The East Asian Crisis—Two Years Later

Eisuke Sakakibara

Driven by the information and telecommunications revolution, global capital markets have become extremely volatile and increasingly subject to boom and bust cycles. This article argues that the ideal solution to the instability of a global economy with free movement of capital is to create a genuine lender of last resort. The International Monetary Fund has played the role of lender of last resort in part, but the realities of international politics make it difficult to expand its role significantly. The article proposes ways in which emerging economies, particularly those in Asia, can defend themselves, individually and as a group, against the inherent instability of global capital markets. It argues for strengthening regional cooperation in Asia in such areas as liberalizing trade and investment, developing regional debt markets, coordinating exchange rate policy, and creating a regional financing mechanism.

The East Asian financial crisis prompted wide-ranging analysis of the factors that may have caused it. Early in the crisis discussions focused on macroeconomic fundamentals and structural problems in the countries affected. This was only natural, since the Group of Seven (G-7) and the International Monetary Fund (IMF) had been operating under the premise that sound macroeconomic policies and liberalized markets were the basic requirements for good economic performance. Moreover, since the collapse of the Soviet Union in the early 1990s, policy advisers had emphasized structural reforms to move quickly to an open market economy, along with sound macroeconomic management. This initial reaction to the East Asian crisis was derived from what John Williamson (1990) termed "the Washington consensus."

Later research revealed, however, that macroeconomic indicators were generally strong among the East Asian countries hit by the crisis. Neither market interest rate spreads nor country risk ratings had indicated macroeconomic weaknesses. There

Eisuke Sakakibara is professor and director of the Global Security Research Center at Keio University, in Tokyo, Japan.

Annual World Bank Conference on Development Economics 2000
©2001 The International Bank for Reconstruction and Development / THE WORLD BANK

were structural weaknesses in corporate and national governance, but these had existed for decades. Why they suddenly became a problem in 1997 is difficult to explain. Even the problems of the East Asian financial systems had existed for many years. Moreover, many countries with weak banking systems were not hit by crisis. As Barry Bosworth (1999) rightly points out,

> to generate a crisis of the magnitude of East Asia there is a need to link a weak banking system to some other triggering event. . . . In East Asia the trigger was financial liberalization and the effort to link domestic financial markets to those of other countries. Many countries have encountered difficulties in managing this process of financial market reform. (pp. 1–2)

In all the countries hit by crisis in 1994–97, from Mexico to the Republic of Korea, aggregate short-term debt exceeded foreign reserves by a substantial margin (Radelet and Sachs 1998). Gradual recognition of this fact, along with the lack of a lender of last resort in foreign currencies, particularly U.S. dollars, triggered the financial panic, which resembled a domestic bank run. The gap between short-term debt, owed largely to nonresidents, and foreign reserves had resulted in part from liberalization of capital controls.

Monetary authorities attempted to defend the fixed or quasi-fixed exchange rates by intervening in foreign exchange markets. Many economists have argued that this defense of unrealistic exchange rates was one of the main causes of the crisis. The Council on Foreign Relations task force on the future international financial architecture, for example, advised against pegging exchange rates and strongly against using funds from the IMF or G-7 to support "unsustainable pegs" (Institute for International Economics 1999).

True, there were cases, such as Thailand, where the exchange rate was overvalued and market interventions to support the peg depleted foreign reserves, triggering the crisis. Also true, however, is that the adoption of a floating exchange rate regime in the midst of or before the crises in Mexico, Thailand, and Indonesia led to a free fall in their exchange rates, significantly aggravating the situation. One might argue that if these countries had floated their exchange rates much earlier—say, when foreign capital was flowing in—the outcome would have been different. Is there any merit to this argument? Suppose Thailand had floated its exchange rate in 1994–95, when there was investor euphoria about Asia. If Thai authorities had not intervened in the market, the baht would have appreciated more. Of course, if the market were rational, taking into account the exchange rate risk, capital flows to Thailand would have declined. My conjecture is that it would not have happened that way.

For economists, particularly those educated in the neoclassical paradigm, it is natural to assume that market participants will behave rationally. In reality, it turned out to be more profitable to ride with the herd and try to skillfully manage the boom and bust cycle: enjoy the boom but jump ship before the other market participants do. In the global economy, where markets have become so interdependent and rev-

olutionary technological innovations create great uncertainty, the assumption of one stable equilibrium is unwarranted. There are multiple equilibria, and once we leave one equilibrium we are likely to be thrown into great instability. In this kind of situation exchange rate flexibility is not necessarily a good thing. Given investors' euphoric expectations about the future, free-floating exchange rates might have accelerated, not moderated, the boom, resulting in a more serious bursting of the bubble.

