proposed to eliminate the existing "escape clauses" altogether, and move to full dollarisation. In Brazil, the proposal induced critical reactions. It would have closed the option of monetary cooperation with Brazil over the long run, and was seen as contrary to the advance, or even the survival of Mercosur.

Argentina maintained its convertibility system, and the recession continued in 2000. This time, the banking sector did not show noticeable liquidity problems, and did not become object of distrust by depositors, although the supply of credit to private borrowers contracted as growth in deposits slowed down and the public sector increased its demand for loans in the domestic market. The government made efforts to control the fiscal situation. Although higher tax rates and spending cuts generated a non-negligible primary surplus, the deficit rose because of the increasing interest payments. The growth of public debt and the visible difficulties in strengthening fiscal policies caused strong concern. As the recession persisted and the need for adjustment continued, the public became pessimistic about income prospects, which weakened domestic demand and indirectly influenced tax revenues. The aggregate volume of exports had resisted the 1999 shock without a large fall, but the value of sales dropped. The performance of exports was in clear contrast with the rapid growth of previous years.

While Mercosur was going through a period of trade frictions and uncertainty about its future as a trade area, the countries had taken steps to define some guidelines for macroeconomic convergence. There were common views about the importance of running low-deficit fiscal policies and keeping inflation low. It was also accepted that there was an element of regional public good in the macroeconomic stability of each country. The guidelines had analogies with the targets that European countries established at Maastricht, but there was no presumption that the Mercosur economies were to unify their currencies, and exchange rates were not part of the set of guidelines. The numerical criteria were meant as indications of policy intentions, which the parties could use as benchmarks in discussing the macroeconomic situation of the region. The agreement reached in December 2000 was that the countries would announce targets for inflation and the net deficit of the consolidated public sector. Since 2002, there would be a 3% cap on the fiscal deficit, with Brazil being allowed a 3.5% level in the first two years. Also, starting in 2005, those countries with net public debts of over 40% of GDP would determine trajectories that would reduce them to that level. Inflation was to remain below 5% between 2002 and 2005; thereafter, an "inflationary core" would be defined, with an annual maximum of 4%. In case a country deviated from the guidelines, it would be required to present a set of corrective measures, which would be discussed by the economic authorities of the area. The enforcement mechanisms were clearly lax, although the exercises could generate over time reputational effects that create incentives for governments to satisfy the guidelines and to use them in their own internal bargainings. However, the regional guidelines did not result in visible effects, as the Argentine crisis rapidly worsened.

By the end of 2000, the Argentine government was practically cut off from international credit markets. A large emergency package of credits by multilateral agencies and local financial institutions caused only transitory relief. After some weeks, the indications that fiscal outcomes were definitely off-target made country risk coefficients shoot up again, and led to the resignation of the economic authorities. A new economic team proposed deep cuts in government spending, but the programme caused strong opposition, and was not put into practice. In March 2001, the authorities imposed a tax on banking transactions, raised tariffs on consumption goods and reduced those on extra-regional imports of capital goods, which was reluctantly accepted by Brazil. The government also announced sectoral "competitivity programmes" with measures such as tax rebates. Reserve requirements were lowered to reduce the crowding out effect of government bond sales to the banks. A large swap operation with outstanding bonds was carried out, in order to cut financing requirements of the government in the following years. Although the interests on the newly issued bonds were high, the authorities saw the swap as a crucial measure to dissipate the immediate fears of default. Beyond the urgencies of financial management, economic policies faced the task of reinforcing the expectations that the economy could meet the conditions for external and fiscal solvency.

In the changing economic conditions of the nineties, the currency board regime and Mercosur had been crucial "fixed points" of Argentine policies. Now they came under discussion. The authorities proposed to modify the exchange rate system, maintaining the features of convertibility, but pegging the peso to a dollar-euro basket. This measure tried to provide more stability to the domestic price level, and it was meant to signal a rejection of the alternatives of devaluation and dollarisation. However, the modification in the monetary system raised the fears of devaluation, especially after the government decided to apply immediately the euro-dollar basket to commercial transactions.

In Argentina, some opinion leaders suggested to transform Mercosur into a free trade area, or advocated a bilateral trade pact with the US – clearly regarded with disfavour in Brazil – while others wanted Mercosur to go further in its economic integration, and act jointly in the negotiations for the Free Trade Area of the Americas (FTAA). However, in Argentina, voices demanding protection appeared to be louder than those stressing the advantages of producing for the regional market, especially at a moment where the Real was again experiencing a substantial depreciation. The integration project clearly had lost its momentum and its appeal to the private sector.

The anticipation of a hard landing for the Argentine economy had become widespread. In the last months of 2001, the level of activity dived vertically, as the capital flight accelerated and future income prospects were viewed with more and more pessimism. Fiscal revenues went rapidly down, which contributed to a further increase of country risk spreads. By the end of November, the public's rush to convert bank deposits into foreign assets became a massive run. In response, the authorities imposed restrictions on the withdrawals of cash from the banks, and established exchange controls. These measures, in effect, suspended the convertibility of deposits into currency, and that of pesos into dollars, which were at the core of the monetary and financial systems. The decision of the IMF to deny the disbursement of funds in December sent a clear message. The social situation aggravated by the liquidity squeeze, which affected particularly lower-income groups who operate in the informal economy. This led to strong tensions, culminating in riots after which the national authorities resigned. The credibility of the fixed exchange rate system had vanished and the economic conditions eventually led to a deep institutional crisis.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

3 Macroeconomic Interdependencies

In the nineties, the volume of bilateral trade between the two largest countries of Mercosur remained small. The ratio of trade to GDP is much lower than in the European case. The economies stayed rather closed and, in the case of Brazil, the share of the regional partners in its total trade was quite low. However, trade flows showed a high variability, so that changes in bilateral trade were quite large. Thus, sometimes, the swings in the regional exchanges of goods reached magnitudes comparable with those of the incremental movements of trade between European countries. On several occasions, the shifts in trade with Brazil have had macroeconomic effects on Argentina. The impulses in the other direction were smaller, but not insignificant. During the nineties, the increase in intra-regional exports represented a significant fraction of the total growth in Brazilian exports.

