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Nouriel Roubini

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Subject: International ERP chapters.

Jeff, here they are.

Happy new year. Nouriel

===== ATTACHMENT 1 =====

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Chapter 7: The Evolution and Reform of the International Financial System

[Note: Sentences in square brackets may be dropped in the final revision to shorten the chapter]

1. INTRODUCTION

The financial problems which began in Asia last year have exposed weaknesses in emerging market countries and in the international financial system. In response to the widespread financial turmoil in 1997-98, the United States has taken steps, jointly with the international community, to contain the financial crisis and to foster reforms of the international financial system in order to make it less crisis prone.

This turmoil followed a robust period of increasing integration of world product and financial markets. The trend toward increasing integration is perhaps best epitomized by the long-anticipated realization of European Monetary Union in January 1999. Even as this historic monetary union takes place, repeated episodes of financial turmoil in the 1990s have generated concern about the adverse consequences of financial integration. Speculative attacks on Asian currencies in 1997-98 have some elements in common with speculative attacks on European currencies in 1992-93 and the Mexican peso crisis in 1994.

The recurrence of currency and financial crises in the world economy poses major challenges to policy makers. Is the process of financial integration and globalization partly to be blamed for the instability observed in global financial markets? What are the causes of

these recurrent crises, instability, and financial market volatility? Does integration into modern global financial markets require the surrender of macroeconomic sovereignty? Should free capital mobility be restricted with capital controls? Can the Bretton Woods institutions (the IMF and the World Bank), designed for a world of fixed exchange rates and limited capital mobility, still maintain stability in a radically different environment? What regime of exchange rates in small countries is best-suited for the new world of global capital mobility? Which institutional framework provides stability for the international financial system? Answers to these questions are necessary to strengthen the stability of the international financial system and ensure that the process of global financial integration will continue to sustain growth, increase in welfare and opportunity for the world economy.

The chapter starts with the main elements of the proposed reform of the international financial architecture. It then provides an analysis of the next steps to be considered in the redesign of the the international financial system. Finally, it considers European Monetary Union and the prospects for the euro as an international currency and possible implications for the U.S. dollar.

1. REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

FROM HALIFAX TO THE G22 REPORTS

After the Mexican peso crisis a broad debate ensued on the steps needed to strengthen

the international financial architecture. Although the debate the onset of the crisis, the crisis gave it considerable impetus and pertinence. The Summit of G7 leaders in Halifax, Nova Scotia, in 1995 initiated work in a number of areas. One such area was the need for additional means to achieve an orderly resolution of future financial crises. The Finance Ministers and Central Bank Governors of the G10 countries were asked to review ideas. The G10 established a working party that submitted a report – informally known as the Rey Report, after its chairman – to the ministers and governors in May 1996.

The report suggested that domestic moral hazard can potentially contribute to crises and stressed the need for better market-based procedures for debt workout. Debt workouts for countries and firms in financial distress may entail restructuring the terms of debt contracts and/or writedowns of the value of the liability. Specific reforms of bond contracts (such as sharing clauses, majority voting and creditors' committees) were suggested. Changes in IMF rules to permit "lending into arrears" were also considered, to enable the IMF to continue lending to debtor countries that had temporarily suspended debt-service payments but had continued to comply with IMF adjustment policies. Recent financial turmoil has underscored the importance of implementing these and other reforms.

A number of important additional innovations did follow the Halifax process: the development of international data standards (under the IMF's Special Data Dissemination Standard); international banking standards (the Basle core principles for banking supervision); an

emergency financing mechanism in the IMF; and the decision to expand credit facilities under the New Arrangements to Borrow.

The 1997 eruption of the crisis in Asia demonstrated the need to reconsider important questions about the operation of the international system. In November 1997, on the occasion of the APEC (Asian Pacific Economic Cooperation) Leaders Summit in Vancouver, a number of Asian leaders expressed a desire for a “global” meeting of finance ministers and central bank governors to discuss the crisis and broader issues. President Clinton responded by calling on Secretary Rubin and Chairman Greenspan to convene such a meeting. Finance ministers and central bank governors from twenty-two countries (the G22) thus gathered in Washington on April 16 to resume exploring ways to reform the international financial system to reduce the frequency and severity of crises. Ministers and governors called for the creation of three working groups to examine the following central issues: greater transparency and openness; stronger financial systems; and appropriate burden sharing between the official and private sector in times of crisis. The three working groups of the G22 presented their reports in October 1998 on the occasion of the annual meetings of the IMF and World Bank.

GREATER TRANSPARENCY AND OPENNESS

There is a broad consensus on the need for greater transparency by debtor countries and international financial institutions. As with previous crises, the Asian crisis reiterated the

importance of transparency and sufficient information about macroeconomic conditions (such as the size, maturity and currency composition of external liabilities as well as the true level of foreign exchange reserves). It also underscored the need for accurate information about the true financial accounts of financial and non-financial enterprises. Without such information outsiders are unable to adequately assess the true conditions of governments and private sector firms. The crisis also made clear the importance of transparency on the part of international institutions themselves, and led to calls for the IMF and other international financial institutions to be more open and transparent about their activities, economic analysis, policy advice and recommendations.

The report of the working group on transparency and accountability makes several recommendations. First, it calls upon the IMF to examine and broadly publicize countries' adherence to international standards of data transparency as well as, more broadly, standards of transparency in the conduct of fiscal and monetary policy. Second, the report urges the adoption of international agreements on better accounting and disclosure standards for private financial institutions -- including sound practices for how bank loans are evaluated, how banks provision reserves for loan losses and how they disclose credit risks associated with borrowers who may experience financial distress. Third, the international community (including national authorities, international bodies and the private financial sector) is called upon to consider appropriate measures for disclosure of international exposures of all types of financial

institutions, including hedge funds and other highly leveraged financial institutions.

Finally, the IMF and other international financial institutions (IFIs) were called to be more open and transparent. The report recommends several ways to make IFIs more transparent. For example, it recommends that IFIs adopt a presumption in favor of the release of information, except where release might compromise confidentiality. It also calls for publication of program documents, background papers to reports following the regular yearly visit by the IMF to a member state and Press Information Notices (PINS) following the IMF Executive Board discussion of reports on member countries economic conditions, policy papers and program reviews.

While undoubtedly important, transparency alone will not be enough to prevent another major crisis from occurring. Information in Asia on statistics such as the countries' net foreign reserves (including central banks' forward transactions) and the offshore liabilities of the financial and corporate system would have certainly been useful. The dearth of this information may well have exacerbated investors' uncertainty. It is hard to argue, however, that the most important information was hidden. Current account balances and overall figures on foreign liabilities, as well as myriad other data, were regularly published. Until the onset of the crisis, investors apparently ignored the warning signals coming from a number of indicators. More is needed than just information.

REFORMING AND STRENGTHENING DOMESTIC FINANCIAL INSTITUTIONS

Financial sector weaknesses now appear to have been a central cause of both the Asian crisis and previous financial crises. National banks and other financial institutions borrowed excessively from abroad and lent excessively at home, thus playing a key role in channeling funds toward projects that were marginal if not outright unprofitable. Insufficient expertise in the regulatory institutions led to supervision of banks that was lax and regulation of the financial system that was weak. Banks held insufficient capital against risky loans (i.e. their capital adequacy ratios were low), and insurance of bank deposits was implicit or poorly designed. As a result, incentives for project selection and monitoring were distorted, and connected lending practices – those in which financial firms in a business group made loans to other firms in the group without objectively evaluating or monitoring their soundness – were widespread. All these factors contributed to the build-up of severe structural weaknesses in the undercapitalized financial system. The most visible manifestation was a growing share of non-performing loans. The impact of such factors was exacerbated by the increased supply of funds from abroad, the latter in part facilitated by the process of capital account liberalization and financial market deregulation in the region during the 1990s.

The recurrent link between currency, debt and banking crises is now clear. Strengthening domestic financial systems will thus be a central element of ongoing systemic reform. The list of specific measures required is long, and will take years to complete. A

partial list of the reforms recommended by the G22 includes: strong prudential regulation and supervision of bank and non-bank financial institutions; application of enhanced capital adequacy ratios; design of explicit and effective deposit insurance schemes; design and implementation of disclosure rules, bankruptcy and foreclosure laws; development of liquid and deep financial markets, especially securities (bond and equity) markets; national implementation of the Basle core principles of banking supervision and IOSCO's objectives and principles of securities regulation; coordination and cooperation among international organizations and international supervisory entities in strengthening financial systems; technical assistance for and training of government official and regulators; improvement of corporate governance both in the financial and non-financial sector; and implementation of efficient insolvency and debtor-creditor regimes that would facilitate workouts for corporations in financial distress.

BETTER CRISIS RESOLUTION, DEBT WORKOUT MECHANISMS AND PRIVATE SECTOR BURDEN SHARING

While strengthening financial systems may prevent some crises from occurring or make those that do occur less virulent, it cannot be expected to eliminate them altogether. As a result, establishing means of resolving crises at minimum cost to economic growth and performance while maintaining appropriate incentives for prudent private behavior is essential.

This very important task constitutes the final pillar of international financial reform.

The G22 report suggested that responses to crises need to include appropriate private sector burden sharing and new financing mechanisms to combat contagion. Private sector burden sharing is critical, not only because there will not be sufficient official money for all circumstances, but also because it helps to induce market discipline and reduce potential moral hazard problems deriving from official assistance. The perception that sufficient official assistance may be made available to allow a country to meet all contractual obligations without commensurate commitments from the private sector could distort the incentives of both creditors and debtors. While the international community will continue to provide assistance -- conditioned on economic reform -- to deal with the problems that gave rise to economic crises, appropriate private sector burden sharing is a factor in the orderly resolution of a financial crisis. It is important to develop mechanisms to allow the private sector to participate constructively to the containment of crises and their resolution over time.

New procedures need to be developed for effective management of financial difficulties that are suitable to modern markets. When banks accounted for the majority of international capital flows, it was easier to coordinate private sector efforts to restructure and reduce debt burdens where necessary, in parallel with official sector support efforts. Today, the proliferation of creditor institutions and instruments and the growth of international bond markets makes it more difficult to coordinate the actions of creditors during a crisis.

Moreover, unilateral actions such as mandatory debt restructurings and moratoria on repayment of debt can be highly disruptive and can lead to contagion as they increase the perceived probability that other countries may follow similar policies. For example, the contagion from Russia to Latin America in the summer of 1998 followed the unilateral debt restructuring imposed by Russia on its ruble debt creditors. Given the goals of developing orderly workout regimes and private sector burden sharing, the report called for a number of recommendations.

A range of policies to help prevent crises and limit the scope of those crises that do occur.

Recommendations include: maintaining appropriate exchange rate regimes, developing liquid domestic bond markets, implementing effective insolvency and debtor-creditor regimes, limiting the scope of government guarantees, and developing insurance schemes that protect borrowers against sudden liquidity shortages and explicitly provide for greater risk-sharing between debtors and creditors.

Measures that could improve creditor coordination in the event of a crisis.

Following some of the Rey Report recommendations, the G22 proposed to include creditor coordination clauses in bond contracts among debtors and creditors to foster mechanisms for coordination among creditors, debtors and the international official community. “Collective action clauses” in bond contracts are needed to provide for: (i) collective representation of creditors to facilitate the efficient coordination of a large group of creditors; (ii) majority action to alter the payment terms of the contract so that unanimity is not required to

restructure bond debt; and (iii) sharing of payments among creditors to discourage disruptive legal action and preferential settlements that benefit a few creditors at the expense of others.

New methods of crisis containment and management, including methods to reduce the disruption associated with the extreme case of a temporary suspension of debt payments.

A temporary suspension of debt payments (either the interest due on bonds and loans and/or the principal value of the debt contract) should not, and normally will not, be undertaken until all other reasonable alternatives have been exhausted, because of the significant economic and financial costs associated with it. Recent experience has underscored the fact that unilateral mandatory suspensions of debt payments and restructuring actions, especially if they substitute for reform and adjustment, are highly disruptive. However, temporary suspensions of debt payments may occur, particularly in the event of unanticipated adverse market developments. In these cases, it will be important to have orderly and cooperative approaches for negotiating the restructuring of contractual obligations rather than unilateral actions that disrupt markets and shatter investors' confidence.