This is not to say that exchange rate flexibility is necessarily bad. But under ordinary circumstances price flexibility alone does not solve the boom and bust cycle that characterizes the "virtualized" global market. We need to recognize that boom and bust are sometimes inevitable and that an appropriate mechanism has to be established to minimize the risk that the bust will turn into a systemic market collapse. This leads inevitably to the issue of the interplay between the enormous international capital flows into the liberalized markets of emerging economies—flows that can rapidly reverse direction—and the workings of domestic and international financial systems, including domestic financial authorities and international financial institutions.

Several things would help stabilize global capital markets. Emerging economies should strengthen their banking and financial systems and improve corporate governance. Industrial countries should devise prudent regulations for lending institutions and require greater transparency in their operations. International institutions such as the IMF should improve surveillance. But we know very well that such efforts will not change the fundamental nature of global financial markets, prone to herding, panics, contagion, and boom and bust cycles. World opinion has moved on from the market fundamentalism of the early days of the East Asian crisis to a somewhat more balanced and realistic view.

The finance ministers' report to the G-8 summit in Cologne in June 1999 represents important progress in this respect. Haruhiko Kuroda (1999), Japan's vice minister of finance for international affairs, cites three major improvements recommended by the report to the G-8 summit: an emphasis on orderly sequencing in liberalizing capital accounts, allowing the possibility of short-term capital controls; prudent regulation and disclosure of highly leveraged institutions; and recognition of the need for private sector participation in the IMF rescue plan. As he states, it is quite surprising that the G-7 countries—particularly the United States, which had long endorsed the Washington consensus—agreed to these recommendations, a dramatic shift in their position. The East Asian crisis was so severe, and the contagion so extensive, that even those carrying the flag for market fundamentalism were forced to rethink their positions.

George Soros, the wizard of global financial markets, wrote a book entitled *The Crisis of Global Capitalism* (1998) in which he argues that these global markets are inherently unstable. Expounding on two basic concepts, "reflexivity" and "fallibility," he leads us to the conclusion that "market fundamentalism is today a greater threat to open society than any totalitarian ideology" (p. 16). Many market players may disagree with him, but they at least agree that appropriate public infrastructure,

including tough supervision and oversight by monetary authorities on both the lenders' and the borrowers' side, must complement market discipline.

As the crisis recedes, however, a sense of complacency seems to be spreading, particularly in the private sector. The discussions and recommendations in the G-7, G-20, and other forums may not lead to any fundamental reforms of global capital markets, but end up only in minor interior redecoration. We need to seriously address fundamental issues during this period of calm, because it may well be the calm between two storms. And the next storm could well be bigger than the one we experienced in 1994–99. Instant access to information and the worldwide telecommunications revolution have made capital markets more global and virtual, and thus more unstable and vulnerable to shocks.

Purist Solutions—An International Lender of Last Resort and Capital Controls

Mervyn King (1999), deputy governor of the Bank of England, points to two "purist" or logically clean solutions to the instability of global capital markets: creating an international lender of last resort with free movement of capital and reinstating permanent capital controls. He then concludes that neither is feasible or desirable under today's international political regime and instead advocates muddling through, or the "middle way."

The Politics of an International Lender of Last Resort

King discounts the possibility of creating an international lender of last resort by saying "the basic reason is the maxim: 'it's the politics, stupid.'" Unfortunately, he is right. Still, it is probably useful, particularly for the countries at the periphery, to analyze the nature of international politics. Since Japan is a little further removed from the center than the United Kingdom is, I may be in a better position than Deputy Governor King to perform this task.

Alan Meltzer (1986) writes that

> the central bank is called the lender of last resort because it is capable of lending—and to prevent failure of solvent banks must lend—in periods when no other lender is either capable or willing to lend in sufficient volume to prevent or end a financial panic. (p. 83)

While in the domestic context the central bank acts as lender of last resort, in the current international context neither the IMF nor the IMF and the World Bank combined play this role. However, if all the G-7 countries and the IMF were "willing to lend in sufficient volume to prevent or end a financial panic," they could serve the function of international lender of last resort. The question is, why couldn't we—or, more precisely, why were we unwilling to—formalize a lender-of-last-resort mechanism centered on the G-7 during the East Asian crisis?