The evidence about the determinants of trade flows between Argentina and Brazil indicates that there has been an asymmetry in the effect of the macroeconomic variables (real output and exchange rate) of the buyer and the seller. Roughly speaking, the influences on the demand side have been more important, both for the Argentine sales to Brazil and for the flows in the opposite direction. This feature was again observed in 1999 when, given the devaluation in Brazil and the recession in Argentina, there was a sharp fall in the bilateral exports and imports. Another salient characteristic of trade between the two countries was that, although exchange rate effects were sizeable (with long-run elasticities of the order of 1), there was a particularly large response to the level of activity in the economy of the importing country. Thus, the volatility of trade flows seems to have been due in part to shifts in real exchange rates, but mostly to the fluctuations in real output.

The perspective of an easy access to the regional market and the expectation that this would be a growing one were probably important factors in investment decisions during the nineties, and in particular induced FDI to the area. By contrast, uncertainties about Mercosur had a negative effect on investment since the late nineties, especially in Argentina. The regional effects on real investment, even if hard to quantify, were a source of interdependence. However, the external financing of each country proceeded through international markets, and the credit movements between the economies (leaving aside those directly connected with trade) were quite small. Accordingly, the transmission of impulses through financial channels worked through the perceptions and decisions of international operators.

Contagion effects on asset demands may be induced by a variety of

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

mechanisms. Establishing the relevance of each one in concrete instances is not a trivial matter, and prediction is even more difficult. Still, there has been some evidence of correlation between the prices of assets of different "emerging markets", which may increase during crisis episodes (Calvo and Reinhart, 1995; Eichengreen, Rose and Wyplosz, 1996; Ganopolsky and Schmuckler, 1998; Rigobon, 1999). The "country risk" indicators of Argentina and Brazil show associations in their movements, but the differential interest rate spreads of the two economies also shows wide shifts. For instance, while by late 1996 the yield of Argentine bonds was somewhat higher than that of their Brazilian analogues, by the end of 1998 the Brazilian risk factor had risen substantially above that of Argentina, and the gap further increased in early 1999. By contrast, later on, the Argentine spread was clearly larger, and grew well above the indices for Brazil and other "emerging markets', as the prospects of default caused a precipitous fall in the prices of bonds.

This behaviour indicates that the specific conditions of each economy had a definite influence on asset prices, and that there was a certain "differentiation". The financial interdependence was neither automatic nor necessarily tight. At the same time, however, there are concrete reasons why the valuation of assets of both economies do indeed depend on one another. The Brazilian credit markets suffered comparatively little from the Argentine crisis in 2001, which has contributed to the relief in international financial circles about the weak contagious effects of the troubles in Argentina. It seems unlikely, however, that the supply of credit to each country would become entirely de-coupled.

All Mercosur countries experienced macroeconomic effects from others in the region, especially in periods of turbulence. Although countries had an interest in avoiding "excess volatility" of the region as a whole, it did not result in a concrete set of actions that the parties were willing and able to undertake.

The Mercosur economies have wide differences in size. Brazil is large for regional standards (even more so after the Argentine devaluation of 2002), and perceives itself as such. A Brazilian economy that generates the expectation of steady growth and low inflation may naturally evolve into a regional "focal point" regarding the configuration of economic policies and the response to shocks. But that expectation remained to be established. Argentina had a particular pattern of economic relations, with Brazil as its main trading partner, a good part of FDI coming from the EU and a dollarised financial system, while a group of influential opinion makers saw a trade association with the US (possibly with dollarisation) as the best alternative available. This mixed pattern created a potential for tensions, especially at times of uncertainty about the macroeconomic

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

performance of the Mercosur economies. The member countries seemed to be in doubt about the significance of the integration project, and looked at the attitudes of their partners with concern.

The macroeconomic policy approaches showed some convergence over time, but also clear-cut contrasts. The differences in monetary policies in Argentina and Brazil in the nineties can be ascribed to a great extent to the specific conditions of each economy, although at times the analytical views also diverged. In practice, the exchange rate policies were placed "out of discussion" when considering macroeconomic cooperation in the region.

It was often stressed that the development of Mercosur should start with easy steps, like the exchange of information and discussion of economic projections and policies, to establish a practice of working together. However, such routines were not developed in Mercosur. They may have had a non-trivial content in making it easier for partners to predict the behaviour of others and to consider opportunities for common action. An expectation of repeated interaction could have helped in creating incentives for the participants to establish "mutual confidence". While macroeconomic cooperation among countries not participating in a trade area is clearly conceivable, in practice, progress in dealing jointly with macroeconomic issues seems to require that the partners perceive their economic relationship as a convenient long-term project. By the end of the nineties, that was an open question in Mercosur. At the same time, the controversies that were raised about the trade and investment policies of the countries of the region underscored the influence of macroeconomic conditions on the attitudes concerning intra-regional commerce. Trade and macroeconomic matters should have been considered in conjunction, and with a long-run perspective. However, this would not have made the problem easier, particularly when turbulences shortened the decision horizons.

4 Crisis Prevention: Some General Comments

Economic crises have been much analysed. Much of the recent effort has been directed to modelling large currency depreciations or abrupt falls in spending and credit flows within a framework that assumes that agents understand the workings of the environment (although they may be surprised by the realisation of random exogenous shocks, from known probability distributions). The approach allows for coordination failures (in the form of "bad collective choices" among multiple equilibria, perhaps triggered by a realisation of some extraneous "sunspot variable"), but always maintaining the presumption that individual plans are consistent with one another, and that expectations are "as good as can possibly be" given the information available. Quite apart from the usefulness of the results of that work, the expectational assumptions contrast with the common observation that crises tend to motivate agents (and analysts) to "rethink" the implicit or explicit models that they had been applying in order to make interpretations and forecasts.[8]

Large disturbances often happen when too optimistic income expectations – leading to a rapid expansion of credit supply and demand – are put into question. This type of crisis appears to be associated with revisions of beliefs about the trend of incomes, with consequences for the anticipated solvency of debtors and the willingness of agents with access to credit to enter into debt.[9]

From this point of view, the emergence of crises would be related to difficulties in projecting the future value of "fundamental variables", which in turn may induce agents to form incoherent expectations and make decisions that depart from a "sustainable path". Such difficulties are likely to be particularly relevant in economies that are undergoing transitions in their configuration or performance, and where past patterns of behaviour do not form a sound basis for making forecasts. "Model uncertainty" would then seem an integral part of the process leading to a crisis, although, once this happens, the features of propagation and amplification mechanisms (through credit channels, for example) may show recurrently observed features.