The international community and private creditors also have an interest in providing incentives for strong and sustained policy adjustments and structural reforms when a country experiences a crisis and is forced to suspend debt payments temporarily. These interests can be furthered by allowing the international community to signal its conditional willingness to provide financial support, when appropriate, even if the country has imposed a temporary payments suspension and is therefore "in arrears" in its payments to private creditors. Such a policy of IMF "lending into arrears" (i.e., IMF lending to a country that has suspended payments and has

not yet cooperatively restructured its debt with private creditors) should be provided only if a government's decision to suspend payments reflects the absence of reasonable alternatives, if the government is willing to undertake strong policy adjustment and if the government is engaged in good faith efforts with creditors to find a cooperative solution to the country's payments difficulties.

Measures to help facilitate prompt and orderly workouts of external debt.

Several measures can be undertaken to facilitate this process. First, insolvency regimes (such as domestic U.S. Chapter 11 corporate restructuring) generally provide a mechanism for the provision of new, senior credits to assure the ongoing operation of the firm and the restructuring of existing debt. Means of encouraging the private sector to provide new credits (such as loans for working capital for production and exports) in the event of a crisis or suspension of debt payments should be carefully considered. Either formal or informal assurances, for example, could be granted by the debtor country that greater payment seniority would be given to certain new credits. Second, it also might be possible to create, *ex ante*, a standing, privately-funded mechanism to provide new credits before a crisis or in the event of a crisis or payments suspension. For example, Argentina arranged for lines of credit with international banks that can be activated if speculative capital outflows lead to a loss of foreign reserves. Third, while national insolvency regimes (such as bankruptcy laws) provide the standard mechanism and appropriate legal and institutional framework for the restructuring of corporate debt, a crisis in the corporate sector can be of sufficient magnitude to threaten the solvency of the financial system in the crisis country. Consequently, there may be occasions

when the government will need to develop a framework for encouraging negotiations between private debtors and their creditors. Such a framework might include: (i) the establishment of creditors' committees; (ii) the removal of legal and regulatory obstacles to debt restructuring; and (iii), in certain extreme cases, the establishment of exchange rate insurance schemes to provide an inducement to negotiate and to facilitate the valuation and adjustment of outstanding claims. The Asian Growth and Recovery Initiative recently launched by the U.S. and Japan represents an effort to support implementation of more comprehensive and accelerated restructuring of banks and corporations.

Implementation of the reforms of the international financial architecture suggested by the G22 reports will take time. But it will reduce the likelihood of future crises and reduce the severity of those that do occur.

ADOPTION OF MEASURES TO REFORM THE INTERNATIONAL FINANCIAL ARCHITECTURE

Following the G22 reports and detailed discussions, including with officials from other industrial and emerging market economies, the Finance Ministers and Central Bank Governors of the G7 countries agreed, in their October 30 Declaration, on specific reforms to strengthen the international financial system. They agreed to carry these forward through their own actions and in the appropriate international financial institutions and forums. These reforms are designed to: increase the transparency and openness of the international financial system; identify and disseminate international principles, standards and codes of best practice; strengthen incentives

to meet these international standards; and strengthen official assistance to help developing countries reinforce their economic and financial infrastructures. They also include policies and processes to ensure the stability and improve the surveillance of the international financial system. Finally, they aim at reforming the International Financial Institutions, such as the IMF, while deepening cooperation among industrialized and developing countries.

2. NEXT STEPS IN THE REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM

In addition to the measures taken to strengthen the fundamentals of the international financial system and assist crisis-affected countries to find a route out of their current difficulties, the international community needs to widen its efforts to strengthen the international financial system. The aim is to create an international financial system for the 21st century that captures the full benefits of global markets and capital flows, minimizes the risk of disruption, and better protects the most vulnerable. At the same time the system must promote international financial stability.

In the October 30 Statement of the G7 Leaders and the Declaration of the G7 Finance Ministers and Central Bank Governors, the G7 committed to initiate further work on a number of other important areas to identify additional concrete steps to strengthen the international financial architecture. These include:

- examining the scope for strengthened prudential regulation in industrial countries.
- further strengthening prudential regulation and financial systems in emerging markets.
- consideration of the elements necessary for the maintenance of sustainable exchange rate

regimes in emerging markets.

- developing new ways to respond to crises.
- assessing proposals for strengthening the IMF.
- minimising the human cost of financial crises and encouraging the adoption of policies that better protect the most vulnerable in society.

The issues involved and challenges faced in achieving these goals are considered next.

STRENGTHENED PRUDENTIAL REGULATION AND SUPERVISION IN INDUSTRIAL COUNTRIES

The crises of the past year have revealed some gaps in the international regulatory infrastructure for promoting financial stability, overseeing national financial systems and coordinating the response to crises. The proliferation of international financial institutions making cross-border financial transactions, the emergence of off-shore financial centers and hedge funds and the development of a wide range of derivative instruments have posed significant challenges to devising appropriate supervisory regimes of the international financial system.

With these challenges, however, have also come a more urgent need to examine the scope for strengthened prudential regulation in industrial countries. New mechanisms might be needed to encourage sound analysis and careful weighing of risks and rewards. New standards for appropriate transparency and disclosure might also need to be considered for all financial market participants.

Enhanced international financial supervision and surveillance

Given the increased degree of global financial integration, better processes are needed for monitoring and promoting stability in the financial system. The International Financial Institutions, working closely with international supervisory and regulatory bodies, need to be able to conduct surveillance of national financial sectors and their regulatory and supervisory regimes with all relevant information accessible to them.

National and international regulatory and supervisory expertise could be effectively harnessed for strengthened financial sector surveillance. A process of peer review could be utilized as well as the IMF's regular surveillance of its member countries. [To that end the IMF's own resources for monitoring countries' financial sectors should be strengthened and structured to take better advantage of existing resources and expertise, including that of the World Bank and banking and securities regulators from other countries.]

Cooperation and coordination would be useful. Key international institutions and key national authorities involved in financial sector stability will need to jointly cooperate to manage and develop policies to foster stability and reduce systemic risk in the international financial system. They will need also to exchange information more systematically on the risks that exist in the international financial system. In this regard, the design of a forum including finance ministries, central banks and securities regulators from the major G7 countries, key emerging markets, relevant international organizations and international financial institutions would be useful. [Given the increasingly important role of emerging markets in the global financial system, an inclusive forum with a directly policy-oriented mandate would be appropriate.]

[While there may be room for greater international coordination of supervisory and financial surveillance activities, good financial supervision must start at the domestic level. The implementation of the wide-reaching reforms suggested by the G22 working group on strengthening financial markets would already go a long way to ensure that financial systems in emerging markets are well-supervised and -regulated.]

Strengthened bank capital regulation

An important international regulatory issue relates to capital standards for globally active banks. The 1988 Basle Capital Accord called for the maintenance of bank capital equal to at least 8 percent of risk-weighted assets. By weighting individual bank assets according to risk, the Accord sought to make sure that banks investing in riskier assets maintained larger capital reserves. [For example, holdings of safe government bonds or cash have a zero weight while long-term lending to emerging markets banks has a 100% weight in computing risk-weighted assets.]

Even at the time of their adoption, it was recognized that the standards called for in the Accord might need to be strengthened and reformed in face of financial innovations and developments in the international financial environment. Effective capital regulation is an evolutionary process and the standards have already been improved in a number of ways in the decade since their first adoption. Some expected shortcomings have become clearer as a result of developments in the domestic and international banking environment. First, a number of financial innovations now allow banks to assume more risk while showing no change in capital ratios. Second, as the recent experience with systemic currency financial crises suggests,

traditional credit risk assessment may not be robust to extreme systemic contingencies. Third, current standards have given incentives to banks in developed countries to make short-term rather than longer-term loans to banks in emerging markets as risk weights on former loans are lower than those on the latter; recent experience, however, suggests that short-term cross-border interbank flows are volatile. Fourth, off-balance sheet items such as derivative positions, committed credit lines and letters of credit create new types of risk such as counterparty credit risk in derivatives (i.e., the risk that your counterparty might default or not honor the contract) that the current standards are not fully capable of managing. Finally, the risks faced by large international banks are very different from those faced by national and regional banks; uniform standards for all types of financial institutions may not be efficient.

The task of reforming the Basle Capital Accord has just started and will take years to accomplish. There is not yet a consensus on how to reform bank capital regulation but it is likely that a strong and effective system of capital regulation will need to rely on complementary components: strengthened capital standards, greater reliance on robust internal models of risk assessment and market discipline. Capital adequacy ratios will have to be reformed and enhanced to address the new and different risks faced by banks in the globalized economy. A complementary approach is to emphasize less externally imposed standards and rely more on banks' internal models and assessment of risks. For example, a useful approach may be value-at-risk models, already used internally by banks. These are sophisticated models considering the risk and correlation of returns on all the assets and liabilities of a bank to derive a measure of market risk (i.e, how much a bank may lose because of a change in market interest rates). However, such models should be tested for their robustness to conditions of stress in order

to assess the many other risks faced by banks in addition to market risk. In fact, extreme market conditions and financial crises create additional risks (such as credit risk, counterparty risk and small probability of extreme events) that traditional models of the type and distribution of risks cannot assess.

It may also be beneficial to rely more on market discipline for bank capital regulation. For example, some have suggested that certain types of debt (subordinated to other claims on bank assets) may be issued by banks and purchased by other banks at capped interest rates as a way to ensure that financial institutions monitor each others' risk taking. [The logic of this approach is as follows: if bank A has to hold subordinated debt issued by bank B at an upward capped interest rate, it will monitor the risks undertaken by B in order to ensure that the bonds that A is holding do not end up being defaulted upon because of excessively risky loans made by bank B. This is an example of how greater market discipline may be provided.]

There is going to be a broad debate on how to provide effective capital regulation of banks in the globalized environment in which they operate. Also, such standards were designed for G10 banking institutions but the proliferation of financial institutions in emerging markets poses the issues of whether such standards, or strongly enhanced ones, should be imposed on banks in emerging markets. Regulation of market access and standards that restrict international lending activities to large institutions that satisfy restrictive standards may help to limit the risks deriving from the activities of banks in emerging markets. [They are, however, controversial as emerging economies may perceive them as limiting competition and their ability to develop international financial institutions.]

The rapid development of derivative instruments and their massive use in international

financial markets poses another host of difficult regulatory issues. Derivatives can be used to hedge risks and have been very useful in the management of risk by banks, other financial institutions and corporate firms. However, they can also be used for taking highly risky speculative positions. Moreover, as they are off-balance sheet items it may be hard to assess their contribution to the risks taken by the institution using them. [For example, if the credit-worthiness of the counter-party is uncertain, firms or banks who believe they are hedged (e.g. against currency risk) may not be.] Also, some have argued that in an international context derivatives can be used to evade risk-control or prudential regulation, circumvent capital controls or undermine the usefulness of balance of payments capital account categories.

There is a difficult issue of the type of regulatory oversight which should be put in place for derivative instruments. For example, excessive regulation of derivatives could lead the derivative business to move to unregulated offshore markets. The administration is currently undertaking a long-term study of over-the-counter derivative instruments, their potential risks and effects. This study will analyze how the markets work, how they are regulated, and what changes, regulatory or legislative, may be appropriate to reduce systemic risk, to eliminate legal uncertainty, to curtail regulatory arbitrage, and to address the potential use of derivatives for fraud or manipulation. [An important group of questions addressed in the derivatives study concerns leverage. Some market participants may have an appetite for risk out of proportion to their capital and that this can pose risks to global financial markets and ultimately could prove damaging to the economies of the U.S. and other countries.]

Issues posed by hedge funds and other highly-leveraged investment funds

The near-failure of a prominent hedge fund (LTCM) in September 1998 has led to renewed attention to the role and activities of hedge funds and other highly leveraged investment funds. The impact of hedge funds on financial markets certainly does need to be understood better. The administration has called for a study of hedge funds and their relationship with their creditors. Regulation of hedge funds may not be easy - precisely defining "hedge fund" is challenging enough - and may not even be appropriate. Regulation might, for example, lead such funds to move to unregulated offshore markets, in the same way in which the Eurocurrency markets in the 1970s emerged as a response to the excessive regulation of U.S. financial markets.

The hedge fund study is looking at a number of issues, including the issues of disclosure and leverage. More disclosure of information by entities such as hedge funds, particularly to their counterparties and creditors, would be useful and appropriate. It appears that market participants are already demanding more disclosure from hedge funds. [Among the disclosure questions being explored are: what additional disclosure is needed, to whom such disclosures should be made (some or all of counterparties, creditors, investors, regulators, and the public), and whether the government needs to do more to require disclosure.]