The answer is clear. Financial panic in one country or region is not necessarily a crisis for other countries. True, there is a possibility of contagion. After the Russian crisis of August 1998 the fear of contagion became real for the United States. But until then the East Asian crisis had not affected the countries at the center of global capital markets. As long as a crisis remains limited to one country or region, unaffected countries face no urgent political need to pay the significant cost associated with playing international lender of last resort. Realism, not altruism, dictates policy in the G-7 and other countries. Moreover, for financial institutions in countries at the center, including mutual and hedge funds, a crisis elsewhere may present an opportunity to increase profits. In fact, except for the brief period from August 1998 to early 1999, U.S. financial institutions and the U.S. economy gained significantly from the East Asian crisis.

Soros (1998) describes the global capitalist system as "purely functional,"

> and the function it serves is (not surprisingly) economic: the production, consumption and exchange of goods and services. . . . Despite its non-territorial nature, the system does have a center and periphery. The center is the provider of capital; the periphery is the user of capital: the rules of the game are skewed in favor of the center. (p. 122)

For the countries at the periphery, this bias toward the center is the real issue. Even collectively, they do not have the political leverage to persuade the countries at the center. They could wait for the next crisis—which might really hit the center—for those countries to come around. Or they could adopt a defensive mechanism against recurrent crises, imposing emergency or permanent capital controls or creating what King (1999) calls the do-it-yourself lender of last resort. As defensive measures, both involve forsaking benefits of a free capital market and thus lead to efficiency losses. But given the imperfections of today's global capital markets and the potential for huge damage, economic and social, from the next crisis, such defensive measures might be the politically correct choice. If it is politics in countries at the center that hamper purist solutions, countries at the periphery have to opt for the politically clever but economically second-best solutions.

Capital Controls—the Best of the Second-Best Solutions?

A good example of a successful defensive measure by a country at the periphery is Malaysia's imposition of capital controls on 2 September 1998. Economists trained in the neoclassical paradigm have a built-in bias against capital controls, but even those at the IMF had to admit that "controls gave the Malaysian authority some breathing space to address the macroeconomic imbalances and implement banking system reforms" (IMF 2000, p. 13).

The Malaysian National Economic Action Council had prepared a national economic rehabilitation plan in early August 1998, a month before the capital controls were imposed along with exchange controls. Key elements of the plan included sta-

bilizing the value of the ringgit, restoring market credibility, maintaining the stability of the financial market, improving the economic infrastructure, giving priority to social security policies, and rehabilitating every economic sector. The plan aimed to establish a social safety net, increase the transparency of the nation's economic system—while fending off criticism of cronyism—and achieve economic efficiency and a healthy recovery of the financial system.

The plan differed from the orthodox IMF prescriptions in two ways. First, it departed from IMF-style shock therapy, though it took international criticism about cronyism and inadequate transparency seriously. Second, it took a Keynesian approach in its fiscal and monetary policies rather than reflecting the monetarist bias of the IMF recommendations. In the face of strong deflationary pressure from the East Asian financial crisis, adopting Keynesian policies was quite appropriate. Realistic but aggressively implemented structural reforms of the financial system also helped.

As the IMF report (2000) points out, the success of the Malaysian policy also depended crucially on the effectiveness of the controls. That in turn depended on the competence of the central bank, Bank Negara, and the existence of monitoring mechanisms.

> The controls were wide-ranging and combined capital controls with exchange controls, but without restricting payments and transfers for current international transactions and foreign direct investment. . . . Practically all legal channels for a possible buildup of ringgit funds offshore were eliminated. Offshore ringgit were required to return onshore, limits were imposed on imports and exports of ringgit currency, the use of ringgit currency in trade payments and offshore trading of ringgit assets were prohibited, and transfers between external accounts of nonresidents and ringgit credit facilities between residents and nonresidents were prohibited. (IMF 2000, p. 12)

With supplementary measures, the ringgit was effectively insulated, and the exchange rate fixed at 3.8 ringgit per U.S. dollar. The IMF noted that

> since the introduction of controls, there have been no signs of speculative pressures on the exchange rate despite the marked relaxation of fiscal and monetary policies to support weak economic activity. Nor have there been signs that a parallel or non-deliverable forward market is emerging; and no significant circumvention efforts have been reported. (p. 12)

Not all countries at the periphery have the infrastructure to erect effective capital and exchange controls without risking the spread of corruption. Malaysia did, but it was also helped by the end of the global financial crisis in 1999 and the improving international conditions. Nevertheless, the success of defensive capital and exchange controls in the midst of financial crisis remains. Singapore is another example: it has

insulated its currency for many years. Malaysia and Singapore show that imposing capital and exchange controls does not mean that a country must close its doors completely to the rest of the world. Neither can they be called a closed economy: extensive trade and direct and portfolio investment have taken place in Malaysia and Singapore.