The previous argument could have concrete implications. First, crises would typically be hard to anticipate. To identify a situation of excessive spending, the actual evolution of the economy has to be compared to a reference path, which can only be determined by making some conjectures about the economy's future opportunities and performance. Predetermined numerical criteria that try to distinguish between sustainable and unsustainable behaviour would be at best rough rules of thumb that may be qualified or modified by informed judgments. Being alert to the possibility of crises would require active working in interpreting data and

---

8 In this connection, the attempt to extract lessons from crisis episodes presumes that there are new elements to be learned from such phenomena, which were not already incorporated in existing models. It seems paradoxical that much of this work is carried out under the methodological assumption that the beliefs of agents have already "converged to the true model", and according to which the new data that the analyst uses to consider alternative hypotheses would add nothing to the knowledge of the decision makers in the system.

9 The argument refers to the traditional macroeconomic theme of intertemporal coordination (cf. Leijonhufvud, 1981). The connections between expected trends, wealth perceptions and fluctuations in credit and aggregate spending have been explored in Heymann and Sanguinetti (1998), Heymann (2000) and Heymann, Kaufman and Sanguinetti (2001).

analysing scenarios. In a regional setting, this draws the attention towards a routine of joint monitoring of the economic evolution. The opinions of the partners may increasingly gain importance, and eventually lead to actions decided by consensus.[10]

Second, it is analytically appealing to contemplate the determination of economic policies through a set of "contingent rules", which serve to guide expectations and, at the same time leave flexibility to react to shocks. Actual policies are typically set either through more or less strict rules, or in a rather "open ended" way. One of the reasons is imperfect knowledge of the model. The preferred combination of both types of policy scheme, and the institutional "level" at which actions should be taken, seems the outcome of informed groping, rather than the result of a grand exercise of once-and-for-all optimisation. Possibly, preventive measures would take these two forms. For example, prudential regulation of banks, through well-defined restrictions on the portfolios of intermediaries seems to have had effects in preventing the propagation of shocks through the banks (although, clearly such prudential considerations face trade-offs with objectives regarding the cost and segmentation of credit). Fiscal management on the basis of cyclically adjusted variables can be envisaged, although estimating the trend-cycle decomposition is precisely a big difficulty in transitional situations. In any case, there would be room for more or less "flexible" policies that take into account that the risk of crisis could call for "precautionary savings". In these fields, there are opportunities for regional cooperation, such as coordination of bank regulations, and the analysis of common projections and policy alternatives. "Mutual insurance" schemes may be considered, although they are difficult to design and implement.

Crises are likely to combine doubts about a country's solvency with strong liquidity constraints. Access to credit may be tightened to an extent that does not correspond to the debtor's capacity to repay in "normal times" and with a more adequate provision of funds. This point has been recognised, and in recent years, there have been several large international operations to provide liquidity assistance to "emergent" economies. There have been proposals for setting regional funds, that may do part of that work and "constitute a link between individual countries and a strengthened and reformed IMF" (Agosín, 2001; cf. also Griffith-Jones *et al.*, 2001). These may possibly act as "first line of defense" in case of liquidity shocks on some countries, especially if they are of comparatively small size. Their operation would require the establishment of criteria for lending, which can be a useful exercise for regional cooperation.

---

10 Such exercises of joint monitoring can lead to more formalised schemes of "peer review" (cf. Ocampo, 1999), with a potential signalling effect on third parties.

However, the Argentine episode of recent years is a particularly dramatic instance where the potential mechanisms for crisis prevention failed to work. In Argentina, too optimistic expectations in the nineties and political problems, like the "game" between national and provincial fiscal authorities, resulted in excessive spending. The economy was ill-prepared to adjust to lower dollar value of incomes, particularly due to the dollarisation of the financial system.

The Argentine adjustment problem exceeded the regional capacities. In fact, beyond the relevance of statements of support by the Brazilian government, the role of Mercosur in the process that led to the breakdown of the convertibility system was quite limited. The behaviour of out-of-region agents showed the absence of concrete criteria and procedures to deal with solvency problems, and to help countries to handle matters as complex as the exit from convertibility in a dollarised economy.

5 Post Scriptum: The Argentine Crisis in Regional Perspective

At the beginning of 2002, the Argentine peso was finally devalued. The outcome confirmed the worries about the large exit costs of convertibility. In particular, the whole system of economic contracts was put into question, and the urge of the public to withdraw their funds from the banks was only (and partially) suppressed by a compulsory reprogramming of deposits. The collapse of the exchange rate parity opened problems as deep as that of re-defining monetary and fiscal policies and that of handling the effects of the depreciation on the real value of assets, liabilities and the regulated prices of public utilities, in an economy where trust in the political system was practically non-existent, the expectations of creditors and debtors were irreconcilable, the government had defaulted on its debt and, in addition to already sharp recession, day-to-day transactions were constrained by tight liquidity restrictions, even as the demand for foreign exchange appeared very strong. In these conditions, the disturbance went much beyond those typical of (even turbulent) currency crises, or big recessions: the economy was left in a disorganised state, as public and private agents groped for new patterns of behaviour to operate in a system where contracts had been disrupted and many agents had suffered large wealth losses. This left an extremely complex task of reconstructing basic elements of the economic system, while the processing and allocation of the large costs of the disturbance was under way. Meanwhile, the messages from abroad mostly urged the definition of a "sustainable programme" (left unspecified as a whole, apart from the requirement that more pressure to adjust be put on national and,

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

particularly, provincial fiscal policies) before any form of assistance could be contemplated. Thus, the first quarter of 2002 passed without concrete negotiations between the government and the IMF.

