RECENT BAILOUTS AND REFORM OF THE INTERNATIONAL MONETARY FUND

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I. INTRODUCTION

In October 1998 the Federal Reserve Bank of Chicago and the International Monetary Fund (IMF) co-sponsored a conference entitled “Asia: An Analysis of Financial Crisis.” Karin Lissakers, one of 24 directors representing 182 IMF member countries, proffered “A View from the Executive Board.” Noting that, while the IMF’s annual surveillance reviews–or Article IV consultations–are “supposed to provide an early warning of trouble ahead”, the board concluded that the pre-crisis “macroeconomic fundamentals in Asia by conventional definition looked strong.” Moreover, Ms. Lissakers acknowledges that (Lissakers, 1999, p. 4):

> As we discussed the Asian performance, some on the board questioned the sustainability of twenty-five to thirty percent or more rates of private credit expansion year after year and wondered about the soundness of the underlying investments....the weight of opinion was that this had worked well so far, and....seemed to be the norm for Asia, the standard for the ‘Asian model’.

While stipulating that “There were, nevertheless, warning signs in Thailand....”, Ms. Lissakers suggests that the IMF “did not pay sufficient attention to other indicators...most notably the rapid build-up of foreign short-term obligations by banks and the nonbank private sector, especially in Korea and Thailand.” And, finally, Ms. Lissakers acknowledges that (Lissakers, 1999, pp. 4-5):

- The IMF “did not worry enough about the incentives pegged or managed exchange rates give to both borrowers and creditors to accumulate unsustainable cross-border, cross-currency exposures”;

- The IMF “was unaware of the extraordinary leverage of Korean companies...[and] did not focus on the weak accounting and disclosure practices of banks and nonbanks; or the loose loan loss provisioning and generous rollovers of banks to their key clients”;

- The IMF “underestimated the impact of the Japanese government’s contractionary fiscal stance,” and

- The IMF “also underestimated the effect of political factors. ‘Political risk is unfashionable in the sophisticated financial world of the 1990s. Private sector financial analysts, too, largely discounted the fragility of the political underpinnings of the Asian economies and did not fully comprehend the extent to which rampant corruption was discrediting regimes...as well as weakening economies directly....”

Having characterized what the IMF "saw before the crisis", what the IMF "overlooked", and what was "hidden" from the IMF's view, Ms. Lissakers observes that (Lissakers, 1999, p. 7):

> At the very outset [of the July 1997 crisis] with Thailand, and then Indonesia, we debated heatedly whether high domestic interest rates or steep currency depreciation would do less damage to the economies we were trying to save....
>
> We chose higher interest rates as the less damaging option.

Lissakers should know a number of questions emerge. Central among these are: (1) Should the IMF [and private sector financial analysts] have "read" the fundamentals differently? (2) Should a kind of inertial success have been imputed to the "Asian model"? (3) Should more attention have been paid to the build-up of short-term, frequently dollar-denominated obligations? (4) Should the "weak accounting and disclosure practices of banks and nonbanks" and the "loose loan loss provisioning and generous rollovers" of banks to "their key clients" have come as a surprise? (5) Should the implications, especially for Southeast Asian exports, of Japanese contractionary policy have been better appreciated? (6) The predilections of the "sophisticated financial world of the 1990s" notwithstanding, should explicit account have been taken of "political risk", and of the implications both for political stability and economic performance of "rampant corruption"? (7) In choosing higher interest rates (rather than "steep currency depreciation"), did the IMF address the real causes of the crisis?

II. WHAT SHOULD HAVE BEEN KNOWN

An appraisal of the "fundamentals" of Southeast Asian economies must be predicated on an understanding of the key feature of the Asian development model. Whereas Latin American and other nations once pursued an import substitution approach, the development model common to Southeast Asian nations is "export-oriented" growth.[1] Presumptively, this should have been understood by foreign investors, by foreign banks, by the Clinton Administration, and by the IMF. Given that it was understood, attention should have centered on a set of salient facts, notably that despite the emphasis on exports, the Southeast Asian "tigers" experienced persistent current account deficits:

Current Account
(percent of GDP)

	Average 1990-1995	1996
South Korea	-1.2	-4.7
Indonesia	-2.5	-3.3
Thailand	-6.6	-7.9
Malaysia	-6.2	-4.9
Philippines	-4.1	-4.7

Source: Michel Camdessus, Managing Director of the International Monetary Fund, Presentation, Frankfurt, Germany, January 16, 1999, Table 1.

While there is nothing intrinsically bad about current account deficits, they are the mirror images of capital account surpluses; in this instance, of net capital inflows to the Asian crisis countries. From the IMF's perspective, account should have been taken of the possibility that the capital inflows may have been excessive, and of the fact that the defense of pegged or "managed" exchange rates is manifestly more difficult in the presence of persistent current account deficits. This fact must be juxtaposed against the commitment by most governments in the region to peg, or tie, their currencies to the U.S. dollar.[2] At issue is whether persistent current account deficits provide an early warning sign of speculative attacks on a currency. Employing the concept of a required intertemporal balance in the current account,[3] it is clear that "a warning signal of the East Asian currency crisis had been flashing for years before the crisis" (Yan, 1999, pp. 284-285):

- The first quarter of 1989 was the "watershed for [South Korea's] current account balance." Since then, the real exchange rate "was doggedly overvalued"–with the "coming presidential election and the banking crisis also bring[ing] uncertainty."
- The statistics "indicate that in the 12 quarters up to the first quarter of 1996, [Indonesia's] intertemporal current account balance had been unsustainable." While the rupiah depreciated steadily, "the magnitude of the depreciation [was] insufficient to correct its current account deficit."
- Thailand's statistics show "a persistent violation of...intertemporal balance", with "the turning point in 1987."
- While two big depreciations in 1991 and 1994 "helped bring [the Philippines'] current account up", the corrections "were not enough to turn around its intertemporal balance."

If foreign investors, foreign banks, the Clinton Administration and the IMF should, for years, have been sensitive to the increasing probability of speculative attacks on Southeast Asian currencies, they should also have been cognizant of other facts.[4] First, it should have been understood that more than 50% of Asian exports are to other Asian countries (Lee, 1999, p. 64). Given that Japan, the economic giant of the region–and the second largest economy in the world–had been in recession since 1990, this should have given pause.[5] While some have argued that, while "The prolonged sluggishness of the Japanese economy inhibited exports from its East Asian neighbors...there are reasons to think it was not a critical factor" (Whitt, 1999, p. 24), it was, nevertheless, a factor of which account should have been taken. So too, should notice have been taken of the fact of growing excess capacity in the region (Lee, 1999, p. 79). Indeed, almost three months before the Thai baht was devalued, Walter Russell Mead observed that the East Asian, export-oriented economies confronted a problem of size (Mead, 1997):

> As the export-oriented bandwagon gets more crowded, it tends to slow down....as more countries jumped on the bandwagon, external constraints became more daunting.

> In 1987 Taiwan's bilateral trade surplus with the U.S. peaked, at $800 per capita. That surplus...totaled only $16 billion, or $64 per U.S. resident, [so that] the U.S. could absorb it without trouble. If China had the same per capita bilateral trade surplus with the U.S., our trade deficit with China would be $988 billion....Throw in Indonesia, Pakistan, India and Bangladash...and the U.S. trade deficit with East and South Asia would reach $2.1 trillion, or 28% of gross domestic product.[6]

That China should figure prominently in this adumbration of Asian economies' excess capacity is appropriate, both because China has adopted the Asian "tiger" growth model (Faison, 1997), and because Chinese producers have incentives to overproduce. In effect, "many [Chinese] managers continue to measure success in terms of boosting production" (Editorial, *Wall Street Journal*, April 10, 1997).