Of course, capital and exchange controls are just one of many defensive policies that small, open economies could use, but the examples here show that in the absence of a true international lender of last resort, countries at the periphery can insulate their economy in selected areas and still reap the benefits of free flows of goods and services. Market fundamentalists often preach that market liberalization is an all or nothing undertaking. That is not the case. Countries can, and perhaps should, opt for partial liberalization, depending on their size, stage of development, and social and political environment. In this respect Dani Rodrik (1998) is right in arguing against capital account convertibility:

> One wonders which of the ills of international capital markets the proposed medicine (capital account convertibility) will remedy. Will the African countries get the foreign capital they need if they remove capital controls? Will "emerging markets" be less at risk of being flooded with foreign capital when such flows conflict with the domestic goals of inflation control or of maintaining a competitive exchange rate? Will sudden reversals become less likely than before? Will contagion across countries be less severe? Will more of the inflows take the form of long-term physical investments rather than short-term flows? . . . It is not that capital controls are necessarily the answer to these problems; they are not. But capital-account liberalization fits the bill less. (p. 2)

To use King's term, a defensive "middle-way" approach to capital and exchange controls may be the appropriate second-best solution for many emerging economies.

Developing Regional Capital Markets and Currency Arrangements

In a recent speech Lawrence Summers, secretary of the U.S. Treasury, argued for "a greater focus on the strength of national balance sheets" (1999, p. 3). In view of the experience of the East Asian crisis, I agree with him. Summers (1999) contended that

> the IMF should actively promote a more fully integrated assessment of a country's liquidity and balance sheet. Governments need to think long and hard about their approach to financial liberalization—and, in particular, the danger of opening up to short-term capital in the presence of too many domestic guarantees. And they need to manage the government's own debt in a way that best insures them against future risks. The most sophisticated debt managers are not those who achieve the lowest possible cost of borrowing. (p. 3)

That the U.S. treasury secretary came around to recognizing the "danger of opening up to short-term capital" is quite interesting. But he is right that management of national debt—or of assets and liabilities, including short-term capital—was a crucial element of the East Asian crisis. In fact, Donald Tsang, Hong Kong's financial secretary, recognized this in the midst of the crisis, in December 1997, writing that "the Asian currency problem is essentially one of funding mismatch compounded by ineffective intermediations" (1997, p. 68). It was indeed a currency and maturity mismatch that led to the deterioration of the crisis countries' balance sheets. For Korea and Thailand financial institutions' short-term borrowings in U.S. dollars were the problem; for Indonesia it was corporations' short-term U.S. dollar borrowings.

The IMF surveillance of countries' liquidity and balance sheets suggested by Summers would be useful. But the question is whether it would be possible to compile satisfactory balance sheets for private sector entities, including their offshore and off–balance sheet transactions. If effective capital and exchange controls were in place, these statistics would be collected and scrutinized. It would also theoretically be possible to do so if there were legal reporting requirements backed by penalties. Short of such controls and reporting requirements, however, the role of authorities would be more indirect.

But what are the underlying factors leading to the balance sheet problems? As Tsang (1997) points out,

> despite generally strong economic fundamentals, high savings and prudential fiscal policy among its economies, Asia traditionally invests most of its savings outside the region, mainly in OECD markets. Funds flow back to Asia in the form of foreign direct investment and portfolio investment. Indeed, most of Asian's official foreign reserves are invested overseas in long-term instruments, while coming into Asia are bank loans, direct and portfolio investment, which are largely short-term. (p. 68)

The reason is that Asia lacks deep, resilient debt markets and that the United States and other OECD countries are at the center of global capital markets. Moreover, most Asian investments overseas are in U.S. dollars or, more recently, in euro and yen, and much of the capital that flows back is also denominated in U.S. dollars.