The study will also focus on the issue of leverage. The study is evaluating how the risks of what may appear to be excessive leverage in financial markets can be minimized. It appears that creditors to hedge funds, and indeed creditors across the derivatives market broadly, are reducing the amount of leverage they are willing to provide. There also seems to be a consensus among U.S. banking regulators that existing regulatory tools need to be used to encourage banks

to make more prudent decisions. Along these lines, the study is asking whether the government needs to do more to discourage excessive leverage and, if so, what the appropriate steps might be. It also considers the international aspects of these questions, and a number of the Working Group agencies are participating in several international studies.

In their October 30 Declaration, the G7 committed themselves to strengthen, in their own countries, the regulatory focus on risk management systems and prudential standards in financial sector institutions; in particular, examining the implications arising from the operation of leveraged international financial organizations including hedge funds and offshore institutions. It was agreed that appropriate means should be sought to encourage off-shore centers to comply with internationally agreed standards and other countries which participate in the global capital markets were called upon to take similar action. They also called for the appropriate committees headquartered in the BIS, in conjunction with emerging market countries, national authorities, and other relevant private and public sector bodies, to examine the question of appropriate transparency and disclosure standards for private sector financial institutions involved in international capital flows, such as investment banks, hedge funds and other institutional investors.

STRENGTHENING PRUDENTIAL REGULATION AND FINANCIAL SYSTEMS AND IMPROVING POLICIES IN EMERGING MARKETS

The G7 also agreed upon the need to further strengthen prudential regulation and financial systems in emerging markets. It endorsed an examination of measures to increase the

resilience of financial systems and to promote the adoption of international standards and best practices. Utilizing enhanced market discipline as well as other legal and regulatory means have been suggested to motivate countries to adopt and enforce international standards and practices.

Orderly liberalization of capital flows

The opening of capital markets in emerging economies must be carried out in a careful and well sequenced manner if countries are to benefit from closer integration into the global economy. Effective regulatory and supervisory regimes must be in place and the financial sector must be poised to adequately deal with risk. International financial institutions should play a constructive role in facilitating this orderly opening of the capital account.

Countries with capital account restrictions need to proceed orderly and progressively in liberalizing their capital account. The benefits of free capital flows are numerous, especially when financial systems are strong. The United States and most other leading industrial countries, for example, do well without capital controls. If financial systems are weak, poorly regulated and subject to institutional distortions, however, rapid capital account liberalization can cause problems. It can lead to too much accumulation of foreign debt, excessive short-term borrowing and lending, and a mismatch of maturities and currency denominations of assets and liabilities of financial institutions and corporate firms. All have proven to be destabilizing in the many episodes of financial and currency crises. These potential pitfalls, however, underscore the need to strengthen the financial system as the capital account is progressively liberalized, not to eschew liberalization altogether.

There are indeed strong arguments for free capital mobility, especially when domestic financial systems are strong and properly supervised and regulated. First, free capital mobility leads to a market allocation of saving to the best investment opportunities. Investors

may earn a higher rate of return abroad than they could if limited to the domestic market, while firms and other borrowers in high-growth countries can obtain funds more cheaply abroad than if they had to finance their investments at home. A case for restricting capital mobility would require the identification of strong distortions in the market allocation of capital. Second, free capital mobility allows investors and households to diversify risks and have access to a larger pool of assets; the benefits of portfolio diversification are enhanced by access to foreign investment opportunities. Third, the scrutiny of global investors provides an important discipline on policy-makers. Well-functioning capital markets discourage, for example, excessive monetary and fiscal expansion, since inflation, budget deficits and current account deficits quickly lead to reserve outflows and currency depreciation.

It may prove to be necessary to develop principles to guide countries that are liberalizing and opening their capital markets on how to reduce the vulnerability of their financial systems to sudden shifts in capital flows. These could include, for example, promotion of longer-term, equity financing with an open policy to foreign direct investment. Conversely, it might be necessary to discourage cross-border short-term interbank flows which are likely both to be volatile and affected by distortions caused by financial safety nets. There is now growing support for some sort of moderation of these flows, within the sphere of prudential banking regulation.

Prudential regulation of short-term interbank cross-border inflows

One approach to ensure the stability of short-term cross-border interbank flows is through enhanced prudential banking standards. On the borrower side, a range of possible measures could be considered that may

help to discourage imprudent foreign currency borrowing, while relying on market mechanisms to the extent possible. Prudential bank standards, such as limits on a bank's open foreign currency positions, if enforced effectively, could reduce the riskier kinds of foreign borrowing by banks. Some countries have experimented with regulatory requirements that force their banking systems to maintain "liquidity buffers" to protect against the risk of sudden shifts in funds out of the banking system. Argentina, for example, has required banks to maintain large, liquid reserves against their short-term liabilities, including their short-term foreign liabilities. [One could consider requiring higher reserve requirement ratios on bank liabilities representing cross-border interbank loans and deposits.]

One could also try to dampen volatile short-term cross-border interbank flows on the lender side, i.e. the banks in the industrial countries. Current Basle capital adequacy standards provide incentives to lending banks in developed countries to prefer short-term loans to banks in emerging markets over long-term loans, since risk weights on short-term loans are lower than those on supposedly "more risky" long-term bank loans. One could change the standards to affect short-term bank lending to emerging markets via a careful use of risk weights on these type of loans.

Broader controls on all short-term capital inflows?

More controversially, some have suggested wider use of market-based, Chilean-style restraints on all short-term capital inflows to deter short-term foreign borrowing by both banks and domestic corporations. According to some, the experience of Asia, for example, suggests that there was large scale risky cross-border borrowing undertaken directly by corporate firms. [Controls on inflows have also been argued to help in the management of monetary policy when surges in inflows create difficult problems of how to sterilize their impact and

avoid an inflationary surge in the money supply.]

The effectiveness of such controls has been questioned, in particular for countries with weak economic policies. First, evasion and leakages (especially via trade credits) tend to make capital controls less effective over time. Second, it has been argued that the apparent success of Chile in avoiding a major currency crisis has been due more to the very effective prudential regulation and supervision of the financial system than to the existence of controls on short-term inflows. Third, such controls have favored large corporations (who are more capable of avoiding controls, by issuing lightly taxed American Depository Receipts) at the expense of small and medium ones. Fourth, prudential regulation of the short-term interbank cross-border inflows rather than widespread controls on all inflows may be sufficient to ensure the stability of the financial system.

The available empirical evidence from countries that have imposed controls on a broad range of short-term capital inflows shows that they do appear to affect the composition of inflows (away from short-term maturities and towards the longer-term, and towards FDI) but they do not appear to affect the overall volume of capital inflows. If the rationale for controls is to reduce particularly risky short-term borrowing, such evidence can be seen as supportive. Opponents of controls, however, point out that, during the recent financial turmoil, Chile, Colombia and Brazil have all reduced their controls in order to stimulate urgently needed capital inflows and reduce pressures against their currencies. Another point of view is that these moves do not undermine the rationale of slowing down short-term capital inflows temporarily during a cyclical phase where such inflows are feared to be excessive, in contrast to the crisis or outflow phase of the cycle. [In this view, controls may be seen as a temporary tool to be used during episodes of a surge in inflows rather than a

permanent policy instrument restricting the flow of capital.]

Given the mixed and limited evidence on their effectiveness and the numerous arguments against them, policies to restrict all short-term inflows remain quite controversial. [The experience of Argentina may suggest that a strong system of prudential regulation rather than more widespread controls on all short-term inflows could be sufficient to ensure system stability when an effective system of prudential regulation and supervision of the financial system is in place.]

Controls on capital outflows

In the aftermath of the Asian crisis, some have suggested that countries should introduce controls on capital outflows as a way to prevent “destabilizing” capital flight. One argument presented in their favor is that they could help to stimulate growth, for example in East Asia, by lowering nominal interest rates. With a high degree of capital mobility, a reduction in interest rates leads to capital outflows, and in turn currency devaluation. Like high interest rates, currency depreciation can be recessionary because of the high burden of foreign currency debt. Capital controls therefore have been advocated to break the link between interest rates and exchange rates, allowing lower interest rates *without* the costs of a currency devaluation.

However, many arguments against capital controls in a crisis have been advanced. First, it has been argued that the correct policy response to the structural problems underlying the Asian crisis and previous financial crises would not be capital controls, but rather a sound, well-regulated and effectively supervised financial system, thus avoiding the policy distortions that lead to excessive borrowing. A second argument is that controls on outflows are often administered in institutional frameworks in which they are used to extract rents and delay

necessary reforms. Elaborate foreign exchange controls lead to rent-seeking behavior and corruption, and distort international trade. Third, approval of targeted controls might lead countries to use capital controls indiscriminately, thus insulating unsound policies from the discipline of the marketplace. Fourth, over time, investors may find ways to avoid controls. Fifth, capital controls and other restrictions of domestic capital markets are often a form of financial repression -- a distortionary form of taxation -- that reduces the incentive to save. Studies point out that capital controls in Latin America in the aftermath of the 1980s debt crisis led to negative real interest rates that eventually led to more capital flight rather than less. Sixth, anticipated controls on capital outflows may accelerate a crisis rather than postpone it and may lead to perverse international contagion. In this regard, it has been suggested that the news of capital controls in Russia and Malaysia in August 1998 was a factor in the spread of financial panic to Latin America and the other emerging markets. Finally, controls on outflows may also discourage capital inflows that emerging markets need to finance domestic investment and enhance growth.

Moreover, in the case of Asia interest rates have already fallen substantially relative to the peaks of the crisis. [By the second half of 1998, they were back to pre-crisis levels in Korea.] In spite of this lowering of interest rates, there is still a severe credit crunch in many countries as many financial institutions are in severe financial distress and unwilling to lend to corporate firms suffering from the severe debt overhang of very high debt to equity ratios. If this analysis is correct, capital controls and lower interest rates would do little to ease the credit crunch. Instead, what Asia may need now is an accelerated debt restructuring process that will recapitalize banks,

reduce the corporate debt overhang and provide firms with working capital and trade financing to allow them to produce and export again. Capital controls may do little to help these more structural impediments to a recovery of economic growth in the region.

Improved policies in developing countries

In general, better policies in emerging markets are needed to promote their domestic stability and limit vulnerability to crises caused by shifts in global capital. In particular:

Sound macroeconomic policies. Countries need consistent monetary and exchange rate policies as well as fiscal policies that avoid excessive accumulation of government debt.

Prudent public debt management. Borrowing short-term, and in foreign currencies, can be very appealing; it is cheaper and often easier in the short-run. But too much of this kind of borrowing makes governments and countries vulnerable to sudden shifts in investor confidence. In the long-run it can be very costly. Sound debt management is important to provide some “insurance” against the risk of temporary market disruptions.

Stronger financial systems. Countries can greatly reduce their financial system vulnerability by adopting any of the following measures: adhering to the Basle Core Principles for Effective Banking Supervision and other international standards now being developed; encouraging greater foreign participation in emerging markets, to spread better regulatory and risk management practices; developing a better credit culture in the banking system; and prohibiting directed lending and other “non-arms length relationships” between lenders and borrowers.

Development of capital markets in emerging economies. Greater reliance on equity and

other financing that does not result in the build up of excessive debt burdens should limit vulnerability to crises. This could include efforts to develop local/regional capital markets.

Stronger legal infrastructure. The Asian crisis demonstrated that for private markets to work effectively, better financial regulation is not enough. There must, for example, also be clear and enforceable bankruptcy laws, so that a crisis in a single bank or company can be dealt with before it spreads. There must also be sound corporate governance, so that investors' and shareholders' rights are clear, and strong judicial systems, so that laws in these areas can be clearly enforced.

NEW STRUCTURES FOR OFFICIAL FINANCE

The recent global financial turmoil pointed to the need to develop new ways to respond to crises. This requires exploring the possibilities of new structures for official finance the conditions of which would reflect better the evolution of modern markets. It also call for examining new procedures for coordination of the relevant international bodies and national authorities and for greater participation by the private sector in crisis containment and crisis resolution, including through the use of innovative financing techniques.

The U.S. has proposed a new IMF precautionary facility that will allow large-scale international assistance in the form of a line of credit rather than a traditional, highly-tranched package. This proposed facility has been intended to facilitate the rapid restoration of confidence in those cases where problems stem more from contagion than from poor policies.