Perhaps with growing Chinese export capacity in mind, the chaebol–South Korea's conglomerates–were reported in May 1996 to be concerned about the erosion of advantages that had made them "export powerhouses." The chaebol were reported to be "investing overseas at a manic pace, as life grows tougher in their once-cozy home market"; a strategy which caused some analysts to fear that (Schuman, 1996):

> ...South Korea's business groups are taking on too much risk too quickly....The chaebol already are burdened by heavy debts....[7]

Indeed, the growing–and enormous–debt burden of South Korea's chaebols led, by early 1997, to the failure of major affiliates of the Jinro, Hanbo and Sammi groups, and to the sale of assets by Ssangyong Group, the sixth-largest chaebol. The result was that, by April, 1997, the *Wall Street Journal* was proclaiming that the "Troubles of Korean Conglomerates Intensify, Signaling End of an Era" (Schuman and Cho, 1997).

Yet if South Korea was troubled by the intersection of excess capacity and heavy private sector debt, so too was Thailand. After suffering huge losses, the Bangkok Bank of Commerce PCL was seized in May 1995 by the Finance Ministry. By March 3, 1997 the Thai government had ordered financial institutions to set aside nearly $2 billion to protect themselves in the face of a rising volume of bad loans.[8] This confluence of events led to the following assessment (Sherer, 1997):

> The mistake that many Thai managers and foreign investors made, [Thai] economists say, was assuming that rapid economic growth necessarily translates into growth in corporate profits. It doesn't, but Thais learned this the hard way, after building up massive overcapacity.[9]

Similar patterns emerged in other countries, notably Indonesia (Afiff, 1999, pp. 198-199), Japan[10] and, for somewhat different reasons, in Singapore.[11]

These facts emerged–and were a matter of public record–well before the July 2, 1997 devaluation of the Thai baht. Yet, in the face of these warning signs, lenders–who should have known better–continued to make short-term loans denominated in dollars, francs or marks. The fact that some loans made to South Korean, Thai, Indonesian and other banks were, in turn, used to tender loans to "crony capitalists" should also have been known.[12] The motivation to continue lending was, and is, clear (O'Brien et al, 1998):

> The Asian lending frenzy began because the region's economic promise once seemed endless...
>
> But, an American banker, who...spoke on condition of anonymity, said the warning signs had always been there – bankers just did not want to see them.[13]

Of course, banks were not alone in their denial or, perhaps, ignorance of the facts. In August, 1994, Barton M. Biggs, the chief global investment strategist for Morgan Stanley Dean Witter & Company "declared that the smaller Asian markets–Thailand, Indonesia and Hong Kong–would be 'the best place in the world to be for the next five years'" (Kristof and Wyatt, 1999). Yet, after predicting that Thai stocks would soar in 1996, Mr. Biggs watched them fall 36 percent. This fact notwithstanding, on January 14, 1997 he averred that: "We tend to think there are a lot of opportunities in Asian emerging markets", referring specially to Thailand, South Korea, India and Singapore (Kristof and Wyatt, 1999).

If, as *The New York Times* suggests, these views "were representative of Wall Street's euphoria about Asia", this underlying optimism seems also to reflect the pre-crisis thinking of Treasury Secretary Rubin, the Clinton Administration generally, and the IMF.[14]

In October 1995, in the wake of the Mexican peso devaluation and bailout, Treasury Secretary Rubin asserted that "there had been progress toward constructing a new 'financial safety net' to prevent future Mexican-style financial disasters" (Lewis, 1995). It seems clear that the fact of the bailout and the Treasury Secretary's assurances "convinced investors that some countries were too strategically important to fail" (Kristof and Sanger, 1999). It is also clear that the perception of an implicit loan guarantee contributed to "moral hazard" (Calomiris, 1998a).[15]

It is very probable that the expectation that bad loans would be underwritten either by home governments or by the IMF encouraged risk-taking which might otherwise not have occurred. Moreover, at the same time that Treasury Secretary Rubin was encouraging a sanguine view of the risks attaching to developing country investment, the IMF was painting a picture of continuing economic growth–particularly in Southeast Asia. In April 1996 the IMF reported that developing nations would continue to enjoy growth rates three times as high as industrial nations–with the strongest growth in Asia (Stevenson, 1996). One year later, and less than three months before the Thai baht's devaluation, the IMF predicted that "Newly Industrialized Asia" would experience growth rates of 5.7 and 6.1% in 1997 and 1998, respectively (Schlesinger, 1997). And, all the while, the Clinton Administration was pressing President Clinton's view that the Asian countries had changed "from dominoes to dynamos" (Kristof and Sanger, 1999). Indeed, the President's Cabinet approved a "big emerging markets" plan "to identify 10 rising economic powers and push relentlessly to win business for American companies there" (Kristof and Sanger, 1999). According to *The New York Times*, Commerce Secretary Ron Brown set up a "war room" with computer tracking of big contracts "and everyone from the C.I.A. to ambassadors to the President himself was called upon to help land deals" (Kristof and Sanger, 1999). The motive force was the Administration's view that Asia was a "potential gold mine for American banks and brokerages." Indeed, Laura D'Andrea Tyson, the former chairman of President Clinton's Council of Economic Advisors and head of the National Economic Council suggested that "Our financial services industry wanted into these markets" (Kristof and Sanger, 1999).

In the face of this unguarded optimism–fueled in no small part by the IMF and the Clinton Administration–it should come as no surprise that, as James Wolfensohn, president of the World Bank has observed, "very sophisticated banks loaned to Indonesian companies without any real knowledge of their financial condition....they did go nuts" (Kristof and Sanger, 1999). Indeed. And the same could be said of lending activity in South Korea, Thailand, and other Southeast Asian nations.

It has been suggested that the global investment industry "has drifted toward computer models and number crunchers" (Kristof and Wyatt, 1999). Whether or not this is true, at least one analyst has concluded that (Afiff, 1999, p. 191):

> Apparently those specialists who focused on the economies of East Asia were dazzled by the long period of rapid growth. This led them to fall prey to the often-voiced belief that the Asian economies, relying on the somewhat ill-defined term 'Asian values', were so well-managed that they were immune from financial crisis. Whatever the cause of our blindness....the myriad of econometric models now widely used [did not] provide any better predictions.

Given the array of brightly flashing early warning signs, the "specialists" should have been alert to the increasing possibility of Southeast Asian currency devaluation and declining economic growth. If the specialists' blindness is to be rationalized it is clear that the notion that they were "dazzled by the long period of rapid growth" may be a necessary condition. But it is not sufficient. Some of the responsibility belongs to the Clinton Administration and to the IMF. The record shows that the brightly flashing warning signs notwithstanding, both the Administration and the IMF perceived a rosy Southeast Asian scenario. Yet, if the econometric models and "number crunching" did not yield "any better predictions", the reasons are clear.

On the one hand, the econometric models employ as independent variables the macroeconomic data to which the IMF's Karin Lissakers refers (1999, p. 4):

> The macroeconomic fundamentals in Asia by conventional definition looked strong – low inflation, fiscal balance or surplus, strong private savings, high rates of capital formation, strong export performance, ample foreign direct investment, stable currencies, large foreign exchange reserves, modest debt/GDP ratios.

While, as we have seen, some of these macroeconomic fundamentals were not, in fact, "strong", the irremediable fact is that "macro" variables do not capture evolving–and decisive – microeconomic conditions.[16] In short, explicit account was not taken of industry–and firm–specific export competition, excess capacity, deteriorating balance sheets and, in general, of the prevailing institutional arrangements among governments, banks and debtors. Add to this the fact that "There is no consensus about which specific [macroeconomic] indicators should be used as early warning signals" (Yan, 1999, p. 278) and it should come as no surprise that econometric models did not yield "any better predictions." [17]

All of this is not to excuse the Asian specialists, the bankers, the Clinton Administration, or the IMF. Each should have read the warning signs–and each should have understood the limitations of rarefied, institutionless, macroeconomic models. Notable among these limitations is the problem of finding a metric by which to measure "political risks"; factors whose effects the IMF underestimated. That the IMF should have underestimated these effects is disturbing; that the Asian specialists should have done so is unconscionable.