In this instance, too, Mercosur was not a major actor. The Argentine crisis did not show strong financial repercussions on Brazil. Movements in foreign trade induced by the Argentine situation did not seem to cause large macroeconomic consequences in Brazil, although the fall in Argentina purchases was quite large. As for Argentina, the sharp real devaluation of the peso and the drastic fall in domestic demand greatly increased the quantitative importance of exports for the domestic economy. Consequently, the regional effects on the Argentine economy became more important.

Mercosur was launched during a period of much uncertainty, and has continued with governments of different political colours. Over time, it became a visible part of the economic environment for agents and policymakers. Since the last part of the nineties, the integration project suffered a very severe setback. However, it is unlikely that the strengthening of the economic relations between the countries that took place during the nineties will be wholly reversed. In spite of the increased asymmetries, the regional performance will remain a permanent concern in each economy. Whether Argentina can establish eventually a stable monetary system without a strict external anchoring, will undoubtedly be an important factor in the regional interactions.

The countries of the Mercosur region have concrete arguments to keep investing in establishing practices of cooperation, particularly in macroeconomic matters. The gains to be obtained in the long run from those regional cooperation efforts would depend on the intensity of interdependencies, and therefore on the size of the economies of the regional partners. The likelihood of large shocks, but also the expectation of long-run growth or recovery of the economies of the region provide an incentive for some type of regional approach to macroeconomic problems.

Over time, regional policy cooperation may possibly perform limited but important roles in dealing with the incentives to use trade frictions as demand-shifting devices, and in signalling that Mercosur intends to continue to provide the framework for regional trade in the future. Post-crisis joint monitoring of the macroeconomic evolution seems particularly relevant. It matters greatly to have a common framework available to evaluate scenarios and policy options, and to consider responses (even if "ad-hoc") to new disturbances, or measures to help sustain recoveries. The regional guidelines on public finances and inflation that were agreed in 2000 had little immediate impact, and clearly they did not operate as actual restrictions for the decisions of each country. However, at some point, they may serve a purpose in defining common attitudes regarding central aspects of policies, and as indicators of objectives and triggers for discussions.

References

Agosín, M.R. (2001), "Fortalecimiento de la cooperación financiera regional", In: *Revista de CEPAL*, Vol. 73.

Baumann, R., (ed.) (2000), *Brasil, Uma Década en Transicao*, CEPAL-Editora Campus, Río de Janeiro.

Calvo, G. and C. Reinhart (1995), "Capital Inflows to Latin America, Is There Evidence of Contagion Effects?", mimeo.

CEPAL (2001), *Una Década de Luces y Sombras. América Latina y el Caribe en los Años Noventa*, Editorial Alfaomega, Bogotá.

Eichengreen, B., A. Rose and C. Wyplosz (1996), "Contagious Currency Crises", NBER Working Paper, London.

Ganopolsky, E. and S. Schmuckler (1998), "Crisis Management in Argentina during the 1994-95 Mexican Crisis", Policy Research Working Paper, World Bank, Washington D.C.

Griffith-Jones, S. *et al*. (2001), "Reform of the International Financial Architecture, Views, Priorities and Concerns of Governments and the Private Sector in the Western Hemisphere and Eastern Europe", Report commissioned by DFID, Brighton.

Heymann, D. (2000), "Major Macroeconomic Disturbances, Expectations and Policy Responses", In: *CEPAL Review*, Vol. 70.

Heymann, D. and P. Sanguinetti (1998), "Business Cycles from Misperceived Trends", In: *Economic Notes*, No. 2.

Heymann, D. and B. Kosacoff (eds.) (2000), *La Argentina de los Noventa*, Editorial Eudeba-CEPAL, Buenos Aires.

Heymann, D., M. Kaufman and P. Sanguinetti (2001), "Learning about Trends, Spending and Credit Fluctuations in Open Economies", In: A. Leijonhufvud (ed.), *Monetary Theory as Guide for Monetary Policy*, Palgrave (forthcoming).

Leijonhufvud, A. (1981), *Information and Coordination*, Oxford University Press, Oxford.

Mussa, M. (2002), "Argentina and the Fund, From Triumph to Tragedy", mimeo, Institute for International Economics, Washington D.C.

Ocampo, J. A. (1999), *La Reforma del Sistema Financiero Internacional: un Debate en Marcha*, Fondo de Cultura Económica-CEPAL, Santiago de Chile.

Rigobon, R. (1999), "On the Measurement of the International Propagation of Shocks", MIT Working Paper, Massachusetts Institute

of Technology.
Stallings, B. and W. Peres (2000), *Growth, Employment, and Equity: The Impact of the Economic Reforms in Latin America and the Caribbean.* ECLAC/Brookings Institution Press, Washington D.C.

Comment on Yung Chul Park and Daniel Heymann

Amar Bhattacharya

I will look at the papers of Park and Heymann together: What do they tell us about regional arrangements? Daniel's paper provides a very good overview of the history of Mercosur, in a very textured way, and informs us about the problems that arose. There is not much to comment on what happened.

There are two kinds of obstacles in Mercosur that are worth highlighting. The first is the asymmetric marriage between Brazil and Argentina, but that is not *per se* the Achilles heel. The Achilles heel is: trying to make a marriage with a country that decided to fix its currency, and a country that decided to keep its options open in terms of exchange rate arrangements.

Why does it matter? It matters because in the new world the shocks are coming in the form of capital movements. It is not macroeconomic disturbances or trade disturbances that are driving the story. There is an exogenous shock, driven by "model uncertainty", as Daniel calls it very nicely. As a result, there is a huge change in relative prices between the currencies of Brazil and Argentina, and that of course makes the marriage completely untenable. That is the fundamental flaw of the Mercosur arrangement. As long as this remains it is not possible to achieve stable trade relations, nor macroeconomic policy coordination. So I share the very cautious prognosis about what will happen.