International bank runs

The rationale for a precautionary facility for countries subject to an attack in spite of their good economic policies is based on the possibility of “international bank runs”. Currency crises are formally analogous to, but more complex than, domestic bank runs of the sort discussed in Box 6-5 in Chapter 6. With unrestricted capital markets, domestic banks are free to accept deposits from both domestic and foreign residents, in both domestic and foreign currency. [In considering currency crises, however, other domestic institutions also have to be included. In general, any financial institution that issues short-term liabilities that can be converted into foreign currency can play a role in a currency crisis.]

As in a closed economy, these liabilities are used primarily to fund longer-term, illiquid investments that cannot be readily converted to cash. If bank depositors -- both foreign and domestic -- seek to exchange their claims on financial institutions for foreign currency, an “international bank run” can result. In such an event, a rapid loss of reserves and extreme strain on the exchange rate is likely to ensue. The Korean experience in October 1997 suggests that such an outcome is more likely in the presence of large amounts of highly-volatile short-term liabilities, such as interbank loans from foreign banks.

The logic of a precautionary facility

The provision of liquidity in a currency crisis poses a problem not faced in domestic bank runs. Both types of crisis begin with a widespread attempt to convert short-term claims into currency. In a closed economy, the central bank can satisfy these claims by issuing (in principle) an unlimited supply of domestic currency. In an open economy, on the other hand, the central bank can only provide foreign currency up to the extent of its stock of foreign reserves. Since all

short-term domestic currency assets of the country (not just dollar deposits in banks) can in principle be converted into foreign currency during an attack, the domestic central bank may not be able to cover all potential claims. It is this fact that suggests the potential benefits of a precautionary facility for countries that have been unjustifiably hit by financial contagion.

In a domestic context, the lender of last resort role played by central banks and institutions such as deposit insurance are aimed at preventing self-fulfilling bank runs. However, such insurance creates moral hazard incentives: if banks' deposits are insured and/or liquidity support is guaranteed in the case of a run, banks will have an incentive to make more risky loans than they would in the absence of insurance. The solution to this problem is strong capital adequacy standards and prudential supervision and regulation of banks.

In the international context, the expected provision of official liquidity may also lead to distorted incentives: expectations of official emergency financing may lead international investors to lend carelessly and domestic governments to engage in risky policies. Moral hazard in the domestic context can also be mitigated if insolvent banks can be distinguished from illiquid ones. Ideally, in the international context, precautionary financial support should be given to countries with good policies who are innocent bystanders in episodes of contagion and be withheld from countries with weak policies. Drawing this distinction is obviously considerably more difficult among countries than among banks. There is a spectrum of crises, from those that stem primarily from poor policies to those that stem primarily from contagion. In practice, most fall somewhere in the middle. A regime for crisis response should provide for some combination of financial assistance and policy changes. The provision of large-scale official

international finance raises also difficult questions: what criteria should be used for access to large scale assistance, and on what terms; how should it be linked to private sector involvement; and where will the required resources come from.

However, just as there is a role for the government to intervene to prevent a domestic financial crisis from destabilizing the domestic financial system, there is a role for the international community to intervene in an international financial crisis to help limit contagion and global instability. The current crisis has demonstrated that the official community needs, at times, to be able to provide huge financing packages to quell potential contagion and instability. Congressional support for an increase in the IMF quota will provide the IMF with an important pool of new, uncommitted funds. The proposed new IMF precautionary facility may allow large-scale international assistance for those cases where problems stem more from contagion than from poor policies. It may make sense in today's world of large and sudden liquidity needs for more official money to be available up-front in return for more up-front policy changes[, than in traditional IMF programs].

In their October 30 Declaration, the G7 agreed that, in response to the current exceptional circumstances in the international capital markets, strengthened arrangements for dealing with contagion are needed. The central element would be the establishment of an enhanced IMF Facility which would provide a contingent short-term line of credit for countries pursuing strong IMF-approved policies. This facility could be drawn upon in times of need and would entail appropriate interest rates along with shorter maturities. The facility would be accompanied by appropriate private sector involvement. [In appropriate circumstances the facility could be

complemented, in individual cases, by bilateral contingent financing activated alongside the IMF facility. It would remain up to individual G7 governments and other governments concerned to decide in each case whether to provide such bilateral financing.]

THE EXCHANGE RATE REGIME FOR SMALL COUNTRIES

It is important to consider the elements necessary for the maintenance of sustainable exchange rate regimes in emerging markets, including consistent macro-economic policies that promote stability in individual countries and in the system as a whole. Many of the lessons carry over to small open economies as well.

[Given that large fluctuations between the currencies of major countries economies are likely to continue, that many emerging markets have extensive trading ties to a number of major industrial economies, and that the credibility of the policy environment in many emerging markets will take time to establish, the choice of an appropriate exchange rate for emerging markets economy is particularly difficult.] [Exchange rate regimes vary in the degree of rigidity. They range from insitutional arrangements like monetary unions, dollarized regimes, currency boards, to conventional fixed exchange rates, to managed floats, crawling pegs and unmanaged floats.]

Exchange rate regimes are institutional choices that signal policies, priorities, and commitments. There is no single exchange rate regime that is best for all countries: rather the choice must be based on a country's circumstances. The theory of "optimal currency areas" is discussed in the next section (see Box 7-2). No matter what exchange rate an emerging market economy chooses, it is critical that it be

backed by a consistent policy regime. Macroeconomic stability is based on good policies, irrespective of the exchange rate regimes. Policy mistakes which can contribute to a currency crisis can occur in the context of any exchange rate regime. Thus, strong financial regulation and appropriate monetary and fiscal policies are essential in all exchange rate regimes.

Benefits of fixed exchange rate regimes

Alternative exchange rate regimes have different implications for the ability to pursue macroeconomic stabilization while maintaining policy credibility. First, note that the three goals of free capital mobility, independent monetary policy and exchange rate fixity are not conceptually consistent (a concept defined as the principle of the “impossible trinity”). In fact, under perfect capital mobility, a country choosing a fixed exchange rate loses its ability to pursue an independent monetary policy; conversely, autonomous monetary policy can be pursued at the cost of being unable to peg the exchange rate. Therefore, a choice must be made between exchange rate fixity and monetary policy autonomy if free capital mobility is to be maintained.

Relatively rigid fixed exchange rates can be an important signal of policy commitment to achieving and maintaining low inflation, especially when countries are seeking rapid disinflation from conditions of high inflation or hyperinflation, as part of a consistent plan for macroeconomic stability. [The fixed rate provides an anchor for expectations and can accomplish a sharp reduction of inflation as it helps economic agents to focus expectations on a stable prices by eliminating price increases for foreign goods.] [A sustainable and credible commitment to fixed exchange rates requires consistent macroeconomic policies such as fiscal

and monetary restraint and strong and well-supervised financial systems.]

By eliminating exchange rate risk, a fixed exchange rate regime may also encourage international trade. Indeed, there is some evidence of negative effects of exchange rate volatility on trade volumes. Fixed rate regimes may also provide monetary and fiscal discipline. The loss of monetary autonomy under fixed exchange rates limits the ability of monetary authorities to pursue excessively expansionary and inflationary monetary policies. Indeed, there is some evidence that inflation rates tend to be lower under regimes of fixed exchange rates. Fiscal discipline may also be enhanced under fixed rates: as the ability of monetary authorities to monetize fiscal deficits with seigniorage is limited, the tendency to have loose fiscal policies may be restrained.

Adopting a fixed exchange rate does not, however, automatically provide fiscal discipline. Instead, adopting a fixed exchange rate and/or a currency board requires fiscal discipline and a strong financial system to be credible (See Box 7-1 for a discussion of currency boards). In a fixed exchange rate regime, domestic financial obligations are potential claims on a country's hard currency reserves; lack of monetary and fiscal credibility can lead to capital flight, the depletion of such reserves and the eventual collapse of a peg.

Credible currency boards may be able to prevent a currency crisis but they limit the ability of the monetary authority to perform its function of lender of last resort if bank runs occur, an issue that is exacerbated when a fraction of the liabilities of the banking system is denominated in foreign currency. Strong financial systems with well supervised banks (such as those in Hong Kong and Argentina) are thus necessary conditions for a credible currency board. Contingent

credit facilities that allow the central bank to borrow reserves during a period of speculative pressure may also help.

Benefits of more exchange rate flexibility

There are also a number of factors that suggest the benefits of greater exchange rate flexibility. The three episodes of currency crisis in the 1990s occurred under regimes where exchange rates were either fixed or kept in a narrow band. Semi-fixed exchange rate regimes, as well as floating regimes, have at times led to real currency appreciations that worsened a current account deficit, and contributed to triggering a crisis. The experience suggests that the expectations-anchor role of fixed rates can be useful, but also that maintaining protracted fixed rates in the aftermath of exchange rate-based stabilizations can lead to real appreciation (due to residual inflation) and deteriorating trade balances, which can eventually undermine the fixed-rate parity.

Exchange rate-based stabilizations may be more successful if the initial fixed rate anchor regime is followed by a crawling peg regime where the exchange rate is allowed to depreciate on the basis of the inflation differential between the domestic economy and the world. Such a policy may help prevent real appreciation and external imbalances that often eventually undermine rigid fixed rate regimes. [While introducing flexibility during a crisis can be highly destabilizing, there is often reluctance to introduce greater exchange rate flexibility during times of stability, even though such flexibility may help countries in avoiding future crisis by facilitating a country's adjustment to external shocks.] [Some countries have made strong institutional

commitments to a rigid fixed exchange rate regime; other countries could benefit from increasing flexibility during periods of macroeconomic and financial stability, when the move to flexibility may be less disruptive.]

Fixed exchange rates may also have reduced the perceived risk of foreign currency-denominated borrowing by banks and firms, by inducing the false belief that they face only one-sided uncertainty on the movements of the exchange rate. In fact, while a depreciation is ruled out, the currency might be allowed to strengthen benefitting agents who have borrowed in foreign currency. In this regard, more flexible exchange rates explicitly introduce two-way risk: the currency may depreciate as well as appreciate. This may prevent the accumulation of unhedged foreign currency liabilities as investors will consider that borrowing in foreign currency may lead to an increase in the burden of such debt if the domestic currency depreciates.

Flexible rate regimes may also allow for more macroeconomic policy flexibility than more rigid exchange rate regimes, and thus can facilitate a country's adjustment to external shocks. Examples of such shocks are the swings in capital flows and terms of trade shocks that have been factors in recent crises.

[Systems of pegged but adjustable exchange rates allow more room for a lender of last resort role for the government than currency boards but at the risk of undermining the commitment to a fixed exchange rate. In general, a large stock of short-term foreign

currency-denominated liabilities in the banking system is problematic for all regimes of exchange rate fixity. Regimes of more exchange rate flexibility allow a stronger lender of last resort function for the monetary authorities at the cost of potentially greater exchange rate movements. Thus, policies to limit a country's vulnerability to large swings in capital flows, and to ensure the availability of needed liquidity in the event of market volatility are required regardless of a country's exchange rate regime.]

[Monetary discipline under fixed rates may not always be automatic and binding. Under fixed exchange rates, domestic credit expansion will lead to a loss of reserves. If the contractionary effect on the monetary base of such a loss of reserves is sterilized with compensating open market operations, such sterilized intervention will eventually deplete the reserves, as the experience of East Asia in 1997 suggests. So, while fixed rates should provide monetary discipline by constraining the ability to increase domestic credit, governments at times do otherwise, thus eventually undermining the pegged parity.]

[Also, fiscal discipline may not necessarily be greater under fixed exchange rates. Some argue that flexible exchange rates may provide more discipline because, under such a regime, large budget deficits – that are expected to be monetized – lead to a politically punishing currency depreciation. Then, the threat of depreciation under flexible rates can be a deterrent to policymakers trying to pursue loose fiscal policies. Under fixed exchange rates, instead, policymakers do not pay right away the costs of bad fiscal policies. As the currency is pegged, an expansionary fiscal policy does not immediately lead to a costly currency depreciation.

Instead, such fiscal behavior can for awhile be hidden behind a bond-financing of the deficits with no devaluation. Even if the deficit is financed through a monetary increase in domestic credit the devaluation can be postponed with a loss of foreign reserves. Either way, the market discipline against excessive fiscal deficits may be loosened. Russia in 1996-98 may be an example of the problems of incomplete fiscal discipline under fixed exchange rates.]