An explicit accounting of Asian political risks did not, in any case, require formal econometric modeling. All that would have been required was an elementary understanding of observable reality: The region is, in a generic sense, a tinderbox: "Asia's share of global arms imports has risen from 15 percent in the early 1980s to more than 35 percent today" (Zakaria, 1997). The 1988 economic collapse of Burma (Myanmar) precipitated demonstrations "that were crushed with appalling brutality by the military...." (Horne, 1997). In 1991 a bloodless military coup overthrew Thailand's democratically elected government (Pace, 1999). In 1996, prior to Taiwan's first presidential election, China announced its intention "to seal off half of the southern approach to the Taiwan Strait to shipping and air traffic" (Editorial, *Wall Street Journal*, March 12, 1996). By February, 1997 South Korea was questioning "the premise that the safest way to deal with North Korea is to encourage a modicum of stability and greater interchange between the North and the outside world" (Editorial, *The New York Times*, February 21, 1997). In April 1997 Singapore Senior Minister Lee Kuan referred to Malaysia's southern state of Johor as "notorious for shootings, muggings and car-jackings" (Editorial, *Wall Street Journal*, April 14, 1997). In April 1997 factional fighting escalated in Cambodia (Wain, 1997), and seven Asian nations meeting in the Maldives "acknowledged that their failure to curb hostilities that have troubled the region for 50 years has cost their countries dearly in lost trade and other ties" (Burns, 1997). The "hostilities that have troubled the region" include (Zakaria, 1997): Japan and Russia, Russia and China, China and India, Japan and China, Japan and South Korea, Laos and China, China and Burma, India and Pakistan, Cambodia and Vietnam, China and Vietnam, China and Taiwan, Indonesia and Timor, and Malaysia and the Philippines. While the list is not exhaustive, it is instructive. The difficulty of modeling these inherently destabilizing interrelationships is no excuse for the IMF's admitted underestimation of the "effect(s) of political factors." It would appear that a rudimentary understanding of regional history would have tempered the "euphoria about Asia" which apparently influenced the judgement of investors, bankers, the Clinton Administration and the IMF.

The essential point is that ignorance of, or failure to appreciate, the warning signs and the regional history does not absolve those who were susceptible to the "Asian euphoria."[18] While it is true that the borrowers and their governments bear responsibility for the cronyism, the corruption and the foreign currency-denominated short-term borrowing, the lenders, the Clinton Administration and the IMF are also culpable. Indeed, it is clear that the lenders, the Administration and the IMF have incentive to shift the blame to the borrowers (Stiglitz, 1999, p. 33):

> In the early stages of the crisis,...rhetoric placed the blame squarely on the countries themselves. The same interests that had prompted financial and capital market liberalization had an incentive to deflect attention from potential problems with the system: The problem was within the borrowing countries, they argued. Lenders had an interest in shifting blame for the bad loans: It was weaknesses in the borrowing countries' financial systems, plus a lack of transparency, that was to blame.

The problem with this, as Stiglitz emphasized in February, 1998, is that "Only one year ago, the East Asian countries were held up as models for other developing countries. Today legion's of critics are condemning them for their unworkable systems...." Yet, "In their haste to place exclusive blame on the governments in the region, many critics have also forgotten that every loan requires not just a borrower, but also a lender" (Stiglitz, 1998).

Shifting responsibility to the borrowing countries accomplishes at least three things: (1) It absolves the lenders, the Asian financial market specialists, the Clinton Administration and the IMF. (2) It provides a rationale for IMF intervention and conditionality; conditions imposed on countries in exchange for an IMF bailout. (3) The bailouts, in turn, enable the lenders to shift costs to the countries which the IMF sets out to save.

III. THE IMF'S BAILOUTS

In her remarks, IMF director Karin Lissakers emphasized that (1999, p. 7):

> ...[the 24 IMF directors] debated heatedly whether high domestic interest rates or steep currency depreciation would do less damage to the economies we were trying to save...
>
> We chose higher interest rates as the less damaging option.

Given this basic decision, the broad outlines of the IMF's programs emerged (Camdessus, 1999):

> Since the countries faced an immediate liquidity crisis coupled with profound structural problems, the programs required....
>
> First, structural reform, particularly in the financial sector....
>
> Second, macroeconomic policies were designed initially to stabilize the economy and...to support the economic recovery. Monetary policy aimed to prevent a spiral of depreciation and inflation....Fiscal policy aimed to complement monetary policy, and to make room in the budget for the costs of bank restructuring....
>
> Third, large official financing packages were seen as an essential complement to the macroeconomic and structural policies adopted to help

> break the self-reinforcing cycle of capital outflows, exchange rate depreciation, and financial sector weakness.

In effect, the Asian crisis countries were offered large official financing packages in exchange for what Joseph Stiglitz, Senior Vice President for Development Economics and Chief Economist at the World Bank has styled “beggar-thyself” policies (Stiglitz, 1999). While the IMF programs largely immunized lenders from the consequences of their actions, they shifted the costs to the countries the IMF was trying to save, and to taxpayers of IMF donor nations. Given the banks’ headlong rush into Asia–in spite of the increasingly vivid warning signals–this raises profound questions about both the propriety and the morality of the IMF’s approach (Passell, 1998). As Nobel laureate Milton Friedman has observed, “The [IMF] effort is hurting the countries they are lending to, and benefiting the foreigners who lent to them.... The United States does give foreign aid. But this is a different kind of foreign aid. It only goes through countries like Thailand to Bankers Trust” (Kristof and WuDunn, 1999).

The findings of the International Financial Institution Advisory Commission comport with this assessment (Meltzer, 2000, p. 33):

> What can be said with certainty is that: (1) to forestall outflows, Thailand, Korea and others followed Mexico by guaranteeing private debts denomiated in foreign currencies, (2) foreign lenders made the subsequent crisis much worse by offering short-term loans before the crisis under the guarantees and (3) as the size of the short-term debt increased, dependence on IMF or foreign government loans became increasingly likely; otherwise the guarantees could not be honored.

<u>Banking Crises, Moral Hazard and Exchange Rates: The Lessons of History</u>

It is interesting that those who pushed aggressively for capital account liberalization[19]–a good idea–were, in general, the same people who pushed for the bailouts. As Joseph Stiglitz, the World Bank’s chief economist, has observed (1999, pp. 17 and 18):

> It has become increasingly apparent that the stance that seemed to be prevalent until recent months – first, that countries should implement full capital account liberalization, including removal of all barriers to short-term capital flows, and, second, that international action in the form of bailouts are required to prevent contagion with its adverse economic effects – was intellectually incoherent....
>
> I suggest that the real concern is not the succession of macroeconomic disturbances that contagion might bring...but rather the threat it poses to lenders and, more generally, to suppliers of capital.

Once again, the essential point is that the suppliers of capital to Southeast Asia should have read the early warning signs. The same is true of the Clinton Administration and the IMF. But there is a larger issue: It is clear that the Asian euphoria was partly influenced by the Clinton Administration’s sensitivity to the notion that “Our financial services industry wanted into these markets” (Kristof and Sanger, 1999). But it is also clear that, in their rush to enable the "suppliers of capital" to enter these markets, neither the Administration nor the suppliers took account of the implications of the Asian countries' rickety financial infrastructure (Kristof and Sanger, 1999):

> ...while economists welcome free capital flows in principle, extensive scholarly work had clearly established the importance of 'sequencing' – meaning that countries should liberalize capital flows only after building up bank supervision and a legal infrastructure.