Indeed, during the years preceding the crisis capital inflows to crisis-affected countries far exceeded outflows. Total inflows for five Asian countries—Indonesia, Korea, Malaysia, the Philippines, and Thailand—increased from $47.4 billion in 1994 to $92.8 billion in 1996. Foreign reserves increased from $22.9 billion in 1994 to only $37.9 billion in 1996. Of the $92.8 billion in inflows in 1996, $74.0 billion, mostly short-term capital, went through commercial banks and nonbank private corporations.

Yet in the postcrisis period structural characteristics in East Asia remain such that the region continues to supply substantial liquidity to the world. Two things are imperative for the region: to avoid the dramatic reversals in capital flows that gen-

erate boom and bust cycles and to use its abundant liquidity to smoothly meet capital needs in the region. An obvious solution is to create well-functioning capital markets—or, more specifically, debt markets—in the region.

Creating Asian Debt Markets

During the crisis Tsang advocated using international financial institutions such as the World Bank and Asian Development Bank to kick-start private markets for debt in the region. He argued for having such institutions issue high-quality debt paper in Asian markets to supplement liquidity to crisis countries. The Japanese government did take an initiative intended to boost the development of debt markets. In the second phase of the New Miyazawa Initiative it provided government funds directly and through the Japan Fund of the Asian Development Bank to partially guarantee sovereign debt issued by Asian countries.

The failure to develop well-functioning capital markets has left mobilization of the enormous savings in Asia to domestic and foreign banks, which have not received adequate supervision. Bank managers and supervisors have been given responsibility for monitoring the management of these assets, but in the absence of sufficient market checks the quality of the monitoring has been poor. Maturity transformation and the currency composition of assets and liabilities have been especially problematic. Development of markets for medium- to long-term debt denominated in domestic currencies or in foreign currencies other than the U.S. dollar would have done much to help prevent excessive exposure to short-term U.S. dollar liabilities.

What are the impediments to establishing such markets in Asia? Consider the example of Japan, which probably has the most developed government debt market in the region, though it lags substantially behind London and New York in infrastructure.

In fiscal 1999 Japan eliminated tax barriers, such as the withholding tax and securities transaction tax, at least for Japanese government bonds. But several other issues need attention. Full-scale competitive auctioning needs to be implemented quickly. Only 60 percent of 10-year government bonds, the core product of the Japanese government bond market, are sold through competitive auctioning. The government is just starting to issue a five-year note to serve as a benchmark medium-term note—something that had not been done in the past because of the conflict with the financial debentures of long-term credit banks. More important, the reopening of issues to increase their volume is badly needed to give greater depth to the market.

Quick action is also needed on settlement and clearance, to achieve the real-time settlement critical for global transactions. The Bank of Japan's settlement system needs to be made compatible with the Brussels-based Euroclear system, for example, and a regional clearance system linking Tokyo, Hong Kong, Singapore, Sydney, and other Asian markets needs to be quickly established. Development of repo (repurchase agreement) and futures markets should also be encouraged, in Japan and elsewhere in the region.

The development of bond markets in Japan and other Asian countries has been delayed by banks' traditional dominance of financial intermediation, essentially because bonds are a close substitute for bank lending. Thus creating well-functioning capital markets implies fundamentally restructuring banking operations. Banks should be encouraged to diversify beyond their traditional lending business by increasing their participation in fee businesses and market-oriented operations. Securitization of loans and dealing and trading by banks in government and private securities markets and foreign exchange markets should also be encouraged. Market making by the principal dealers, including banks, is crucial in developing efficient securities and foreign exchange markets.

Many of these comments about capital markets in Japan also apply to those in other Asian countries. All these capital markets—whether in Tokyo, Hong Kong, or Kuala Lumpur—should be closely linked. And they should deal not only in national but also in regional and global issues, with transactions conducted on the basis of a standard legal and financial infrastructure.

Moving toward Regional Currency Cooperation

Closely related to the challenge of creating debt markets is the issue of currency mismatch or excessive dollarization. Recognition of excessive dollarization or rigid pegging to the U.S. dollar, with short-term borrowing in U.S. dollars, as among the main causes of the East Asian crisis has led to contemplation of various alternative exchange rate systems in the region. Current thinking in academia seems to lean toward two extremes: an absolutely fixed regime, such as a currency board or complete dollarization (as in Panama), or free flotation.