More work needs to be done to determine whether certain exchange rate regimes provide more stability in the presence of high capital mobility and the potential for sudden reversals of capital flows following changes in investors' expectations. The choice of a particular exchange rate regime cannot, however, substitute for sound macroeconomic policies and strong financial systems as the foundations for true financial stability.

One extreme form of fixed exchange rates is a monetary union. The next section discusses the prospects of the European Monetary Union and whether Europe represents an "optimal currency area".

Box 7-1. - Currency Boards

Until recently a forgotten relic of colonial history, currency boards and currency board-like arrangements are increasingly advocated by a small group of economists. They have had positive results in Argentina, Hong Kong and elsewhere. However, currency boards are probably an excessively restrictive method of achieving monetary control for most countries.

A currency board is a monetary institution which only issues domestic currency that is

fully backed by foreign assets. The principal attributes of a currency board include the following:

- an exchange rate that is fixed not just by policy, but by law
- a reserve requirement stipulating that each dollar's worth of domestic currency is backed by a dollar's worth of foreign reserves
- a self-correcting balance of payments mechanism, in which a payments deficit automatically contracts the money supply, resulting in a contraction of spending.

By holding 100 percent reserves, the government hopes to insure convertibility. By maintaining a strict unyielding exchange rate, it hopes to ensure credibility.

The first currency board was established by the British in Mauritius in 1849. The use of currency boards eventually spread to 70 British colonies. The purpose was to provide the colonies with a stable currency without the associated difficulty of issuing sterling notes and coins that were costly to replace if lost or destroyed. The colonies also benefitted from this approach in that they could earn interest on the foreign currency assets being held in reserve. The use of currency boards peaked in the 1940s and declined thereafter. In the 1960s, many newly independent African countries replaced their currency board with a central bank, and most other countries followed suit in the 1970s.

The introduction of a currency board-like arrangement in Argentina in 1991 reflects a small resurgence in their use worldwide. Other economies that have introduced them include Hong Kong (1983), Estonia (1992), Lithuania (1994), and Bulgaria (1997). The major benefit of a currency board is the credibility it lends to monetary policy by removing the option of

printing money to finance government expenditures. In Argentina, for example, this credibility helped reduce interest rates from 12 percent to 2 percent per month in very short order, as well as reducing inflation dramatically. The presence of a currency board probably also helped to resist the pressures on the Argentine peso unleashed after the 1994 Mexican peso crisis (the “Tequila” contagion). Currency boards have also been credited with reducing inflation dramatically in Hong Kong, Estonia, and Lithuania.

Currency board supporters are pushing for their wider use—in particular, for Indonesia, Mexico, Russia, and Ukraine. But implementing a currency board has some drawbacks (some of which are common to any fixed exchange rate regime):

- These countries may not have sufficient reserves on hand to start a currency board.
- The domestic economy becomes linked to the reserve-currency economy even more tightly than in a conventional fixed exchange rate regime; the monetary policy that is appropriate for one country is not necessarily appropriate for the other.
- Currency board systems tend to be procyclical. When times are good, money flows in, interest rates are low and the economy booms. When times are bad, as Argentina discovered in 1995 as a serious recession followed the capital outflows, the ensuing bust can be severe.
- The central bank’s function of lender of last resort for ailing financial institutions is impaired. Therefore, it is essential to have a strong, well supervised and regulated financial system.

Although currency boards are generally deemed more appropriate for countries with

smaller, more open economies, a dramatic hyperinflation and the absence of a credible monetary authority prompted Argentina to adopt a currency board. Assistance from the IMF helped to provide the necessary reserves initially and to weather the 1995 pressure on the currency deriving from large capital outflows. Since 1991, Argentina has become a model of price stability and has achieved laudable growth rates. The exception to this performance was the “tequila”-induced recession in 1995, from which Argentina has rebounded strongly. GDP growth was 4.4 percent in 1996 and about 7 percent in 1997, with prices and interest rates expected to remain steady. By all accounts, the currency board has worked for Argentina.

In general, proclaiming a currency board does not automatically guarantee the credibility of the fixed rate peg; such regime requires fiscal discipline and a strong and well supervised financial system to be credible, in addition to the rule of law. The lack of these solid fundamentals will undermine a currency board.

IMF REFORM

It is necessary to assess proposals for strengthening the IMF, so as to improve its programmes and procedures in crisis prevention and resolution. Also, proposals for strengthening the Interim and Development Committees of the IMF and World Bank have to be assessed.

MINIMIZING THE HUMAN COSTS OF FINANCIAL CRISES

As the sharp recessions in East Asia have led to a steep increase in both the

unemployment and poverty rate, and inflicted severe social costs, strengthening social safety nets in crisis countries is also an important goal of stabilization packages. Ways must be found to minimize the human cost of financial crises and encourage the adoption of policies that better protect the most vulnerable in society.

More attention must be given in times of crisis to the effect of economic adjustment on the most vulnerable groups in society. The World Bank should develop as a matter of urgency general principles of good practice in social policy, in consultation with other relevant institutions. These should be drawn upon in developing adjustment programmes in response to crises.

3. EUROPEAN ECONOMIC AND MONETARY UNION

The European response during the 1990s to the challenges presented by exchange rate volatility and financial globalization has been to accelerate the economic and financial integration of the continent. As part of this process, eleven members of the European Union embarked in a project of monetary unification that took effect on January 1, 1999, with Stage Three of the process of European Monetary Union (EMU). As noted at the outset of the chapter, European integration raises some of the same analytical issues and policy challenges as integration of the emerging market countries into the world financial system.

THE EMU SCHEDULE

In the spring of 1998, a summit of European Union (EU) heads of government decided that EMU should proceed, as envisioned in the Maastricht Treaty of 1991. Initial members were selected upon assessments by the European Monetary Institute, the forerunner of the European Central Bank, and the European Commission, as to which countries met the Maastricht Treaty's convergence criteria. The criteria for membership in the single-currency were: government deficits and total debt had to be no more than 3 percent and 60 percent of gross domestic product, respectively. Inflation rates and long-term interest rates also had to be within 1.5 percentage points and 2 percentage points of the average of the three countries with the lowest inflation. Finally, members' currencies must also have stayed within the Exchange Rate Mechanism bands for two years.

These criteria had to be met in 1997 for a country to qualify as a founding member of EMU on January 1, 1999. Twelve of the fifteen members of the EU wished to participate, and eleven were found to satisfy the criteria for membership. This, in part, reflected remarkable progress at fiscal consolidation since the targets had seemed out of reach for members such as Italy a mere year or two in advance. Of the countries desiring membership, only Greece was deemed not to satisfy the criteria. Of the other three EU countries, United Kingdom and Denmark opted not to join for the time being while Sweden chose not to qualify by remaining out of the Exchange Rate Mechanism.

The remarkable convergence of financial conditions in the European countries is clear from the data on the 11 EMU countries' short-term and long-term interest rates (see Charts 6-3 and 6-4) that both sharply converged after 1996. Differences in interest rates across countries can

be due to three factors: a currency premium related to the risk of devaluation, a liquidity premium and a country premium related to the possibility of default on the public debt. With monetary union starting in January 1999, short term interest rates converged as currency risk was eliminated and default risk is close to zero for very short-term public debt. Even after monetary union, differences among long-term interest rates may remain as different EMU countries with different stocks of public debt may be perceived as having different default probabilities. However, long-term interest rates in the euro-11 area converged quite sharply by the fall of 1998 as well. This convergence depends on two factors. First, the fiscal adjustment required by the Maastricht criteria led to a significant reduction of the country risk premium. Second, the equality in future short-term rates after monetary union implies that long-rates, that should be a weighted average of expected future short rates, should also substantially converge.

In July 1998 the European Central Bank came into existence, superceding its predecessor, the European Monetary Institute. On January 1, 1999 the single currency, the euro, was created as the currency of the 11 EMU countries. The European Central Bank took control of monetary policy in all EMU countries. While the euro was formally created on January 1, existing national notes and coins will continue to circulate until euro cash is introduced. From 1999, different forms of cash exist in EMU member states. But they are no longer separate currencies - they are "non-decimal denominations" of the euro, locked in at permanent conversion rates. (By analogy, most American dollar bills carry a circular seal with a letter inside denoting the Federal Reserve District from which they come. However, Europeans will continue for some time to be more aware of the geographic origin of the currency they carry than Americans are.) Only in 2002,

will euro cash (coins and notes) come in and national currencies be phased out. This transition period is necessary because central banks need time to print the banknotes and mint coins; retailers and banks also want time to prepare; and the public sector needs time to prepare as governments have to consider how to change their services over to the use of the euro.

While euro cash will be introduced only in 2002, in the three years between now and then many changes will occur. Government bonds issued after 1999 will have to be denominated in euro. Also, almost all existing issues of marketable government debt by the participating countries is expected to be redenominated in euros at the end of 1998. Moreover, several large European companies plan to begin accounting in euros in 1999. Such a move may lead smaller firms to follow. Even businesses who do not switch their internal accounting to euro may quote prices in euro for trading before 2002. Consumers and the public sector are likely to be using national currency units until 2002. In general, European governments agreed that there will be "no compulsion" and "no prohibition" in the use of the euro between 1999 and 2002.

BENEFITS AND POTENTIAL COSTS OF EMU

There are several potential benefits of EMU. Transaction costs in trade will be lowered as exchange rate risk and currency transactions within Europe will both be eliminated; and the ensuing goods market integration and price competition will be beneficial to consumers. Integrated European financial markets will be broadened and deepened. Inflation discipline will be preserved by an independent European Central Bank committed to price stability. It is hoped that fiscal discipline will also result since membership requires, as agreed in the Growth and

Stability Pact, maintenance of disciplined fiscal balance and fines may be imposed on offending countries. The lack of independent monetary policies and the limited role of fiscal policies will make more urgent the need for structural reforms in Europe. In this sense, EMU could serve as a discipline tool to nudge European countries to implement structural reforms more rapidly and eliminate impediments to sustained economic growth.

Finally, creation of a stable area of monetary stability is a commendable culmination of the 50-year economic, social and political integration that has taken place in Europe. Indeed, the original motivation for economic integration in Europe was to make sure that the countries in the heart of Europe, which had fought three wars over the preceding 100 years, never did so again. This is one reason why, in historical perspective, European integration has always been in the political interest of the United States. Even in an economic sense, the U.S. will benefit as a trading partner from strong economic growth and performance in Europe, which may be enhanced by the single currency project in the long run.

However, EMU may also entail some potential costs. First, there will be no national monetary autonomy that might be necessary to respond to asymmetric national shocks, meaning unexpected economic developments that affect some countries differentially than others. Such shocks may require national exchange rate adjustment, but this tool will no longer be available in a monetary union. Second, labor market flexibility and labor mobility are required to adjust to asymmetric shocks in the absence of independent monetary policies. But labor mobility is much lower among the nations of Europe than it is, for example, among the American states. Third, although fiscal policy can play a stabilization role in the absence of independent monetary

policy, the rules for EMU membership constrain the national ability to use such a tool. Finally, in Europe there is also little in the way of a central system of federal taxes and transfers to cushion against regional/national shocks as compared to the United States. Limited labor mobility, structural labor market rigidities, and decentralized and constrained fiscal policy might imply that Europe may not fully satisfy the criteria for an “optimal currency area”. (These points are elaborated in Box 7-2 on Optimum Currency Areas).

Box 7-2 - Is Europe an Optimum Currency Area?

The theory of **optimum currency areas** provides a set of criteria to indicate what countries should become members of a common monetary union. Some research suggests that the nations of the EU are less well-suited to a common currency than are, for example, the states of the United States. Nevertheless, Europe is becoming increasingly integrated over time, and this may tip the balance in the direction of satisfying the optimum currency area criteria in the future.

The need for monetary independence. Why do countries ever need independent currencies? If a country (or other geographic region) suffers an adverse "shock," such as a fall in demand for its products, it may want to follow a more expansionary monetary policy, in order to stimulate demand and head off unemployment. Yet, if it does not have an independent currency, it will not be able to undertake monetary expansion.

To take an example, in the early 1990s Germany experienced a sudden increase in interest rates (which arose out of the re-unification of the country and the associated increase in West

German spending in the Eastern lander). It was difficult for other European countries to accept this increase in German interest rates, because it did not suit their own economic conditions. The resultant strains broke apart Europe's Exchange Rate Mechanism in 1992-93.