As Kaminsky and Reinhart emphasize, the antecedents of the Asian crises corresponded almost precisely to those described in 1985 by Diaz-Alejandro as the predicates of the 1982 Chilean crisis (1999, pp. 494-495). Based on the Carlos Diaz-Alejandro analysis and other, earlier contributions to the literature, Kaminsky and Reinhart insist that "The Thai, Indonesian and Korean crises are not the first examples of dual currency and banking woes...." (1999, p. 473). Indeed, based on data and information relating to 76 currency crises and 26 banking crises they conclude that (pp. 494-495):

> ...our analysis of earlier episodes reveals that many of the features and antecedents of the crisis in Asia were common to a substantial number of crisis episodes in Latin America, Europe, and elsewhere....
>
> At the roots of the meltdown of the Thai baht, Korean won, and Indonesian rupiah lay systemic banking problems.[20]

The systemic banking problems to which Kaminsky and Reinhart refer reduce, in their essentials, to the following (Calomiris, 1998b, p.5):

> Banking systems worldwide have become the key source of financial instability. Economists have pointed to several key problems that feed that instability. First and foremost are incentive problems that encourage risk taking.... Before banks were protected by government safety nets, economic downturns produced contractions of bank credit supply and reductions in bank dividends, as banks scrambled to reassure depositors that bank losses would not result in losses for depositors.
>
> But safety net protection through domestic deposit insurance and IMF lending has removed that important disciplinary check on bank behavior.

The predictable result of safety net protection–ultimately, of taxpayer protection of banks and their claimants–is the conscious absorption of increased asset risk by banks. Moreover, the propensity to engage in inefficient risk-taking is exacerbated when, as a result of adverse macroeconomic shocks, banks suffer depletion of their capital.

Characteristically, this moral hazard problem is associated with the emergence of two liquidity problems: (1) Banking panics may result when bank debt holders become aware of banking sector losses, and (2) Bailout-induced government illiquidity may be the catalyst to currency collapse. The latter reflects the fact that, whereas "The IMF provides only a small wealth transfer to its borrowers in the form of loan subsidy...the IMF pressures borrowers to bail out foreign bank lenders and lends support and legitimacy to domestic bailouts, too, by requiring taxation to finance the repayment of the IMF loans." Whether warranted or not, government illiquidity often results in "self-fulfilling collapses of currencies"; in "unwarranted speculative pressure on exchange rates." It is this dynamic which accounts for the fact that "Bank losses precede and cause exchange rate collapses"; a dynamic which is, moreover, all-too-familiar (Calomiris, 1998b, p. 5):

> Over the last 20 years, 90 banking crises have occurred.... In at least 10 cases, banking system losses will exceed 20 percent of GDP....
>
> Banking system collapses due to excessive risk taking by banks have been a common feature of all recent financial collapses. Bank losses precede and cause exchange rate collapses.

Given this history, the implications of the banking system and other institutional problems extant in Thailand, Korea, Indonesia and the other crisis countries should have been appreciated by all who aggressively pursued capital account liberalization. While capital account liberalization is desirable, the lesson of earlier crises "underlines the need for more effective monitoring and regulation of the asset and liability structures of financial institutions" (Obstfeld, 1999, p. 25). This lesson had been codified in a literature with which the Asian specialists, the capital suppliers, the Clinton Administration and the IMF should have been familiar. The corollary is that attention should have been paid to the need for "more effective monitoring and regulation of the asset and liability structures of financial institutions"–all as a prerequisite to capital account liberalization.

While the World Bank's chief economist attributes the failure to attend to this institutional detail to reliance on the neoclassical model (Stiglitz, 1999, p. 22)–an issue taken up in section VI, below–the essential point is that, in the absence of an appropriate financial infrastructure, a currency crisis was all-but-inevitable, especially in light of the Asian nations' chronic current account deficits. In effect, the stability of the fixed or "managed" exchange rate regime which the suppliers of capital, the Clinton Administration and the IMF explicitly or implicitly endorsed was jeopardized by their failure to attend to the lessons of history.

<u>The IMF's "Less Damaging Option"</u>

In January, 1999 Shailendra Anjaria, Director of the IMF's External Relations Department remarked that "the IMF remains acutely concerned about the greater-than-anticipated contractions in economic activity in the affected countries" (1999).[21]

It is possible to question whether the IMF should have anticipated the contractionary effects of its restrictive fiscal policy prescription.[22] To raise this question is, of course, to engage the IMF on its terms. The real issue is: Did the IMF fail to anticipate the crisis? Did it, in other words, fail to address the banking sector problems for which it was partially responsible?

As it happens, its critics generally chose to engage the IMF on its terms. Jeffrey Sachs (1997) argued that:

> The IMF's usual target is a government living beyond its means....
>
> In Southeast Asia, this story simply does not apply. Indonesia, Malaysia, the Philippines and Thailand have all been running budget surpluses, not deficits. Inflation has been low in all of the countries. Foreign exchange reserves, until this past year, were stable or rising, not falling.
>
> The problem emerged in the private sector....

Given this interpretation of the empirical record, Sachs concluded that the IMF's austerity program was inappropriate. Whether one agrees with his conclusion or not, it is indisputable that the problem did emerge in the private sector; in a banking sector characterized by cronyism, by inefficient risk-taking and, in general, by a decision environment unrestrained by market discipline. As has been emphasized, the IMF should have recognized that: (1) Banking crises always precede exchange rate crises; (2) tight fiscal policy can be counter-productive, and (3) The Asian crisis could have been avoided had the region's systemic banking problems been addressed before the system collapsed.

At a December, 1998 seminar, "a senior IMF official conceded that the Fund had made some judgments 'too quickly' and had mistakenly thought that it was seeing a repeat of past currency crises, particularly the one that Mexico had in 1995" (Sanger, 1998).

That the IMF should have seen an analogy between the nature of the Asian currency crisis and that of the Mexican crisis is remarkable. Yet, at least one lesson from the aftermath of the Mexican crisis should have been transparent. Indeed, by January 1999 the IMF admitted that "it had made mistakes, underestimating the likelihood of a major economic downturn and misjudging the market's response" (Reuters, 1999):

> Noting that the [IMF] forecasters could have drawn on experience from countries like Mexico, where a currency collapse was followed by tumbling output, the report added, 'The impression remains that both the Fund and outsiders erred in some ways that could have been avoided....'

The Mexican experience should, at minimum, have sensitized the IMF to the possibility that its restrictive fiscal policy prescription could both amplify and accelerate the Asian crisis countries' readily apparent recessionary impulse. There is, moreover, a curious anomaly: At the same time that the IMF was urging Japan to "widen its [budget] deficits to clean up its banks", it was "pressing [the Asian crisis countries' governments] for less government spending and higher taxes to offset costs of restructuring ailing banks" (Davis and Wessel, 1998). The intellectual incoherence of this posture should have been obvious to the IMF–and to the United States Treasury. Yet, we know that the Treasury Department had adopted the same approach (Wessel, 1998):

> The best economic minds in Washington – Robert Rubin and Lawrence Summers at the Treasury, Alan Greenspan at the Federal Reserve, Stanley Fischer at the International Monetary Fund – are teaching the economic seminar of their lives.

> Call it Asian Contagion 101. The pupils are policy makers in Asia....Here are the gleanings from early lectures.
>
> Japan is in recession. Its banks are ailing. Its currency is weak. The obvious solution: Keep interest rates low....Widen the budget deficit....
>
> South Korea, Indonesia and Thailand are also in recession. Their banks are ailing. Their currencies are weak. The solution is obvious: Keep interest rates high....Keep the budget deficits under control....
>
> What's going on here?