Second, there is uncertainty in terms of competition between Mercosur and the Free Trade Area of the Americas (FTAA). There is clearly uncertainty about the evolution of the exchange rate regime and the transition of it in Argentina, and it is very clear that Brazil has moved very speedily not just to a floating exchange rate regime but to an inflation targeting system that now makes their system much more irreversible. This makes the chances of success of Mercosur smaller.

I'd like now to step back and use Daniel's paper, and the issues that Yung Chul Park covered to ask: what is it what we mean by regional financial arrangements? A lot of the traditional discussion has been driven by trade integration, trade blocs, etc. And from there we go to financial integration, exchange rate coordination, exchange rate alignment and maybe even a simple currency bloc. What was interesting in the previous

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

discussion is that we were talking about fixed versus floating exchange rates *for a country*. But the issue that matters is really fixity of exchange rates *within a regional bloc*. This is the point Charles Wyplosz was making before. Do East Asian countries, for example, want to see greater fixity in exchange rates between themselves even if they want to float vis-à-vis others? And what does that imply in terms of crisis prevention and crisis management?

The issue of what a national approach on exchange rate policy ought to be, is an important issue, but I do not believe it should be the central topic of this conference; after all, this conference is about regional arrangements. Having said that, I would say that the issues of regional financial arrangements or crisis prevention and crisis management are not necessarily the same as for trade blocs, and this is something that is worth pushing the boundary of thinking. What do we mean by an appropriate regional bloc, what do we mean by regional financial arrangements and what are appropriate blocs to constitute such regional arrangements?

In particular – if I pick up on the very important insight that is stressed in the paper by Daniel – there is in this world this "model uncertainty". You can think about it as a boom-bust problem – that is, as expectation changes that happen in the boom period versus the bust period. What are the reasons for these very large surges and withdrawals of capital flows and is there a correlation in these surges and withdrawals between groups of countries? There could be many reasons for it. A first reason, obviously, may be the degree of real integration. But there are also expectation changes that are driving such contagion. So there is no simple answer as to why we have contagion. Given that, what are the criteria that we would think of in terms of an appropriate universe for putting in place regional financial arrangements?

One is contagion and there are very good measures of contagion. You could say that the 'Tequila' crisis in Mexico affected Argentina and Brazil more than East Asia. There are very good estimates of it. I make that point because it shows that contagion can happen even outside a trade bloc; it was not Mercosur that triggered contagion but it was Mexico.

A second criterion for regional financial arrangement could be risk pooling. There is covariance risk in the group that is suffering contagion. So if you want risk pooling you draw in people that are not that much correlated to you and that have deep pockets. So maybe regional financial arrangements should have a broader membership rather than a narrow membership.

A third point was implicit in what Yung Chul Park was saying. The Chiang Mai group – if my personal recollection goes back to December of 1997 in the meeting after the Manila Framework group meeting – excludes the Anglo-Saxons. There were four economies who were members of the Manila Framework group that were not invited to the December 1997 meeting that became the origin for the Chiang Mai group. The reasons for this may be – like José Antonio Ocampo was saying – the degree of ownership there is in a group that is willing to commit itself in a political sense. I only raise this to say that clearly trade is not the appropriate benchmark for defining a "regional" group in terms of financial arrangements. You are not going to get to a world of instantaneous exchange rate coordination and a currency bloc.

So, what is an appropriate group? I do not think we have yet an answer to that. Nor is it necessarily that it is a single group. Let me illustrate by giving you an example. In East Asia, since the East Asian crisis, there has been a major revamping of the APEC finance ministers' process to focus on issues of what they had been calling regional financial architecture. If you look at the agenda of any APEC finance ministers' meeting, you will see that it has been more focused on the financial aspects of coordination, not just in a macro sense, but on prudential regulation, on corporate governance, credit rating agencies, you name it.

Second, there are two groups that have been set up that are quite unique, the Manila Framework group and the Chiang Mai Initiative. These are the first groups that have been explicitly set up to deal with financial crises. Most of the other groups, the Mercosur group, for example, come from the trade angle. Even the Andean Reserve Fund, I would argue, is not really a financial crisis-driven but a development finance-driven concept. The innovation of these two Asian groups was that they are really driven by having some kind of a regional element in terms of responding to financial crisis. Then you have ACEP (Asia-Europe parliamentary meeting), which was created to foster trade between Europe and Asia, but has also been very focused on responses to crisis.

Again, the point that I am making is that when you are talking about regional arrangements there is not one regional group but there are indeed many different regional groups, and it is important to say that we are talking about regional *financial* arrangements, not regional *financing* arrangements. Because a lot of the elements of what I would consider part of the regional architecture are actually spread out between these different sets of groups.

Similarly, in Latin America, there is the Latin American Reserve Fund, there is the Western Hemisphere Finance Ministers' process, there is ECLAC, Mercosur, the Andean Pact, there is a variety of groups again, that are carrying out the discussions. Which takes me to a fundamental point about architecture and the division of the work by all parties. In a sense there is a continuum: you have things that are truly international,

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

especially in the area of financial architecture, because capital markets are inherently global. And my personal view is that a lot of the discussions, especially about the rules of the game, have to take place at this international and global level. But, there are roles that can be very importantly played by regional elements as a complement to the international and the national arena.

So what is the agenda in terms of regional integration?

The first is the rules of the game. A point that José Antonio Ocampo made and I share, is that regional groups bring voice to those who are often given less voice in so-called universal groupings. It is therefore an important way of not only extending, but including smaller participants in the process. But it is also a way, as Yung Chul Park was implicitly suggesting, of getting 'political buy-in' at the political level and therefore reinforcing what can be done at the multilateral level.