Labor mobility. Now consider a country or other geographical unit that gives up its monetary independence. Subsequently, in the event of an adverse shock, it might still have other ways of adjusting. One way of adjusting is that workers may move out, to other countries or states with stronger economies. While this might not sound like an attractive solution, it turns out that inter-state migration is the most rapid means of adjustment to economic downturns within the United States (e.g., more rapid than adjustment of wage levels). Labor mobility is an important criteria for an optimum currency area: if a region has this means of adjustment, then it has less need for monetary independence.

Labor mobility among European countries is much lower than in the United States. Thus, by the labor mobility criterion, European countries are less well-suited to a common currency than are American states.

Fiscal transfers. When disparities in income do arise in the United States, federal fiscal policy helps to narrow them. One recent estimate suggests that when a region's per capita income falls by one dollar, the final reduction in its disposable income is only 70 cents. The difference, a 30 percent federal cushioning effect, includes both an automatic decrease in federal tax receipts plus an automatic increase in unemployment compensation and other transfers. The cushioning effect has been estimated at 17 percent in the case of Canadian provinces. European countries have greater scope for domestic fiscal stabilization than do American states.

Furthermore there are some cross-country fiscal transfer mechanisms. Nevertheless, neither the fiscal transfer mechanisms that are already in place within the European Union nor those that are contemplated under EMU -- so-called "structural funds" -- are as large as those in the U.S. or Canadian federal fiscal system.

Judged at least by these two optimum currency area criteria (labor mobility and fiscal transfers), the European Union is not as good a candidate for a monetary union as is the United States. European countries may be less adaptable than American states. This suggests that, if there are shocks in the coming decade that affect EU members differentially as did the German unification shock of 1990, those adversely affected could experience popular resentment against what -- for them -- will be the insufficiently expansionary monetary policies of the rest.

Prospects for EMU. There is good hope, however, for a successful EMU. The degree of integration among EU countries is increasing year by year. The degree of international labor mobility, for example, is likely to be higher in the future than in the past. The Schengen convention now allows free movement of citizens among a subset of European countries. Thus the European countries may come to satisfy the textbook criteria of an optimum currency area in the future, even if they do not fully now.

While such potential costs of EMU have some relevance, some of the objections to EMU have been exaggerated. First, while monetary policy may affect real economic activity in the short-run, it does not in the long-run. Therefore, monetary policy can do little to address structural rigidities, such as labor market inflexibility and real wage rigidity that are generally

thought to keep unemployment rates high in Europe in general and in depressed regions such as southern Italy in particular. These problems will have to be addressed by structural reforms with or without monetary union. Second, the role of fiscal policy is also inherently limited in Europe since fiscal deficits and debt to GDP ratios are still high for several countries. Fiscal retrenchment will continue in Europe with or without EMU; therefore EMU may not be much of a constraint. Third, asymmetric shocks and limited factor mobility will diminish over time as EMU leads to greater real integration among European economies (see Box 7-2). For example, as intra-European trade has grown and will further grow in response to with European integration and EMU, the creation of a common free market for goods, services and factors of production is likely to make idiosyncratic national shocks less prevalent.

Finally, it has been argued that EMU is likely to exert a strong discipline in favor of structural reform. As there will be no national monetary and exchange rate policies and fiscal policy autonomy will be constrained, the ability to use macro instruments to delay structural market reforms will be reduced; governments will have a stronger incentives to pursue policies that further long-run economic growth. The opposite has also been argued by some who fear that EMU will slow the drive to structural reforms. Since reforms are socially costly, the flexibility deriving from monetary, exchange rate and fiscal discretion can ease the transition costs as resources are reallocated. With EMU, the absence of these social “shock absorbers”, may slow down the structural reform process. In that scenario, the absence of the structural reform would continue, creating detriments to EMU.

4.THE EURO AS AN INTERNATIONAL CURRENCY, AND IMPLICATIONS FOR THE U.S. DOLLAR

The formation of a monetary union in Europe is a positive development that could simultaneously benefit the continent, the United States and the world economy. Some have raised a concern, however, that a strong European economy and the emergence of the euro as an alternative 'rival' international currency to the dollar is likely to harm the United States. Such concerns are mostly misguided. The U.S. has benefitted for a long time from a prosperous, growing Europe and since the Marshall Plan after WWII supported the development of strong market economies on the continent. With the development of a large, open and integrated economic area in Europe, the United States will benefit. American producers will be able to export to a very large, integrated European market with no cross-national restrictions to trade. U.S. firms producing in Europe will benefit from the lack of exchange rate volatility, common European standards for goods and services and a large open market. American financial institutions that are already quite competitive in commercial and investment banking services and securities products can benefit from the opportunities provided by the broadening and deepening of integrated European financial markets.

The emergence of the euro as a rival international currency should not be viewed with alarm for a number of reasons. First of all, it is not obvious that the euro will necessarily or rapidly become a major international currency and/or displace the U.S. dollar. Second, even if the euro emerges as a strong international currency, the U.S. will not be hurt. Third, international currency status is not only the outcome of a large home-base for a currency. It is also necessary

that the issuers of the currency maintain stable monetary policies with low inflation rates. One might even argue that it is healthy for the world to have two or more currencies competing for the status of international currency.

The functions of an international currency

What does it mean to be a major international currency, and is it likely that the euro will become one? A currency has three main uses: it can be used as a means of payment; a unit of account; and a store of value. An international currency is simply one that is also used outside its home country for these purposes. Within each of the three functions, an international currency has both official and private uses.

In its store of value function, investors decide how much to hold of their wealth in assets denominated in different currencies. Will public and private investors hold a larger fraction of their portfolio in assets denominated in euros? If yes, there may be large portfolio shifts leading to greater demand for euros and possibly causing a euro appreciation. However, a higher use of euros in portfolios will depend on economic factors such as inflation rates in the euro area, the value of the euro relative to the U.S. dollar and the Japanese yen, the rate of return on euro assets, and economic growth in Europe as well as political factors.

The official side of the store-of-value use is that currencies are held as foreign reserves by central banks. There is a possibility of greater diversification away from U.S. dollar towards the euro. Such a trend would resume the pattern of the 1970s and 1980s, when the dollar's dominant role as a reserve currency gradually shrank to make room for the mark and yen. This trend was suspended in the 1990s. However, such diversification will depend on risk-reward considerations

and the underlying strength of the economies representing such currencies. Countries with strong economic fundamentals, sound currencies and low inflation are more likely to have their currency used as an international currency. As long as the U.S. maintains a strong economy, the international demand for U.S. dollar will remain strong.

A unit of account is a reference scale for quoting prices, which is distinguishable from the actual currency in which assets are held or payments made. On the private sector side of the unit of account function, an international currency is used to invoice imports and exports. Presently, the U.S. dollar plays a dominant role in invoicing around the world, especially for primary commodities like oil. But invoicing will be mostly in euros within Europe. Also, there may be greater use of euros in Central and Eastern Europe, the Middle East and Africa, areas of high and increasing trade with Europe.

One official use of international currencies that can be classified under the unit of account function is for smaller countries to peg their exchange rate. Non-EMU European countries, particularly those in the East, are likely to consider pegging their currencies to the euro for two reasons: they undertake more of their trade and finance with the EU than with the U.S., and they aspire to eventual membership in EMU. If this happens, greater use of the euro as an intervention currency will increase official demand for euros. The unit-of-account, store-of-value, and means-of-payment functions are interrelated.

Currently, the dollar is used as the primary vehicle currency in foreign exchange trading which is one example of means of payment. A trader who wishes to exchange one minor currency for another is more likely to go through the dollar than to go through some other major

currency, or to be able to find a counterparty for a direct “cross trade.” (see Box 7-3 on the role of different international vehicle currencies.)

The private use of a currency as a means of payment in international trade and finance depends on thickness externalities in payments systems. As in the case of a domestic currency, there are significant increasing returns to scale in payments: it is easier and cheaper to use the currency that is used by everyone else. In this regard, the advantages of incumbency and inertia will favor the U.S. dollar even as the euro’s natural home grows to be as large as that of the dollar.

Overall, while it is likely the euro will become an international currency, it is unlikely that the role of the U.S. dollar as a major international currency will be replaced anytime soon.

Is it good or bad to be an international currency?

One should not overemphasize the decidedly modest benefits that having an international currency provides to a country. Does it matter whether the dollar remains the leading international currency? Central banks' reserve currency holdings may have important implications for the determination of the exchange rate. But this is another question. What about the global role of the dollar per se?

Advantages of having a key currency

One can think of five advantages to a country of having its currency used internationally.

(1) Convenience for residents. It is certainly more convenient for a country's exporters, importers, borrowers and lenders to be able to deal in its own currency than foreign currencies.

The global use of the dollar, as with the global use of the English language, is a natural advantage

that American business tends to take for granted. But the benefits from having one's country's currency used as a unit of account should not be overemphasized. Having invoiced imports in domestic currency is beneficial if the domestic currency depreciates, but harmful - relative to foreign currency invoicing - if the domestic currency appreciates. Invoicing in domestic currency does not necessarily shift the currency risk from the buyer to the seller, as the dollar price of imported goods sometimes can change quickly when the exchange rate changes.

(2) More business for the country's banks and other financial institutions. There need be no firm connection from the currency in which banking is conducted to the nationality of the banks (nor from the nationalities of the savers and borrowers to the nationality of the intermediating bank). British banks, for example, continued to do well in the Eurodollar market after the pound's international role waned. Nevertheless, it stands to reason that U.S. banks have a comparative advantage at dealing in dollars. Only U.S. banks have access to the safety net provided by U.S. regulatory authorities (access to the discount window, and so forth).

(3) Seigniorage. This is thought by some to be perhaps the most important advantage of having other countries hold one's currency. They must give up real goods and services, or ownership of the real capital stock, in order to add to the currency balances that they use. Just as American Express reaps profits whenever people hold its travelers' checks, which they are willing to do without receiving interest, so the United States profits whenever people in Argentina or Russia hold dollars that do not pay interest. Seigniorage derives from the fact that the U.S. effectively gets a zero-interest rate loan when dollar bills are held abroad. Wherever hyperinflation or social disorder undermine the public's faith in the local currency, the American

dollar is the preferred alternative. (Illegal activities are another source of demand, of course).

A way to compute cumulative seigniorage is to estimate the stock of dollars held abroad, and multiply by the interest rate. Foreign holdings of U.S. currency are conservatively estimated at 60 per cent of total dollar currency in circulation. With total currency outstanding in mid-1998 at \$441 billion, foreign holdings are about \$265 billion. One simply multiplies by the Treasury bill interest rate, to derive the estimate that seigniorage currently runs about \$13 billion a year. This is implicitly a tax on foreign transactions that are dollar cash-intensive.

(4) Political power and prestige. The benefits of "power and prestige" are decidedly nebulous. Nevertheless, the loss of key currency status and the loss of international creditor status have sometimes been associated, along with such non-economic factors as the loss of colonies and military power, in discussions of the historical decline of great powers.

(5) Ability to borrow in international capital markets in one's own currency. Some have argued that the U.S. ability to finance its current account deficit via foreign borrowing has been facilitated by the ability to issue dollar denominated liabilities. The concern has been expressed that such ability may be hampered by a loss of reserve currency status. This concern is probably overdone. First, many industrial countries whose currency is not a key currency are able to borrow in domestic currency. Second, countries with larger current account deficits (as a share of their GDP) than the U.S. have regularly and persistently financed such imbalances with borrowing in foreign currency rather than their own domestic currency. Countries become unable to borrow to finance current account imbalance when such imbalances become unsustainable. The fact that borrowing may occur in domestic or foreign currency has little to do with such

sustainability.

The ability of the U.S. to borrow in U.S. dollars rather than a foreign currency is also of limited value. Foreign debt needs to be serviced, both principal and interest, regardless of its currency of denomination. A currency depreciation increases the real burden of foreign-currency-denominated debt, but a dollar appreciation would decrease the burden of any U.S. foreign debt denominated in foreign currency. So borrowing in domestic or foreign currency may or may not be beneficial depending on how the exchange rate moves. Financing the foreign debt in one's own country currency gives, in principle, the potential advantage of being able to debase the real value of such debt through inflation. But no one would recommend deliberately following such a destructive economic strategy, given the loss of credibility and the economic costs of high inflation that it would entail. Furthermore, the United States is currently running a budget surplus, making government securities relatively scarce. Most borrowing is currently private.