Indeed. Failure to distinguish between the antecedents of the Mexican and Asian currency crises is one thing. The belated acknowledgement of "greater-than-anticipated contractions in economic activity" is another. Worse still, as the IMF acknowledged in January 1999, "it had probably been too optimistic in assuming that the rescue deals would restore market confidence" (Reuters, 1999). This, of course, is a euphemism for the failure of IMF policies to stabilize the exchange rates of the countries the IMF was trying to save. Indeed, it is not surprising that (Development Prospects Group, 1999, p. 57):

> ...none of the initial policy responses had much immediate effect in stemming pressures on currencies – much of the decline occurred after these measures were taken.[23]

While IMF austerity failed to mitigate the downward pressure on Asian currencies, it is important to emphasize three ideas: (1) While high interest rates impose costs, rapid currency depreciation can also be economically and socially destructive. (2) The pegged exchange rate systems adopted by the Asian crisis countries could not be maintained in the face of the capital flight which was itself motivated by lack of confidence in the countries' weak financial sectors. (3) As Calomiris has emphasized, while "Sachs and others...find little evidence of extreme fundamental weakness in macroeconomic flow indicators (e.g., conventional measures of government deficits or current account deficits)....they are simply looking in the wrong place for evidence of fundamental weakness" (1998b, p. 64). In Calomiris' view, the evidence of fundamental weakness lay elsewhere (1998b, p. 64):

> Expectations of future government expenditures often drive crises, not current expenditures. Financial sector imbalances (expected government costs of a bank bailout...) produce fiscal imbalances through the off-balance sheet contingent liabilities of the government, not through measured flows that show up in today's current account balance or current taxes and expenditures.

What seems clear from all of this is that IMF "austerity" did not address the fundamental illiquidity problems which fueled the Asian crisis. Moreover, in shifting the costs of dealing with the Asian crisis away from the "suppliers of capital" and to the crisis countries, the IMF and the Treasury Department did not succeed in stabilizing the countries' exchange rates. In the process, the IMF imposed costs whose incidence did not fall on the suppliers of capital whose

Asian euphoria they had encouraged. Instead, the costs were imposed within the crisis countries; costs which, while widely dispersed, fell to an important extent on the poorest of those countries' citizens. The fact that the IMF's "targeted fiscal policy positions have been eased over time to allow for greater social spending in [Thailand, South Korea and Indonesia]" (Anjaria, 1999) is revealing.[24] The IMF–and the Treasury–are culpable for the imposition of social and economic costs which could have been avoided. Had attention been paid to the panoply of problems associated with the crisis countries' banking sectors the crisis need never have occurred.

IV. THE SOCIAL COSTS

More than four years after the 1994 Mexican peso devaluation the *Wall Street Journal* asked a rhetorical question: "Is the Mexican Model Worth the Pain?" Observing that, after its devaluation, "Mexico followed almost to the letter the advice of the International Monetary Fund and the U.S. Treasury", the *Journal* noted that:

> Since Mexico's big 1994 currency devaluation, consumers have suffered a staggering 39% drop in their purchasing power. Just since 1997, the number of people living in extreme poverty – defined as workers earning less that $2 a day – has grown by four million, or twice the growth of the population (Millman, 1999).

The point is not that the antecedents of the Mexican and Asian crises were the same. They were not. Nor is it the point that the IMF's U.S. Treasury-supported "austerity" programs were completely at fault. As Anne O. Krueger has emphasized, IMF programs are "normally undertaken when the borrowing country is facing serious economic difficulties." Therefore, while "asking the counterfactual of what would have happened in the absence of Fund support may be the crucial question, yet it is difficult to answer" (1998, p. 1990).

That said, the developing evidence of the post-1994 Mexican experience should have given the IMF and its ally, the U.S. Treasury, pause. Instead–and in spite of the differences between the two episodes–the same conditionality was imposed on the Asian crisis countries. Not surprisingly, while in both Mexico and Asia, at least to some extent, the "rich investors get their money back", the middle class and the poor "pay the price for the IMF's failures" (Rosett, 1999).[25] And, also not surprisingly, "Asians, bolstered by some big name Western economists, blamed the IMF for worsening the crisis" (Sanger and Landler, 1999).

While these are, in their essentials, qualitative assessments of the effects of the IMF-Treasury Department austerity programs, Stewart and Ranis offer what they characterize as some anecdotal evidence on the economic and social status of the Asian crisis countries. Noting first that "Policy reactions [to the Asian crisis]–led by the IMF for Thailand, Indonesia and Korea–generally made the situation worse....", they observe that (1999, pp. 136-142):

- The initial policies advocated by the IMF were "harshly deflationary."

- While the IMF subsequently softened its stance, "the immediate consequences of the crisis and the policy reactions were in the same direction–leading to private bankruptcies and downsizing in both private and public enterprises....”

- Large increases in unemployment were accompanied by “Some reverse migration...as countries (notably Malaysia) eject foreign workers, creating refugees and additional poverty in their countries of origin....”

- While the “agricultural sector has generally been less affected by the crisis....Reverse domestic migration (back to the rural areas) may contribute to the rising rural poverty as wages are depressed by the migrants and income shared....”[26]

- In Indonesia, rising food prices, and “disruptions in transport and distribution due to the political crisis” are likely most to harm the old poor since, “possibly unlike the new poor, they do not have the buffer of prior savings.”

- Whereas the “effects on nutrition are likely to be less marked than effects on income, as low-cost goods form a higher share of consumption.... it is probable that expenditures on items such as education...will tend to be cut back.”

- Despite the relative importance of low-cost foods in families’ consumption bundles, “The increase in poverty and rising food prices, especially in Indonesian, are likely to have led to a rise in malnutrition....” Indeed, while systematic data are not available, “it was reported that about half the children in Indonesia were malnourished, considerably higher than pre-crisis levels, while people in the slum areas of Thailand, Indonesia and Philippines all reported cutting down from three to two meals a day and in some cases only one.... Rising infant mortality is reported by the director of UNICEF’s Indonesian office.”

- Data show that, in Thailand, “the total number of students in school in 1998 was 3.2% below the 1997 level..., and reports note sharply increased drop-out rates in schools in Indonesia and Korea....”

- There is “evidence of rising female-labour, child-labour, prostitution and begging in Thailand, increased child-labour in Indonesia, rising divorce, suicide rates and the sale of human organs in Korea.”

- And, finally, in the face of this “clear evidence of worsening poverty”, there “are virtually no safety nets for the newly unemployed.”

These observations and findings are broadly corroborated by the World Bank’s Development Prospects Group (1999, pp. 103-107). In particular, the Bank estimates that unemployment could rise by the end of 1998 “to about 13 million in Indonesia...3.5 million in Thailand, and 1.6 million in Korea, for a total of 18 million, compared with 5.3 million in 1996.”

In the case of poverty, the Bank observes that "Almost 17 million more people in Indonesia are expected to fall below the poverty line in 1998", while the increases in poverty in Thailand, the Philippines and Malaysia are, respectively, 2.3 million, 665,000 and "under 500,000." And, finally, the Bank observes that "Preliminary reports from Thailand and Indonesia indicate that a growing number of children are not returning for the new school year.... The health status of women and children is also reported to be deteriorating,.... [While] reported increases in child labor, prostitution, and domestic violence...may have long-lasting effects on the social fabric."

V. THE IMPLICATIONS FOR GLOBAL CAPITALISM

Amitai Etzioni (1999, p. 1):, a sociologist, recently wrote that

> ...countries from Russia to Malaysia are being swept by huge waves of rejection of the American form of capitalism. They have discovered that the recommendations of the IMF, the World Bank, AID, and the Jeffrey Sachses of the world, have brought to the majority of their people economic chaos, misery, loss of real income, dilution of assets (especially pensions), falling health standards, indignity, massive organized crime, large-scale corruption, AIDS, drug abuse, self-centeredness, and the worship of materialism.

While the quote embodies a good deal of hyperbole, it is clear that the economic and social costs absorbed by the Asian crisis countries have generated a backlash against "Western capitalism" (Kristof, 1999). Indeed, at a September 1997 meeting in Hong Kong, "After a decade of persuading nations to open their financial markets, American officials...[ran] into a wall of resistance as angry Asian leaders charge[d] that foreign investors and Wall Street-style trading exacerbated Southeast Asia's financial crisis" (Sanger, 1997). Then, in December 1997, the *Wall Street Journal* reported that "From Thailand to South Korea....rallies have featured attacks on the International Monetary Fund and the U.S." (Glain, 1997).[27] Significantly, the "backlash" has not been transitory. In September 1999 the *Wall Street Journal* again reported that "In Asia, victims of capitalism are questioning the devotion to free markets" (Stein, 1999).