These extreme solutions raise concerns. Relatively small, open economies would find it difficult to float their currencies freely, amid vast cross-border capital flows that can suddenly reverse direction, without risking excessive swings in their exchange rates. And while currency boards did not prevent Argentina and Hong Kong from handling the most recent crisis fairly well, Hong Kong paid an enormous price in defending its system. Moreover, since the characteristics of the Hong Kong economy are not necessarily shared by others, its experience with a currency board may not offer lessons for other Asian countries. Excessive rigidity was at the root of the crisis. Thus even such regimes as fixed rates or a currency board system must be managed carefully to allow flexibility when necessary, unless a country or region gives up all sovereignty over its monetary and other policies.

One viable solution might be full or partial currency unification and common or partially shared monetary and other policies. And this may be the direction in which many countries will head in the medium term, with Europe and regions under strong European influence eventually gathering in a euro zone, and the United States and countries with which it has close ties binding together in a U.S. dollar zone.

What about Japan and the other countries of Asia? They would, of course, have the option of eventually participating in either the euro or the U.S. dollar zone. Another option would be to develop a third currency zone, in Asia. Given the diver-

sity among Asian countries, however—in race, culture, history, and stage of development—achieving unification like that in the European model would be extremely difficult. Nor would it be possible for Japan to play the kind of role that the United States might play in the Americas.

A possible alternative would be to develop regional cooperation in trade, investment, and exchange rate systems. Such cooperation might involve forming a basket of regional currencies—an Asian currency unit—and attempting to use this unit as the denominator for trade and exchange transactions. The nations of the region could then eventually develop a scheme like that based on the European currency unit (ecu).

An Asian Monetary Fund

A strategy of creating regional defensive mechanisms—regional debt markets and regional currency cooperation—would not deny the global "middle way" that King recommends. Nor would it block efforts by Summers and others to bring the IMF closer to being a genuine international lender of last resort by narrowing its functions to meeting the liquidity needs of countries affected by crisis. But it recognizes that the asymmetry in today's global financial system means that countries at the center are less likely to devote resources to dealing with crises that remain regional—and that the current calm may strengthen their complacency.

- A potentially important regional defensive policy would be to create what King (1999) calls a do-it-yourself lender of last resort, with the aim of providing self-insurance against a liquidity crisis. King suggests several ways of providing such insurance:
- Build up large foreign currency reserves. China already has substantial foreign exchange reserves ($147 billion at the end of June 1999, and Korea raised its reserves from a low of $7.3 billion in November 1997 to $64.8 billion in August 1999. This is not an efficient use of scarce capital, but may be necessary in the absence of more efficient solutions to the risk of crisis. Building up net reserves—through current account surpluses—would reduce world demand at a time that the U.S. economy is likely to provide a smaller stimulus than during the second half of the 1990s. Creating gross reserves by borrowing from abroad and investing the proceeds in liquid international securities also involves costs.
- Set up contingent credit facilities with international banks, as Argentina has done with its contingent repo facility, or collateralized loan facilities along the lines suggested by Martin Feldstein (1999).
- Create regional self-insurance funds.

The recent financial crises make it likely that all these approaches will be pursued. In August–September 1997, for example, the Japanese government proposed a variant of a regional fund, to be known as the Asian Monetary Fund. The idea was essentially to pool part of the foreign reserves of countries in the region. If China, Korea, Japan, and other East Asian countries provided, say, half their reserves to the

fund with specific arrangements for its activation, the fund could serve as an effective regional lender of last resort during the next liquidity crisis.

The Asian Monetary Fund proposal was strongly opposed by the United States and European countries, however, on the grounds that it would undermine the discipline imposed by the IMF and could pose a serous moral hazard problem. But if the fund's function were very narrowly defined as meeting liquidity needs during a crisis, with a specific formula for private sector participation (along the lines of the Korean model, for example), it could complement the IMF's current function. True, if Summers's proposal for restructuring the IMF were implemented, significant overlap might occur. But even then the Asian Monetary Fund's role could be restricted to providing liquidity, with conditions for private sector participation, while the IMF provided surveillance and macroeconomic policy recommendations.

The amount of liquidity that countries would wish to provide to deal with a crisis may differ depending on their risk of contagion. It is only natural for countries close to a crisis that could easily spread to try to contain it by providing liquidity. Indeed, this could be done through bilateral aid, as Japan did under the New Miyazawa Initiative after the Asian Monetary Fund proposal was shot down. Such bilateral aid should probably be formalized as a permanent regional mechanism, however.