Disadvantages of having a key currency

One can think of two disadvantages from the viewpoint of a key-currency country. They explain why Japan, Germany and Switzerland, have in earlier decades been reluctant to have their currencies held and used widely.

(1) Larger fluctuations in demand for the currency. Having one's currency held by a wide variety of people around the world may result in greater variability of demand, although this is not automatically clear. Perhaps such instability is more likely to follow from the increase in the degree of capital mobility than from key currency status per se. In any case, central banks are

particularly concerned that internationalization will make it more difficult to control the money stock. This problem need not arise if they do not intervene in the foreign exchange market. But the central bank may view letting fluctuations in demand for the currency be reflected in the exchange rate as being just as undesirable as letting them be reflected in the money supply.

(2) An increase in the average demand for the currency. This is the other side of seigniorage. In the 1960s and 1970s, the Japanese and German governments were particularly worried about the possibility that if assets were made available to foreign residents, an inflow of capital would cause the currency to appreciate and render exporters uncompetitive on world markets. Some Europeans today express the same concern about the euro.

Box 7-3. How does the dollar currently rank against other international currencies?

Most measures show a gradual decline in international use of the dollar. Reserve currency use, perhaps the most important measure, is shown in Table 7-1. The dollar's share of central bank reserve holdings declined from 76.1 % in 1973 to 56.0 % in 1990. Central banks gradually shifted their portfolio shares into marks and yen. But the dollar's share in reserve holdings has been relatively flat in the 1990s, amounting to 61 % in 1997.

Other major measures of international currency status are shown in Table 7-1. Overall, they tend to show the same thing: the dollar still on top, despite a gradual decline in its use versus the mark and yen over the last twenty years. The dollar is still more important than its three or four rivals combined.

- The first column reports the popularity of major currencies among smaller countries choosing a

peg for their currencies. It is still the case that no currencies anywhere are pegged to the yen. Three currencies (those of Estonia, Bulgaria, Bosnia) are now pegged to the mark, however. Elsewhere (Africa) the French franc is still the most common choice as a peg (29 per cent of peggers) owing to a special set of arrangements with the French Treasury, after the dollar (39 per cent). The dollar share should automatically go down in 1999 as the EU-11 are for the first time counted as pegging to each other.

- 87 percent of trades in the foreign exchange market involve the dollar, as the currency either bought or sold (see third column of the table). This figure (like the share of reserves held in dollars) should automatically go up in 1999, as EMU eliminates transactions among member currencies.
 - The various measures of use of currencies to denominate private international financial transactions -- loans, bonds, and deposits -- still show the dollar as the dominant currency with a 54 percent share.
 - Figures on the use of international currencies as substitutes in local cash transactions, are not generally available. The two leaders are certainly the dollar, for which internationally-circulating cash has been estimated by the Fed at 60 percent of U.S. currency outstanding, or \$240 billion, and the mark, for which international circulation has been estimated by the Bundesbank at 35-40 percent of German currency outstanding, or \$47 billion.
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What are the determinants of international currency status?

Will the dollar in the future maintain its global role? There are four major sorts of

conditions that determine whether a currency is used internationally.

(1) Patterns of output and trade. The currency of a country that has a large share in international output, trade and finance has a natural advantage. The U.S. economy is still larger than the euro-11 economies combined. If Britain and the other remaining EU members (Sweden, Denmark and Greece) join in the future, however, the two currency areas will then be very close in size.

(2) History. There is a strong inertial bias, in favor of using whatever currency has been the vehicle currency in the past. An individual (exporter, importer, borrower, lender, or currency trader) is more likely to use a given currency in his or her transactions if everyone else is doing so. For this reason, the world's choice of international currency is characterized by multiple stable equilibria. The pound remained an important international currency even after the United Kingdom lost its position as an economic superpower early in the century. In the present context, the inertial bias favors the continued central role of the dollar.

(3) The country's financial markets. Capital and money markets must be not only open and free of controls, but also deep, well-developed and liquid. The large financial marketplaces of New York and London clearly benefit the dollar and pound relative to the deutschemark and yen. It remains to be seen whether EMU will turn Frankfurt or Paris into one of the top few financial centers.

(4) Confidence in the value of the currency. Even if a key currency were used only as a unit of account, a necessary qualification would be that its value not fluctuate erratically. As it is, a key currency is also used as a form in which to hold assets (firms hold working balances of

the currencies in which they invoice, investors hold bonds issued internationally, and central banks hold currency reserves). Here confidence that the value of the currency will be stable, and particularly that it will not be inflated away in the future, is critical.

The monetary authorities in Japan, Germany and Switzerland, in the 1970s established a better track record of low inflation than did the United States, which helped their currencies to achieve greater international currency status. Given the good U.S. inflation performance more recently, this is no longer such a concern.

What is the prognosis for the dollar and the euro?

In light of these desiderata for a would-be international currency, is it likely that the euro will rival the dollar as the leading international currency? The euro automatically inherits the roles of the ecu, DM, french franc, and other EMS currencies. Subsequently, the euro's share will probably gradually rise, to move in the direction of "Euroland"'s share of output.

The odds are against the euro's rapidly supplanting the dollar as the world's premier currency. The dollar will probably continue to be the world's favorite currency for holding reserves, pegging minor currencies, invoicing imports and exports, and denominating bonds and lending. It is not that the dollar is ideally suited for this role. At least one characteristic mars its appeal: The United States is a debtor country with a large current account deficit. But an international currency is one that people use because everyone else is using it. Two of the four determinants of reserve currency status -- developed financial markets and historical inertia -- support the dollar over the euro. The third, economic size, is a tie. The fourth determinant is a tie as both Euroland and U.S. have pursued stable monetary policies aimed at maintaining a low

rate of inflation.

While the widespread use of the U.S. dollar as international currency -- unit of invoice, means of payments and store of value -- is testimony to the strength of the U.S. economy and the confidence with which it is viewed around the world, the direct economic benefits deriving from this international role are limited. The welfare of a country is measured by its ability to produce a large quantity of goods and services and provide a sustained increase in real income and consumption opportunities for its citizens. Whether a country's currency is an international currency or not has little to do with such long-run well-being, as the experience of many successful economies whose currencies do not have international roles attests. A strong and healthy U.S. economy that is a leader and champion of sound economic policies has led - as a by-product- to a strong international role for the U.S. dollar.

The introduction of the euro in January 1999 instantly created an international currency that potentially rivals the dollar. The standard measures of international currency use will show a euro that inherits roughly the sum of its constituent currencies. Subsequently the dollar will probably lose share gradually, as it lost share in the 70s and 80s to the mark and yen. There will be some small associated costs for the U.S.. But there is no reason to expect the euro to surpass the dollar anytime soon, nor for the costs from the U.S. viewpoint to outweigh the political and economic advantages to a successful EMU.

5. CONCLUSION

Reforms of the international financial architecture are necessary to create a strengthened

financial architecture for the global market-place of the next millennium that captures the full benefits of international capital flows and global markets, minimizes the risk of disruption, and better protects the most vulnerable.

The United States has worked intensively with key emerging markets, other industrialized nations and the relevant international organizations to put in place the building blocks of this new architecture. The reforms recommended by the G22 and adopted by the G7 are an important starting point. The United States and its G7 partners also agreed to do more to build a modern framework for the global markets of the 21st century and to limit the swings of boom and bust that destroy hope and diminish wealth. Thus, they also committed to initiate new work on a number of other important areas to identify additional steps to strengthen the international financial architecture. All these reforms will ensure that the unprecedented growth, increase in welfare and opportunity experienced in the 50 years after the creation of the Bretton Woods system are maintained in the future.

The United States salutes the formation of the European Monetary Union. The United States has everything to gain and little to lose from the success of this momentous project. Now more than ever, America is well served by having an integrated and prosperous trading partner on the other side of the Atlantic. Europe should benefit from a single currency that supports these ends -- and if Europe benefits, this will greatly benefit the United States. The United States has an enormous stake in Europe emerging under EMU with the capacity to play a more active and constructive role on the world stage -- and with the capacity to be an even stronger economic ally to the United States in the century to come. As ever, Europe is a partner, not a rival. And as our

partner succeeds, so will we.

Chapter 6: Capital Flows in the Global Economy

1. INTRODUCTION

Last year international financial developments posed serious challenges for the world economy. What began in the summer of 1997 as a regional currency crisis in developing Southeast Asia, erupted in 1998 into an economic and financial crisis both deep and wide. By the late summer of 1998, the crisis had extended to many other markets and economies across the world. Russia experienced a severe financial and economic crisis, immediately threatening contagion to Latin American markets. Large-scale withdrawal of capital from emerging markets initially led to a significant increase in their domestic interest rates and in the risk premium on sovereign bonds. Many countries experienced sharp depreciations of their currencies or severe strains on their foreign exchange reserves. Prices of stocks, bonds and other financial and real assets plummeted. Commodity prices continued to fall, engendering talk of global deflation. Ultimately the financial market turbulence led to a general flight from risky assets even within the United States and Western Europe. Japan's hopes for recovery from a long-standing slump were dashed.

A third of all world economies were in recession or slowed markedly by late 1998. World economic growth is estimated by the International Monetary Fund (IMF) at only 2.2 percent in 1998 and forecast at 2.2 percent in 1999, after a robust 4.2 percent in 1997.

Ominously, forecast world growth has almost declined to levels comparable to those of the

pronounced world slowdowns of 1974-75, 1980-83, and 1990-91. The risk of a more severe worldwide economic slowdown has increased, posing new challenges to economic policy.

This widespread financial turmoil - arguably the most severe experienced by the world economy in the last 50 years - followed a robust period of increasing integration of world product and financial markets. World trade has increased dramatically, as trade restrictions have progressively fallen and many countries have embraced historic openness to international trade. At the same time, restrictions on capital flows have been eased and financial markets have become increasingly integrated, leading to an unprecedented volume of international capital flows.

This turbulent period should not cloud the benefits of globalization. Market integration has provided greater opportunity, faster growth, and increasing standards of living for a large portion of the world's population. Trade among countries has fueled growth by harnessing the benefits of comparative advantage and dynamic stimulus to productivity. Financial integration also has advantages. Open capital markets have promoted growth by allocating capital to countries whose domestic investment opportunities exceed domestic saving. Portfolio flows across the world have allowed diversification of risk. The knowledge that global investors are watching over their shoulders has helped discipline governments into following responsible monetary and fiscal policies.

In response to the widespread financial turmoil in 1997-98, the United States, together with other countries and the international financial institutions, has taken steps to contain the financial crisis, to restart the engine of growth in Asia, to minimize the impact of financial

turmoil on other nations and to foster reforms of the international financial system in order to make it less crisis-prone.

A number of other positive developments occurred in the last quarter of 1998: reductions in interest rates by the Federal Reserve and many other industrial and emerging markets central banks; an IMF stabilization package for Brazil aimed at preventing a crisis in that country and stemming regional contagion; signs of structural banking reform and stronger fiscal stimulus in Japan; a strengthening of the yen that contained the risk of further currency depreciations in Asia.

The measures undertaken by the Administration and the international community, as well as the other positive policy developments, led to a recovery of confidence of domestic and international investors after the middle of October and significantly reduced the risk that the world economy would fall into a recession in 1999.

The chapter starts with an analysis of the factors behind the increased global financial integration. The causes of the Asian crisis and its contagion to other economies, the policy response to the global turmoil and the role of Japan are considered next. The chapter concludes with an analysis of the effects of the emerging market crisis on the United States.

Next, chapter 7 discusses the evolution and reform of the international financial system. Specifically, the chapter analyzes the main elements of the proposed reforms of the international financial architecture, the prospects for the European Monetary Union and the implications of the creation of the euro for the U.S. dollar.

2. FINANCIAL GLOBALIZATION, EMERGING MARKETS, AND CRISES

INCREASED INTERNATIONAL CAPITAL FLOWS

The growth of international capital flows is one of the major economic developments in the world economy since the breakdown in the early 1970s of the Bretton Woods system of fixed exchange rates. The first oil shock of 1973-1974 led to large current account imbalances.

Surpluses in oil exporting countries had to be invested, and deficits among oil importers had to be financed. This recycling of 'petrodollars', together with the growth of Euromarkets (spurred by domestic capital market regulations in the United States), led to a surge of international capital flows. In the late 1970s, many developing countries gained access to international capital markets to finance their growing external imbalances. Most of the intermediation occurred through the banking system, leading to large exposures among industrial countries' banks to developing countries.