The point is not that Western capitalism is at fault for the economic and social costs borne by the Asian crisis countries. It is not. Nor is it the point that capital account liberalization in the abstract is at fault. It is not. The point is that the IMF and its Treasury Department allies ignored the pre-crisis warning signs, misdiagnosed the problem, constructed a policy framework which made the problem worse, and set out to shift the costs of dealing with the crisis from the "suppliers of capital" to the crisis countries' citizens. In the process they have generated a backlash which correctly implicates them, but which, unfortunately, may derail the movement toward global free markets. The issue, in short, is the behavior of the IMF, the Treasury Department, and the "suppliers of capital." It is not–and should not be–the efficacy of capital market liberalization.

VI. A "NEW GLOBAL FINANCIAL ARCHITECTURE"?

The Asian backlash, the IMF, the U.S. Treasury and President Clinton have been among the many catalysts to calls for a "new global financial architecture."[28] In her remarks at the Federal Reserve Bank of Chicago-IMF October 1998 conference, IMF Director Karin Lissakers (Lissakers, 1999, p. 9) suggested that, while "There are no magic bullets....a number of themes were sounded in Washington this week that point to some corrective measures." In particular, she suggested that:

> First, we are redefining economic 'fundamentals' to encompass the health of the financial and corporate sector....
>
> Second, there will be an effort to give economic actors fewer places to hide their mistakes....
>
> The IMF should and will become more transparent in its own activities....
>
> There is great determination to ensure that private creditors contribute to the resolution of financial crises. This is essential from a practical standpoint; there isn't enough official money to do the job. There is also concern about moral hazard.[29]

This is, in its essentials, a remarkable mea culpa by an IMF director. Yet it begs the fundamental question of the proper role of the IMF–or of the need for the "capital controls" which some have suggested are necessary.

The question of the proper role of the IMF will be taken up below. For the moment, interest centers on the suggestion that one of the "lessons" of the Asian crisis is that unimpeded international capital flows may be "destabilizing" and that, therefore, capital controls should be imposed.

The "capital controls" debate is not new. Indeed, in August 1995 the *Wall Street Journal* suggested that the IMF had itself taken a backward step and endorsed "controls on international capital flows" (Editorial, August 24, 1995); a charge the IMF later denied (Camdessus, 1995). By November, 1997, as the Asian crisis was unfolding, the debate reemerged. Two ideas received particular attention: (1) The Tobin tax, or a tax on foreign exchange transactions "as a way to slow the movement of capital and prevent vertiginous currency-market swings", and (2) capital controls (Phillips, 1997). Against this backdrop, in rejecting the IMF's austerity program, Malaysia's Prime Minister Mahathir Mohammed institutionalized both an "exit tax" and capital controls. While Mahathir ended most of the controls on September 1, 1999,[30] a debate raged as to whether the tax and capital controls had been a success.[31] Indeed, during their annual review of Malaysia's economy "IMF board members 'broadly agreed that the regime of capital controls...had produced more positive results than many observers had initially expected....'" (Phillips, September 9, 1999).

Having, with the support of the U.S. Treasury, pushed so long and so hard for capital account liberalization, the IMF's assessment of the Malaysian experiment is, at best, confusing.

At minimum, it adds fuel to the debate. Earlier, the World Bank's chief economist, Josesph Stiglitz, had done the same. In October, 1997 he had argued that "Recent developments... underscore the challenges presented by a world of mobile capital–even for countries with strong fundamentals" (Stiglitz, 1997). Then, in an academic publication, Stiglitz (1999, p. 33) argued that:

> It seems clear that East Asia hardly needed the additional capital flows that opening its capital markets brought and that such capital flows brought with them high risks (especially given the state of their financial markets) that more than offset the potential benefits.

Finally, on April 28, 1999 the *Wall Street Journal* reported both that "The World Bank's chief economist is offering support to the notion that developing countries might benefit from imposing some limits on the inflow and outflow of foreign capital", and that Stiglitz had "noted the experience of Malaysia." Adding to the confusion, at the same time that President Clinton and Treasury Secretary Rubin were calling for a new global financial architecture, Rubin–and Federal Reserve Chairman Alan Greenspan–were opposing Japanese, French and German efforts to "promote 'currency stability' by limiting how much each currency can move before governments intervene" (Wessel, 1999) (Phillips and Aalund, 1999). Thus, while French President Jacques Chirac was urging the United States, Japan and Europe to "manage the exchange rates of their currencies...to restore stability to the world economy", such ideas were described as "anathema to...Rubin, who has repeatedly dismissed attempts to manage exchange rates as unworkable" (Sanger, 1999) (Andrews, 1999). Having supported the IMF's "stabilization" policies, Treasury Secretary Rubin was now on record saying that attempts to manage exchange rates are unworkable. And, with the IMF's board soon to declare that "the regime of capital controls...had produced more positive results [in Malaysia] than many observers had initially expected", Rubin–supported by Federal Reserve Chairman Alan Greenspan–resolved to "quash any proposals for strict controls on capital outflows...." (Phillips, September 9, 1999) (Phillips and Aalund, 1999).

The global suppliers of capital, the residents of the Asian crisis countries and the rest of us can be forgiven if we are confused.

There is, however, a way out of this morass. What must be understood is that the Asian crisis was not the result of capital account liberalization. Simply stated, capital account liberalization "refers to the progressive allocation of resources according to market forces rather than personal relationships or by government direction" (Brooks and Oh, 1999, p. 91). Considered in this light, capital account liberalization is unambiguously desirable. The problem is that those who endorsed and underwrote the free international flow of capital ignored the need for the requisite institutional predicates.

Inattention to the necessary institutional predicates–including bank solvency, the use of appropriate accounting standards, transparency, the rule of law and, pari passu, the protection of property rights–has been attributed to rigid employment of institutionless, intendedly value-free neoclassical economic theory. In effect, "That model has led some into an overenthusiastic endorsement of capital and financial market liberalization without encouraging...due attention to many crucial issues" (Stiglitz, 1999, p. 22). Among other things, because the model assumes that all market participants are fully informed, and that all transactions are instantaneous and costless, no account is taken of information asymmetries and correlative opportunistic behavior.[32] As Myerson (1999, p. 1080) has emphasized:

> In development economics an exclusive methodological reliance on price theory can lead naturally to a focus on those aspects of the developing economy that can be formulated within the terms of price theory, such as savings rates and international terms of trade, with a relative neglect of other fundamental problems such as crime and corruption, which can undermine the system of property rights that price theory assumes.

The point is precisely that the cronynism, the corruption, lack of transparency, and all the other institutional maladies to which the IMF pointed <u>after</u> the Asian crisis unfolded should have been appreciated <u>before</u> July 1997. Blind adherence to an institutionless model which, moreover, ignores the importance of ethical behavior to the functioning of markets[33] may have contributed to this theoretical–and empirical–lacuna. Indeed, it is even possible that the IMF, the U.S. Treasury and the suppliers of capital may have chosen to "look the other way" because (Bardhan, 1997, p. 1322):

> Economists have shown that, in the second-best world when there are pre-existing policy induced distortions, additional distortions in the form of black-marketing, smuggling, etc., may actually improve welfare.... The argument for efficiency-improving corruption is a simple extension of this idea.

It is possible, in other words, that the notion that corruption may be efficiency–enhancing informed the IMF's pre-crisis judgment that the Asian model had worked well so far (Lissakers, 1999, p. 4).