Although moral hazard is a serious problem, the moral hazard argument should not be used to distract us from the need for an international lender of last resort with free movement of international capital. The mere existence of a central bank does not pose any moral hazard problem. It is the conditions under which the bank provides liquidity during a crisis that may give rise to moral hazard. The general rule à la Bagehot (1873) of lending with good collateral at punitive rates could be modified, adding a general scheme for private sector participation that leaves substantial discretion for dealing with individual cases. Agreement on lending rules may be easier to reach regionally than globally, given similarities among countries within a region.

Some economists have used the moral hazard argument to defend market fundamentalism. If markets were perfect, maintaining a stable balance between demand and supply, there would be no need for central banks. But once we agree on the need for central banks in the domestic context, the need for an international lender of last resort with free movement of capital cannot be denied. The issue should be what conditions the lender of last resort would impose, not whether the infusion of public funds should be reduced or eliminated. During a liquidity crisis the amount of public funds infused could be very large even with appropriate private sector participation. Countries unaffected by a crisis should not use the moral hazard argument to avoid responsibility. If they have no political incentive to contribute to a fund in their region, they should simply say so.

A regional fund serving as lender of last resort could be combined with other regional cooperation, such as a regional arrangement for exchange rates—a regional currency unit and a mechanism for defending exchange rates within a certain range. Of course, the fund should not be used to defend unrealistic exchange rates. But the common fund would make joint intervention more plausible. This mechanism would

require a common exchange rate policy in the region—cooperation that would have other advantages, given the heavy interdependence among the region's countries.

As in Europe, monetary or international financial cooperation should be accompanied by cooperation in the real sector. An agreement on free trade or on direct investment should probably precede, or at least be pursued simultaneously with, cooperation on a fund and on an exchange rate arrangement. If cooperation in trade and direct investment proceeds with the creation of a regional debt market, a common fund with exchange rate cooperation might develop into an Asian currency zone independent of the euro and U.S. dollar zones. I remain hesitant to recommend aggressively pursuing an Asian currency zone in the short term, since to do so promises to be an enormous challenge. But in the absence of an international lender of last resort, it is an option worth debating within the region and beyond it as we enter the 21st century.

References

Bosworth, Barry. 1999. "Asian Miracle, Crisis and Recovery." Paper presented at Asian Development Bank Institute workshop on development paradigms, 10 December.

Feldstein, Martin. 1999. "A Self-Help Guide for Emerging Markets." *Foreign Affairs* 81 (March–April): 93–109.

G-7 Finance Ministers. 1999. "G-7 Finance Ministers on Global Financial Structure." Paper presented at the G-8 summit, Cologne, 18–20 June.

IMF (International Monetary Fund). 2000. "Country Experiences with the Use and Liberalization of Capital Controls." Staff Report. Washington, D.C.

Institute for International Economics. 1999. "Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture." Report of an independent task force, sponsored by the Council on Foreign Relations. Washington, D.C.

King, Mervyn. 1999. "Reforming the International Financial System: The Middle Way." Paper presented at a session of the Money Marketeers of New York University, Federal Reserve Bank of New York, 9 September, New York.

Kuroda, Haruhiko. 1999. "The Third Way: International Financial System." *Yomiuri Shinbun,* 18–19 November, Tokyo. (In Japanese.)

Meltzer, Alan. 1986. "Financial Failures and Financial Policies." In G.G. Kaufman and R.C. Kormendia, eds., *Deregulating Financial Services: Public Policy Flux.* Cambridge, Mass.: Ballinger.

Radelet, Steven, and Jeffrey D. Sachs. 1998. "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects." *Brookings Papers on Economic Activity* 1: 1–74.

Rodrik, Dani. 1998. "Who Needs Capital-Account Convertibility?" *Essays in International Finance.* Princeton, N.J.: Princeton University,

Soros, George. 1998. *The Crisis of Global Capitalism.* New York: Public Affairs.

Summers, Lawrence. 1999. "The Right Kind of IMF for a Stable Global Financial System." Paper presented at London School of Business, 14 December, London.

Tsang, Donald. 1997. "The Asian Debt Market." *Asiaweek,* 19 December.

Williamson, John. 1990. "What Washington Means by Policy Reform." In John Williamson, ed., *Latin American Adjustment: How Much Has Happened?* Washington, D.C.: Institute for International Economics.