There are three levels, or areas, that may be important in terms of the rules of the game in a world of "model uncertainty". The first is in terms of macro rules of the game. I was struck by Daniel's paper – that Mercosur had actually come to establishing some Maastricht equivalent of macroeconomic rules – I was not aware of it. I think that is quite an interesting innovation, just as a signalling element if nothing else. To this, I would add the whole discussion of standards, financial sector rules etc. And in that context, I would say, this could also be about the importance of safeguards and prudential arrangements, which are not beggar-thy-neighbour. If you want to deal with the "model uncertainty", the accelerator problem or the multiplier problem, it may help to have some commonalities in terms of what Daniel called precautionary arrangements. So again, this may be a useful mechanism where you could have regional arrangements in terms of complementing discussions at the international level.

The second element, as Leslie was suggesting, is what one would call enhanced surveillance. There can be an inherent complementarity and productive tension between multilateral surveillance, regional surveillance, peer review, and, ultimately, surveillance by the market place. There is a range of possible arrangements as we find them, for example, now in East Asia. The surveillance is taking place in Asian finance ministers' processes, that is in ASEAN+3 and APEC. In my view, the most intensive surveillance, with by far the best quality, takes place in the Manila Framework group.

So there is surveillance in very different groups; there is peer review, policy dialogue. We are still at the quite rudimentary stage vis-à-vis policy coordination in the kind of precautionary measures that Daniel was talking about. None of us has talked about the 'peer support' capacity building

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

help that can come from regional arrangements. The big countries then can help in a big way. Korea can share experience, and I know it is valued very much by other countries in the region. So, in these regional arrangements, it is not just a question of monitoring and peer review but there is also a support mechanism.

The final part of the framework is mutual insurance. In any risk pooling n+1 is better than n, unless you have complete coincidence of shocks. Having three members is better than just risk pooling by yourself. But there is absolutely no doubt that within regions the covariance risk is high. What that implies is that there is a big contrast between Latin America and East Asia. As Daniel points out in his paper, one of the reasons why mutual insurance has not played out well in Latin America is because Latin America sometimes has been in perpetual crisis, with very little reserves to run the show. Therefore, nobody is willing to put money into a common kitty, when your back is against the wall and you are trying to protect whatever limited pool that you may have. Now, the contrast between Latin America and East Asia is that the pool in East Asia is much larger, giving East Asia much greater options. But that raises all the questions of what does that do in a Mc Dooley sense, in terms of giving you a bet to pay them.

Then on the topic that was most intensely debated: why should there be a monopoly in international coordination of liquidity support? While I think there can be complementarity, let me add to the debate by saying why I think there is a coordination problem. Essentially, when you are dealing with systemic crises, as opposed to short-term fluctuations, the basic problem is the one that Daniel mentioned in his paper; that is, uncertainty about insolvency, combined with a liquidity problem. It is not a question of insolvency *or* liquidity. It is uncertainty about whether a borrower is insolvent and, *at the same time*, has a liquidity problem. That is the reality of suspended crises. In that context there are two types of coordination problems that arise. The first is the point that Leslie mentioned, which is the balance between adjustment and financing. And somebody has to be an arbiter about that balance. It can be dressed up as conditionality, you can talk about it many days, but there is a real problem about how much adjustment should there be and how much financing should be provided, and there has to be an arbiter. The second coordination problem is, if there is a perception about private sector involvement, then in a *global* capital market you need a *global* coordinator for engagement of the private sector. The lenders are not regional but global players. Therefore, you will need a global coordinator to come in. What kind of private sector involvement should there be? Should there be private sector involvement at all? Who is going to set the rules of the

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

game? For both of those reasons, I would argue that there is an argument for the IMF to be at centre stage in playing a coordinating role.

That does not mean that there is not – as Leslie was pointing out – a role for regional financing arrangements. Regional financing arrangements can do two things. One is, they can intervene so that small problems do not become big problems. But there is a very fine judgment that has to be made about whether that is the case, and that takes you to set a 10 percent rule a 20 or 25 percent rule, but some kind of rule has to be set and regional arrangements could be a mechanism to deal with the short-term volatility. But the moment you are in a systemic dimension, I think you have these fundamental coordination problems and there has to be the kind of complementarity. That is why there is a fundamental need for a coordinator.

So regional arrangements versus a monopolistic coordinator may be a false distinction, and may not be that useful in a practical sense. What you could argue for is that you should set up arrangements that have two aspects of dynamics in it. One of it is financial and the other is, what I would call, improved governance. The financial one is that there is complementarity in terms of what the IMF is able to provide by liquidity support and what the so-called second line of defenses were not able to do. And while regional financing arrangements can play a role, their role will be greater the more endowed the region is with the kind of financing that East Asia has in place. At the political or governance level regional financial arrangements will create a certain healthy tension between global multilateral institutions and the regional institutions. But it could enforce a reconciliation of views. If I caricaturise the previous discussion, Leslie said there is a need for conditionality; Park said regional conditionality would be tighter and more stringent than Fund conditionality; and Ocampo said there should be no conditionality at all. But the reality is, there has to be a decision about at what point do you intervene with conditionality and at what level would you be prepared to intervene without conditionality – which is very much the decision the IMF had to face in terms of their various interventions.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

Floor Discussion of “Regional Economic Integration in East Asia and South America”

Doubts About the IMF Monopoly

José Antonio Ocampo wondered whether the IMF should really have a monopoly in the provision of international liquidity. “In development banking the world long ago moved from monopolies,” he observed. “There is the World Bank, there are the regional development banks, and there are also subregional development banks. But somehow we maintain the position that in the area of liquidity provision there should be a monopoly. Why? Why should the world have just one actor in the area of liquidity provision? Where is the strong argument for that? I think this is really an untenable position.”

Ocampo stressed that the smaller countries would benefit from a move towards a regional monetary arrangement. “It is the small actor in the international scene that would benefit. For example, El Salvador or Honduras or the Czech Republic. Not Japan or China or France or Germany; those countries have a powerful position vis-à-vis the IMF.”

Ocampo believed that the move towards regional regimes would also be good for competitive reasons. “When the IMF has it wrong, and there is no reason to think that the IMF can never have it wrong, there is no other institution saying that it is wrong. This is a strong argument in favour of having other actors go against the analysis of the IMF and generate an independent analysis by themselves.”