Whatever the case, we know that, among other things, the IMF "did not pay sufficient attention to...the rapid build-up of foreign short-term obligations....[and] underestimated the effect of political factors" (Lissakers, 1999, pp. 4-5). This, despite the fact that, as Nobel laureate Douglass North has emphasized (1994, p. 365):

> There is nothing automatic about the evolving of conditions that will permit low-cost transacting in the impersonal markets that are essential to productive economies.... Creating the institutions that will alter the benefit/cost ratios in favor of cooperation in impersonal exchange is a complex process, because it not only entails the creation of economic institutions, but requires that they be undergirded by appropriate political institutions.

That institution building is difficult is clear.[34] That it is a prerequisite for continued, growth-enhancing capital absorption is also clear. But the corollary is not that, because the requisite institutional infrastructure was not in place in the Asian crisis countries, it is capital account liberalization that was at fault. The fault does not lie with liberalized international capital flows. The fault lies with those–the IMF, the U.S. Treasury and the suppliers of capital–who chose either to ignore that the requisite infrastructure was not in place, did not know that the institutional vacuum existed, or failed to understand the important nexus between appropriate institutional arrangements and the efficacy of enhanced capital flows.

Does any of this imply that a new global financial architecture is required, or that capital controls should be imposed? If by "new global architecture", its proponents mean, among other things, establishment of a new IMF Contingent Credit Line, the answer is no. The provision of "preventive" loans to "potentially vulnerable countries"[35] both exacerbates the moral hazard problem and expands the role of an institution, the IMF, whose actions and omissions both contributed to, and magnified the Asian crisis. If they mean the fundamental reform of the IMF, the answer is yes. While some have argued that the IMF "makes a useful contribution to developing countries...(when capital is not highly mobile)" (Krueger, 1998, p. 2016), the irremediable fact is that capital is–and should be–highly mobile. The simple truth is that the IMF in its present form "is ineffective, unnecessary and obsolete" (Shultz, Simon and Wriston, 1998). It should be extensively reformed.[36] Finally, if by new global financial architecture its proponents mean capital controls, the answer is no. While some have argued that "If more effective supervision proves impossible for a country, then there is a second-best case for limiting foreign capital inflows...." (Obstfeld, 1998, p. 26), this argument is hardly persuasive. Perhaps most important, it ignores the role of the suppliers of capital. In a sense, this omission comports with the IMF-U.S. Treasury approach, which shifted the blame for the Asian crisis to the crisis countries and largely immunized the suppliers of capital from the effects of their mistakes. In short, while sovereign nations have a responsibility to construct a financial infrastructure which is congenial to capital inflows, so too do the suppliers of capital have a responsibility. Their responsibility is to exercise due diligence. While the presence of the IMF–and the correlative promise of taxpayer-financed bailouts–provided a perverse incentive structure, its fundamental reform can alter the decision environment in favor of scrupulous, systematic study of the fundamentals. Presumptively, investments in developing countries would then be predicated on an explicit evaluation of both the macroeconomic fundamentals and the state of the socioeconomic, political, legal and accounting infrastructure. And, if loan officers and portfolio managers have a responsibility to exercise due diligence, so too do the capital suppliers' shareholders. While, as principals, they have incentive to monitor their agents' behavior, the prospect of IMF-sponsored bailouts encouraged shareholders to free ride. If the IMF is properly reformed, shareholders will have renewed incentive to monitor their agents' lending and investment decisions.

VII. SOME SUGGESTED INSTITUTIONAL REFORMS

The search for a "new global financial architecture" must take account of both the banking sector and the government illiquidity problems which animated the East Asian and other crises.

Structural reform of the banking sector is essential. Charles Calomiris has proffered a set of banking reforms intended to mitigate the effects of cronyism, corruption, the lack of transparency and–above all–the moral hazard problem (Calomiris, 1998b, p. 6):

> ...(1) capital standards founded on market discipline, achieved through a requirement that banks maintain a minimal proportion of uninsured, junior–that is, subordinated–debt; (2) credible deposit insurance for other bank debt claims; (3) a 20 percent 'cash', or equivalents, reserve requirement for banks; (4) a 20 percent global securities requirement for banks; (5) free entry by domestic and foreign competitors into banking; and (6) limitations on other government assistance to banks.

Yet, as helpful as these sectoral reforms may be, more is needed. Fundamental IMF reform is essential if the government illiquidity problem is to be addressed. A central theme of proponents of this view is that a "New" IMF should return to its roots; to the "original intent of the IMF's founder" (Calomiris, 1998b, p. 7). In effect, the IMF would become an international quasi-lender of last resort (Meltzer, 1999, p. 213), and the existing Exchange Stabilization Fund would be abolished (Calomiris, 1998b, p. 7). Following Bagehot (1873 (1962)), the idea which animates this view is that a financial system requires a lender of last resort to assist financial institutions during liquidity crises. As Meltzer emphasizes (1999, p. 213):

> ...Bagehot distinguished between liquidity and solvency and provided rules that separated the two. He required the borrower to offer marketable assets as collateral for a loan, and he required the lender to charge a penalty rate on all such loans. The collateral requirement separates insolvent from illiquid banks. The penalty rate eliminates subsidies, reduces moral hazard, and reduces reliance on the lender.[37]

This perspective, shared by Calomiris (1998b, p. 8), is reflected in the recommendations of the International Financial Institution Advisory Commission (2000, pp. 42-52). Reduced to their essentials, the recommendations contemplate a smaller institution with well-defined, restricted responsibilities: (1) to act as a quasi-lender of last resort to <u>solvent</u> emerging economies; (2) to collect and disseminate financial and economic data from member countries, and (3) to provide advice–but not impose conditions–relating to economic policy.

Given this limited IMF role, four rules for IMF lending would be imposed (Meltzer, 2000, pp. 44-45):

(1) To limit corruption and reduce risk by increasing portfolio diversification, loan-eligible member countries must permit freedom of entry and operation for foreign financial institutions.

(2) To establish market discipline, commercial banks must be adequately capitalized. This requirement contemplates, <u>inter</u> <u>alia</u>, adequate capitalization through inclusion of a significant equity base, and the issuance of <u>uninsured</u> subordinated debt.

(3) To encourage prudent behavior, safety and soundness, each IMF borrower must publish regularly the maturity structure of its outstanding sovereign and guaranteed debt and off-balance-sheet liabilities.

(4) The IMF should establish a proper fiscal requirement to assure that IMF resources would not be used to underwrite irresponsible budget policies.

The rules would be phased in, with IMF loans restricted to a short maturity, carrying a penalty rate and specifying that the IMF be given priority in payment over all other creditors. The priority of IMF claims could, in turn, be ensured by means of a security or collateral provision, by "negative pledge clauses" preventing governments from subordinating existing creditors by pledging collateral on new loans, or by imposing a prequalification requirement for access to IMF liquidity assistance (Meltzer, 2000, p. 47). Finally, credit limits reflecting the capacity of the sovereign to repay its IMF debt would be imposed.

The Commission's other recommendations (Meltzer, 2000, pp. 46-52) focus, inter alia, on exchange rate policy, and on finance and accounting reforms. The former emphasizes that countries should choose either firmly-fixed or flexible exchange rates. In the event the firmly fixed option is selected, enhanced credibility could be secured by means of a currency board, or by adoption of a strong foreign currency as the domestic currency.

Finally, Calomiris (1998b) envisions bifurcated roles for the IMF and the World Bank. Consonant with the Commission's recommendations, the IMF would be a lender of last resort. For its part, the World Bank would provide subsidies to make privatization and market discipline more achievable. In this way, the World Bank "would facilitate [market] liberalization and, hence, help to expand the IMF membership list" (1998b, pp. 9-10).

These recommendations merit attention. Were they adopted, the ongoing capital controls debate would be rendered moot, and the free flow of capital would be encouraged. Given the new institutional environment, more reliance could be placed upon the due diligence of capital suppliers and shareholder monitoring.[38] Heightened capital supplier prudence would, in turn, provide market-driven incentive for recipient countries to develop the requisite socioeconomic-political-accounting and legal infrastructure.[39]

NOTES

1. On this see Krueger, 1999, pp. 14, 16, and 30 and Kasa, 1998.
2. On this see Kasa, 1998, p. 1 and Neely, 1999, p. 7.
3. Intertemporal balance requires that the current stock of debt equal the present value of current and expected future net of interest surpluses. See Yan, 1999, p. 280.
4. In April 1996 the Federal Reserve Bank of San Francisco observed that "In a number of Asian economies, interest in speculative pressures has recently been heightened by concern about the possible reversal of the vast foreign capital inflows they have experienced in the last decade....(Moreno, 1996, p. 1).
5. For more on the Japanese role in East Asian development, see Terry (1996).
6. For more on the East Asians nations' excess capacity, see Hirsh, 1999 and Kristof and Sanger, 1999.
7. The chaebol had reason to fear that their domestic market was increasingly less secure. Bernard Wysocki, Jr. reported in the July 8, 1996 *Wall Street Journal* that "Over the past decade the so-called Asian tigers– Hong Kong, Singapore, Taiwan and South Korea – - have, taken together, eclipsed Japan as a market for American exports. The tigers buy 13% of [U.S.] exports, while Japan takes in 11%, down from 12% a decade ago." It was against this background that a scandal unfolded surrounding the February, 1997 bankruptcy of South Korea's second largest steel maker, Hanbo Steel Industry. With a debt-to-capital ratio of 22 to one, Hanbo nevertheless used borrowed money to finance a new steel mill at Tangjin. The *Wall Street Journal* speculates that "the government leaned on banks to lend the money" so as "to wean their country off of imported hard-rolled steel" (Editorial, February 6, 1997). So concerned was the South Korean government that it implemented a "frugality campaign" to discourage all imports (Schuman, 1997).
8. See also editorial, *Wall Street Journal*, March 13, 1997.
9. For more on the early warning signs of the "downside to Thailand's economic boom" see Moreno, 1997.
10. See, for example editorial, *Wall Street Journal*, 1995; Bussey, 1995; WuDunn, 1996; Passell, 1996; editorial, *Wall Street Journal*, January 28, 1997; Editorial, *Wall Street Journal*, November 11, 1997; Sapsford, 1997 and Bloomsberg News, 1997.
11. See, for example Kasa, 1994; McDermott, 1996 and Kasa, 1997.
12. In remarks made on December 2, 1997, Meredith Woo-Cummings observed that:

    > Memories can be very short in the media: in the current coverage of the IMF bailout I saw hardly any reference to last year's Korean news, which involved the cashiering of two previous presidents for truly mind-boggling levels of corruption, owing to the very system I am talking about: politicians and political parties collecting huge amounts of money from the chaebol, and offering in return loan guarantees to sustain these cash-strapped firms.

    The events to which Ms. Woo-Cummings refers unfolded in 1996, well before the "Asian crisis" emerged. Given the gravity of the events, it seems plausible to argue that the Asian "specialists", the Clinton Administration and the IMF should have taken note. Indeed, it is difficult to understand how pre-crisis coverage of corruption in East Asian nations could not have been noticed. See, for example Melloan, (November 13, 1995; Gonzales, February 5, 1996; Editorial, May 6, 1996 and Pollack, February 27, 1997).
13. Speaking at a joint World Bank-IMF seminar, Federal Reserve Chairman Alan Greenspan argued that the financial crisis in the East Asian nations in 1997 and 1998 were made much worse by almost total reliance on bank lending (Berry, 1999). On the other hand, Chairman Greenspan said in congressional testimony that "Given a record of real growth rates of close to 10 percent per annum over an extended period of time, it is not surprising that it has been difficult to convince anyone that the economic system practiced in East Asia could not continue to produce positive results indefinitely" (Greenspan, 1998, p. 3). While this may be true, the Asian "specialists," the Clinton Administration and the IMF had a responsibility carefully to monitor evolving conditions before the crisis unfolded.
14. It has been suggested that, for young mutual fund managers, "The safest career move is to follow the herd, even if the herd is going over a cliff" (McDermott, 1999). Perhaps this admonition applies to the bankers and Wall Street investment advisors whose "euphoria about Asia" persisted in the face of eroding East Asian economic conditions. There is, in fact, evidence that "The Asian turmoil appeared to reveal a tendency among investors to treat emerging markets as an asset class" (Staff, Federal Reserve Bank of Atlanta, 1999, p. 17). In effect, the Asian euphoria was not tempered by careful, systematic analysis of country-specific conditions.
15. For an expanded discussion of the moral hazard problem, see pp. 19-23 below.
16. For more on the importance of microeconomic analysis, see (Samuelson, 1998). Among other things,

"Microeconomics deals with incentives. If people and companies face incentives to do stupid (or smart) things, they will do stupid (or smart) things....God lies in the details."

17. For more on the failure of macromodeling to predict the Southeast Asian crisis see (Stiglitz, 1999, pp. 26-27).
18. For more on the warning signs that would have been seen "If investors and policy-makers had been looking a little more closely" see (Neely, 1999, p. 6).
19. The issue of capital account liberalization is taken up in Section VI, below.
20. See also Obstfeld, 1999, pp. 23-26.
21. See also Phillips, January 20, 1999. For more on the reliability of IMF forecasts, see Beach, et al, 1999.
22. See, for example Kristof, 1998.
23. See also Stiglitz, 1999, p. 29.
24. See, for example, Utumporn, 1999. In the case of Indonesia, the IMF first "ridiculed [President] Suharto's budget proposal, which because of exchange rate movements showed a 32 percent spending increase in local currency terms. But three weeks later, having already irreparably harmed Indonesia's image, the fund quietly approved a budget with a 46 percent spending increase" (Kristof and WuDunn, 1999).
25. See also Solomon, 1997; Waldman, 1997; Glain, 1998 and Kristof and WuDunn, 1999.
26. The impact on the agricultural sector may have been more severe than is suggested here. See, for example Waldman, 1999.
27. See also Mydans, 1997 and Sherer, 1998.
28. See, for example Kristof, 1999. For his part, Treasury Secretary Rubin suggested that there is a need to "redo" the "global financial architecture" by creating institutions "as modern as the markets." President Clinton, somewhat obtusely, has insisted that there is a need to "Find a way to facilitate the movement of money...that avoids those dramatic cycles of boom and bust" (Wessel, 1999).
29. Some have argued, for example, that "we would get at least as much stability by forcing a bankruptcy sale as could be expected from a bailout" (Lindsey, 1998, p. 26).
30. See, for example Landler, September 2, 1999 and editorial, *Wall Street Journal*, September 3, 1999.
31. See, for example, Friedman, 1999; Appell, 1999 and Landler, September 4, 1999.
32. See, for example, Roth, 1997 and 1998.
33. See, for example Furubotn and Richter, 1997, pp. 49 and 140 and Buchanan, 1994, p. 125.
34. See, for example Friedman, 1998.
35. See, for example Wolf, 1999.
36. See also Schwartz, 1998; Bandow, 1998 and Sachs and Thiel, 1998.
37. Many of these ideas are embodied in H.R. 3750, "A Bill to Reform the International Monetary Fund," introduced by Congressman Jim Saxton on February 29, 2000.
38. In a recent speech whose general theme was financial risk Federal Reserve Chairman Alan Greenspan argued for more intensive oversight of investment decisions by "boards of directors, senior managers and supervisory authorities.... the advent of sophisticated risk models has not made people with gray hair, or none, wholly obsolete" (Greenspan, 1999).
39. In fact, "the drumbeat for a universal set of accounting rules is growing louder." Presumably, this is reflective of the view that "A lingua franca in accounting could...curb the type of market turbulence that erupted in Thailand, Korea, Indonesia, Russia and Brazil in 1997 by signaling potential financial hot spots" (MacDonald, 1999).

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