Ocampo shared Park’s view that strong conditionality is not really part of the question for regional monetary arrangements. “You probably cannot have an unlimited supply of funds without some sort of conditions. But there are other factors that determine whether you pay or not. A good example is the former Andean Reserve Fund, now called the Latin America Reserve Fund, though it is still basically an Andean fund. Even during the debt crisis of the 1980s it has never lost a single cent while it has never had any conditionality. The basic reason for this is that the member countries have a sense of ownership of the institution. I mean, if you really want to be a beneficiary next time, you have to fulfil your obligations.”

Heiner Flassbeck supported Ocampo’s critical stance on the role of the IMF as the sole global institution in addressing financial crises. “Clearly, a global system would be the best,” he said. “But the strange thing is that,

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

since we do not yet have a global system, countries are pushed to find unilateral solutions. However, you cannot have national solutions for international problems of money and finance. In my view, the unilateral solutions are totally inconsistent and absurd. So, a regional arrangement for the provision of liquidity in times of crisis can be more attractive than the monopolistic arrangement we have now with the IMF."

Flassbeck observed that, in practice, the regional funds always have some conditionality. "Europe always had a certain kind of conditionality. But there may be quite different forms of conditionality and there may be quite different traditional social relations in a country, which give reason to a different kind of conditionality. I agree with Yung Chul and José Antonio that the same degree of pressure and the same force to adjust can be much better applied at the regional than at the international level by a global monopolist."

Yung Chul Park addressed Lipschitz' comment that a regional arrangement would have to be supplementary or complementary to what the IMF is doing. "When we spoke to the Managing Director of the IMF, he said that the IMF is supporting the Chiang Mai Initiative but only on one condition: 'It has to be complementary or supplementary to the IMF facilities.' He emphasised that sentence five times. The Chiang Mai Initiative has, until now, been structured in that way. But the question is: why? Why has it to be complementary and supplementary to the IMF? I have not yet heard any credible explanation."

The Exchange Rate Question

Flassbeck disagreed with Leslie Lipschitz' plea for free floating. "I think we should stop fighting strawman permanently. If you say, 'We all know that exchange rates in Asia had been fixed too much, they should have been more flexible', hardly anybody disagrees. That is not the point. The point is whether we have to move from a soft peg to the corner of fully flexible exchange rates. These have shown to be extremely difficult to manage for small economies. That is the big question.

But what advice has been given to the Asian countries? They have all been advised to liberalise capital flows. Nobody has advised them how to arrange reasonable and rational exchange rate regimes and nobody has assisted them in doing that because, as I said earlier, this would be a global task, or at least a regional task; it cannot be done by a country alone. Because the exchange rate of one country is at least the exchange rate of another. So it is ridiculous to say that we have a national solution for an exchange rate regime. The exchange rate is by definition a multilateral thing."

Zdeněk Drábek observed that those who blame East Asian countries for having applied the wrong exchange rate policies, are misinterpreting history. "The East Asian countries are now being criticised, but for twenty or thirty years they were praised for applying the right kind of exchange rate policies. The exchange rate system worked and worked very well. The only big problem was that at a certain point things were wrong and that nobody noticed that they were wrong. As we were trying to design warning signals for the capital movements, presumably we should have developed a similar kind of warning signal system for countries. But to say that East Asians had it wrong with the exchange rate for twenty or thirty years, is a complete misreading of history."

Oldřich Dědek stressed that, in times of trouble, an overshooting of the exchange rate may be seriously detrimental to the economy. "The policy of high interest rates aims at preventing excessive exchange rate overshooting and restoring credibility in the currency. I do not think that using some policy measures to prevent excessive overshooting has anything to do with moral hazard. In my view, overshooting may have dramatic consequences for the economy. So I have some sympathy for the idea of regional monetary arrangements if they help prevent these dramatic consequences of exchange rate overshooting. Then it would be a good idea. Not when they aim at defending an exchange rate when the fundamentals are wrong."

Park dwelled on the exchange rate question too. "The trend is that most of the countries in East Asia are now moving towards some sort of intermediate regime. They are going to control their capital movements to some extent, with the blessing of the IMF. There is also clearly a need for creating a common basket to peg their currencies to and the question is: what kind of currency should be put in the basket? These are the kind of questions that the thirteen countries of the Chiang Mai Initiative are debating among themselves.

Fixing the exchange rate at national level is not an issue. One of the reasons why we in East Asia are moving towards intermediate regimes is simply because the system of floating rates with deregulated capital market transactions and monetary inflation targeting does not seem to be working very well."

The Markets Can Have It Wrong

Bill White observed that bank money has been haemorrhaging out of Asia ever since the Asian crisis. "The question is: is it connected to the situation in those countries or to the broader global situation?"

According to White it relates to both. "In addition to these global phenomena acting against the best interests of Asia, things like NASDAQ which was doing so wonderfully, there are clearly the idiosyncratic things

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

that Leslie points out. I mean, virtually every one of those countries has got either a significant economic or political problem that investors are conscious of."

Oldřich Dědek agreed with White but stressed that the markets can have it seriously wrong. "We now question the drastic overshooting on the stock markets. But everybody knew that the stock market was wrong in the United States and elsewhere for five to six years. Why didn't we say that before? That is the question. But we all know that the market got it wrong for a long time..."

Park also raised doubts about putting too much faith in the markets. "The notion that we hear constantly from the IMF is, if we push harder and if we work harder to restructure our economies, especially improve corporate financing and banking standards and things like that, we will not have to hold as many reserves as we do now, and the market will realise it. But again, it is not what we observe in the market. Most of the crisis-hit East Asian countries have been successful in reforming their financial institutions and corporations. They have made progress on average. But even if you are making progress in reforming your economic system, the markets do not seem to appreciate and recognise the progress you make. That is our constant frustration."

Global and Regional Rules of the Game

Turning to Daniel Heymann's paper, José Antonio Ocampo emphasised that international financial institutions pretend that they treat countries equally, while in fact they do not because there is a basic asymmetry between the countries. "In Latin America, for example, you only have three countries that could have a systemic influence in Latin America. The other thirty-three countries do not have this influence. That basic asymmetry is reflected in the fact that the countries are being treated differently. The negotiating power that Brazil, Mexico and Argentina have had in international negotiations is totally different from the negotiating power of the smaller countries. The only way the smaller countries can protect themselves is by seeking competition in the provision of services. It is just like the smaller enterprise that would have to shut the door easily if it cannot compete in the provision of services. Because of this basic asymmetry of small players not having real power over the decisions of the major international institution, we have to move to another system.

Why should the IMF not be structured as a network of regional reserve funds? I mean, why don't we adopt the US Federal Reserve System structure or the European Central Bank structure? That would be much better for the IMF's future than the current structure.

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

One comment on Daniel's paper, following up on what Amar has said. The Asians responded to the recent crisis with a common proposal. In Latin America the two major South American countries, Argentina and Brazil, responded by trying to differentiate from each other whereas one would think that they, as partners in Mercosur, would try to coordinate. This paradox comes out very clearly in the paper. Charles Wyplosz points out in his paper as lesson number one: you have to have political will. Why was the political will available for creating Mercosur in the late 1980s and why is it lacking ten years later?"

Yung Chul Park explained why the thirteen East-Asian countries of the Chiang Mai Initiative got together and started talking about the establishment of a regional monetary arrangement. "After the Asian crisis the so-called East Asian Development Model has been under trial. The jury is still out, but as of now, everything that one associates with the East Asian Development Model seems to be wrong. That is the perception we get from our discussions with the international financial institutions including the IMF, the United States, and the G-7 countries. So, it is natural that these East Asian countries are now trying to create some sort of new critical mass at the initial stage. Once they establish this critical mass I am sure the Chiang Mai arrangement will be open to just about anybody because the larger the membership the better the system is going to be as a first line of defense against any kind of impending financial crisis."

Amar Bhattacharya stressed that global institutions are still needed in times of crisis. "Look at Ecuador, Turkey, and at the Korean debt restructuring in late 1997, they were essentially negotiations requiring the involvement of the private sector on the global scale. The creditors were not regional creditors, they were global creditors. So, whoever is going to be responsible for overseeing the debt arrangement, saying 'These are the rules of the game you have to follow,' it cannot be a regional institution; it has to be a global institution. That is the point."

Stephany Griffith-Jones supported Bhattacharya's view. "Amar is right," she said. "There are two coordination problems. One is adjustment, and the other is finance. If you look at finance, Amar is right, the credit markets are global and the debtor countries are not. So one would hope that global institutions would balance the differences in interests and power between the creditors and the country. But the other issue is, that there has to be a global actor who can provide a proper balance between adjustment and finance. And here José Antonio is also right: the more regional arrangements you have, the more power you have as a small member country. That is what the Europeans do; they don't go to the IMF."

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

The IMF as the Global Coordinator?

Yung Chul Park contested the view that one needs a global institution to coordinate creditors and debtors in times of crisis. "It is not clear to me why this would be necessary. Sure, in dealing with the debtors, the creditors come from all over the world. But the regional institutions could easily negotiate the terms of repayment, the conditions under which these countries are going to borrow. Why not? I don't understand why these negotiations have to be conducted at the global level or at the level of the IMF or any other financial institutions that has some leverage or influence. Many East Asian policymakers are unhappy about the subjugation of the Chiang Mai Initiative to the IMF system.

I was involved in managing the crisis in 1997. I can tell you that when a country is in a crisis and every second counts, you don't have time to argue against someone who is going to provide money. There is no time for any kind of intellectual or analytical discussions. You have to accept most of the structural and other macro reforms they ask you to implement. You have to, otherwise you don't obtain the financing. Our problem at that time was not the conditionality of the IMF, but that of some of the G-7 members. They said, 'You have to liberalise this and you have to liberalise that, and then the markets will regain confidence.' In the end it was the G-7 intervention in the market that aborted the crisis. In other words, it was the G-7 that was able to restore confidence in the Korean economy. IMF finance packaging and conditionality did not do anything. These G-7 countries realised that they had to restructure the financing package and increase the amount of liquidity available and in the process they added more items to their conditionality. In this respect, the IMF is very limited in serving as a global institution."

Leslie Lipschitz argued that he had probably negotiated more IMF finance packages than anyone on earth and could not imagine ever having been in the situation where there is blank interception. "Every single IMF standby loan that was negotiated was the result of serious discussions. Every comeback, every position that the authorities had, every analysis of every diagnosis was very seriously considered. Those here, sitting on the other side of the table with me in various Czech negotiations in 1995, know that we agonised over everything. At the end of the day we might have found there were issues on which we struggled to find an agreement, and negotiations were tough, but it was not an imposition. This notion of a conspiracy of highly coordinated G-7 countries sitting in Washington on the phone giving the Fund Mission's Chief detailed directions is just wrong. The G-7 just doesn't have the organisational ability to do that."

Park retorted: "Your facts differ from my facts and there isn't anybody

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org

who could tell us who is right and who is wrong, but I have seen in Korea during the crisis how negotiations go, and I can tell you that they went quite odd...”

Bill White also had the impression that the Korean negotiations were quite odd. “At one point, correct me if I am wrong, it wasn’t the G-7 but it was a very senior US Treasury official who was actually on the same floor as the Fund team at the hotel...”

Park: “That’s true. But Leslie is right as far as G-7 coordination is concerned. The G-7 countries did not coordinate their policies. It was just the US who took the lead. And Leslie is also right in that they were not telling the IMF mission what to do. They were just telling the Koreans what to do and that was the end of the story. As Bill just said, one senior US Treasury official was in the conference hall just about every day from December 10, 1997 to Christmas Eve, persuading the Japanese, the Germans and the other G-7 countries to provide money and to do this and do that. And only when the G-7 agreed and came up with a new financing package, the markets finally took it seriously and stopped attacking the Korean currency. That is on the record. I am not making up the story.”

From: A Regional Approach to Financial Crisis Prevention: Lessons from Europe and Initiatives in Asia, Latin America and Africa, FONDAD, November 2002, www.fondad.org