An excessive build-up of such external liabilities together with loose monetary and fiscal macroeconomic policies triggered the debt crisis of the 1980s, which started with the Mexican crisis of 1982 and rapidly engulfed a large number of developing countries in Latin America and elsewhere. The 1980s were a period of retrenchment with a significant slowdown of capital flows to emerging markets as foreign debts were rescheduled, restructured and finally reduced with the inception of the Brady Plan in 1989.

The resolution of the 1980s debt crisis led to new large-scale capital inflows to emerging markets in the 1990s. New policies of economic liberalization, privatization, market opening,

and macroeconomic stability in Latin America, the historic transition among Central and East European countries to market economies, and the rapid economic growth of Asia all encourage a surge of private capital inflows. Net long-term private flows to developing countries increased from \$42 billion in 1990 to \$ 256 billion in 1997. The largest portion of these flows took the form of foreign direct investment, which totaled \$120 billion in 1997 (see Chart 6-1). Bond flows and portfolio equity flows were also significant, registering \$54 billion and \$32 billion, respectively, in 1997. In contrast, commercial bank loans represented only 21% of net flows, or \$54 billion in 1997.

Historically, bank loans had accounted for about two-thirds of net capital flows to developing economies. In the 1990s, bonds, portfolio equity and foreign direct investment became more prominent than bank lending. This massive switch from bank lending to securitized flows brought with it new challenges relating to the management of financial crises, as the problem of coordinating the actions of a large number of creditors during a crisis has become more difficult.

Table 6-1 reports gross inflows and outflows of foreign direct investment and portfolio investment (two of the main components of capital flows) for both developing and industrial countries. Two points are noteworthy. First, while net flows have been large and growing, gross flows are perhaps a better indicator of financial integration. As domestic investors diversify their portfolios by purchasing foreign assets, foreign investors also increase their purchases of domestic assets. Therefore, gross flows may significantly increase even if net flows remain constant. Gross inflows and outflows of cross-border capital have in fact grown even

faster than net flows. Second, the phenomenon of rising cross-border capital flows applies equally to developing and developed countries. The Mexican peso crisis of December 1994 led to a modest slowdown in the surge of capital to emerging markets in 1995, but capital flows surged again until the explosion of the Asian crisis in the summer of 1997.

Finally, note that another strong trend towards financial integration is represented by the sharp growth of foreign exchange trading in spot markets and via the use of foreign exchange derivative instruments, including forward transactions; such trading is mostly related to financial transactions and has mushroomed at a much faster rate than international trade in goods over the last two decades (Box 6-1).

Box 6-1. The explosive growth of foreign exchange trading.

The single statistic that perhaps best illustrates the dramatic increase in the size of international financial markets is the volume of trading in the world's foreign exchange markets. The Bank for International Settlements, the central banks' bank established in Basle, Switzerland, released in October 1998 a preliminary compilation of its triennial surveys of foreign exchange markets; 43 market centers were surveyed this time. It shows that foreign exchange trading has continued to grow. Volume increased by 26 percent between 1995 and 1998, less than the 45 percent increase between 1992 and 1995. Because the U.S. dollar appreciated after 1995, the increase in non-dollar trades may be understated. Correcting for the dollar's appreciation since the 1995 survey, foreign exchange trading grew 46 percent between April 1995 and April 1998. Volume now stands at \$1.5 trillion per day, after making

corrections to avoid double-counting. By way of comparison, the global volume of merchandise trade in 1997 was \$5.5 trillion *per year*, or about \$22 billion per day. In other words, foreign exchange trading was more than sixty times as great as trade in goods.

Spot transactions vs. Derivatives. Foreign exchange transactions can be divided into spot transactions and derivatives such as forward transactions. In the new survey, spot market purchases amounted to 40 percent of “traditional” foreign exchange transactions, down from 44 percent in 1995. Forward instruments continued to grow in importance relative to spot sales. Over-the-counter derivatives, though still a smaller fraction of total transactions, have been the fastest-growing segment of the market.

Customer Composition. The most striking aspect of the foreign exchange market, after its total volume, has long been the low percentage of trades made on behalf of ultimate customers. In the most recent survey, the share of total transactions involving non-financial customers represents 20 per cent of all turnover.

The major forex centers. Trading tends to be focused in major centers. Arguably there is a natural equilibrium consisting of one major center in each of the three eight-hour time zones. New York is the major center in the Western Hemisphere, with U.S. volume now equal to \$351 billion/day (18 percent of world turnover). Tokyo in the 1980s established itself as the counterpart in the Asian time zone. Its turnover, however, has fallen off recently, as Singaporean markets have gained. Average daily transactions totaled \$149 billion (8 percent of world total) in Japan and \$139 billion in Singapore. London continues to handle the greatest volume of foreign exchange transactions, with the UK share of world turnover increasing to 32

percent, at an average daily volume of \$637 billion.

To summarize, the volume of world trade in foreign exchange has continued to grow. Derivatives far exceed spot market transactions. Most trades take place between professional traders at banks and other financial institutions; only a fraction of foreign exchange sales and purchases directly involve those who ultimately import and export goods, services, and securities.

UNDERLYING CAUSES OF INCREASED INTERNATIONAL FLOWS IN INDUSTRIAL AND EMERGING MARKETS

Several factors undoubtedly contribute to the phenomenal growth of international capital flows. First, financial markets - both domestic and international - have opened up as governments have phased out restrictions on financial transactions. Restrictions on capital account transactions have been progressively reduced or eliminated both in industrial and developing economies. Financial liberalization has in many cases been accompanied by macroeconomic stabilization, privatization, trade liberalization, and deregulation. Such structural reforms in capital-scarce developing countries have provided significant investment opportunities, and a surge of foreign capital has been attracted by the promise of high rates of return. Growth of international trade has also increased the volume of trade-related financing and bolstered trade in derivative instruments to hedge exposures to currency and commercial risk.

At the same time, financial innovations in the U.S. and other advanced economies have

rendered cross-border investments more accessible to international investors. Mutual funds, hedge funds and the emergence of derivative instruments have enabled investors both to hedge some risks and to take on others. A radical increase in the range of instruments and assets available has afforded investors unprecedented opportunities to increase returns and decrease risks through global diversification. A generation ago, domestic wealth was mostly invested in domestic assets. International portfolio diversification is now a reality for a wide range of institutions, investors and households. Revolutionary technological advances in information and communication technology, in conjunction with significantly lower transportation and transaction costs, have underpinned this rapid financial market development.

PREVIOUS FINANCIAL CRISES

Over the last twenty years, financial liberalization and the increase in global capital flows have also coincided with recurring financial crises. The developing country debt crisis of the 1980s inflicted severe economic costs.

In the 1990s, three more financial crises struck. The first occurred in 1992–93. Several currencies in the Exchange Rate Mechanism (ERM) of the European Monetary System experienced speculative attacks, ultimately forcing Britain and Italy to abandon the ERM in the fall of 1992 and let their currencies depreciate, and Sweden (whose currency was effectively pegged to the ERM currencies) to follow suit shortly thereafter. Sequential devaluation of several other ERM currencies ensued, and the ERM exchange rate bands for

France and the other remaining members had to be widened in the summer of 1993. Second, was the collapse of the Mexican peso in December 1994 and the so-called “Tequila effect,” as additional Latin American currencies came under attack. Finally, the devaluation of the Thai baht in July 1997 triggered the Asian currency and financial crisis that has now spread as far as Russia, South Africa and Latin America.

While each of these crises in the 1990s had distinct characteristics and specific causes, several common elements can also be identified. These have factored significantly into subsequent debates surrounding the reform of the international financial architecture, and are explored more fully in that context below.

Increasing Volume and Sophistication of International Financial Transactions

Perhaps the most obvious element that all three crises of this decade have in common is the context in which they occurred: the ongoing process of global financial integration that gained substantial momentum in the 1990s. Both the size and volatility of international capital flows have dramatically increased and the range of assets traded internationally has mushroomed.

Semi-Fixed Exchange Rate Regimes

All three crisis episodes occurred under regimes of semi-pegged currencies. None of the affected economies had literally fixed their exchange rates in a rigid way (with the exceptions of Argentina and Hong Kong, whose currency board-like exchange rate regimes

have successfully withstood the crises). Nevertheless, in each crisis countries had attempted to stabilize the values of their currencies vis-a-vis the currencies of key trading partners. The ERM exchange rates had been subjected to a band (typically plus-or-minus 2 1/4 percent) vis-a-vis each other as a step along the path towards European monetary integration. The Mexican peso had followed a narrow “crawling band” against the dollar, part of its successful strategy to escape the very high inflation rates of the 1980s. And the Asian currencies had loosely targeted baskets in which the dollar had a weight of around 80–90 percent, facilitating their rapid integration into the world system of trade and finance. In the latter two episodes, exchange rate targets made adjustment to trade deficits difficult. Their sudden abandonment reinforced negative expectations intensifying financial market pressures and had severe adverse contractionary effects in the presence of large foreign-currency-denominated debts.

Presence of Contagion

In all three episodes, the crisis quickly spread beyond the country whose markets experienced the initial turbulence. Often the next victims were geographic neighbors and trade partners, and countries that shared some other common traits such as similar policies or economic shocks. At times, as in the summer of 1998, changes in investors’ sentiment and aversion to risk also contributed to contagion within regions and across geographical regions.

Recent Financial Liberalization

Most episodes were preceded by significant capital account liberalization in the crisis country and progressive elimination of capital controls. Italy and France had fully liberalized their capital accounts in the years just prior to the onset of the 1992 ERM crisis. Mexico progressively liberalized its domestic and international financial regime in the early 1990s. Similarly, East Asian countries undertook processes of financial liberalization – both domestic and international – throughout the 1990s.

Concurrent Banking Crises

Many of the crises of the 1990s have typically also been associated with financial sector and banking crises. This is most clearly evident in the Asian and Mexican peso crises, but weaknesses among financial institutions also played a role in the ERM devaluations. In Sweden, Finland and Italy, banking crises emerged in conjunction with the currency turmoil. The Asian crisis provides a stark example of the link between currency and banking crises, underscoring the profound vulnerability that results from fragile financial and banking sectors. The causal links between banking and currencies crises are complex, as financial weaknesses may contribute to a currency crisis while a currency crisis can exacerbate a financial crisis by increasing the burden of foreign currency liabilities.

3. THE ASIAN CRISIS AND THE GLOBAL FINANCIAL TURMOIL

THE ASIAN ECONOMIC MODEL

East Asian countries grew at a very rapid rate for over two decades, a phenomenon widely hailed as the “Asian Miracle.” There was indeed something akin to an economic miracle in East Asia. Thirty years ago it seemed that industrialization was a privilege reserved de facto for the European-settled regions of the world, with the sole exception of Japan. The East Asian “miracle economies” disproved this notion in a few decades.

In the original Industrial Revolution, it took the United Kingdom 58 years to double its income (starting from 1780). It took the United States almost as long (47 years, starting from 1839; and Japan 35 years, from 1885). Korea accomplished the feat in 11 years, from 1966, and then China in just 10 years (counting from 1977).

This economic performance was remarkable. The economic success achieved by many Asian countries increased economic well-being, sharply reduced poverty rates and opened economic opportunity to large masses of individuals in the region. At the same time, East Asian countries maintained a more equal distribution of income and wealth compared to other developing countries. This successful economic performance has been attributed to a number of structural factors: high saving rates, good education, particularly high rates of basic education and literacy, compared to other poor developing countries; a pronounced work ethic; and outward orientation (participation in international trade and investment). Also, effective macroeconomic management contributed low budget deficits and low inflation rates. These are all major determinants of growth that can work in other countries as well.

This is important, because it means that Asia can continue to serve as an example to other

poor countries. That it has already played this role is worth emphasizing. As developing countries around the world opted for capitalism over state planning in the 1980s, they were not only reacting negatively to the conspicuous failures of state planning in their own economies and in the former Soviet bloc, but were also inspired by the positive example of East Asian success. Indeed, this role model is one of the many reasons why the United States continues to have a major stake in East Asian stability and prosperity.

These Asian economies, however, also concealed structural weaknesses which have now been credited with causing the financial crisis. Many can be characterized as the excessive utilization of centralized coordination rather than decentralized market incentives. Particular examples include widespread government favoritism in promoting selected industries and exports, and anti-competitive protection of domestic industries. Practices which distorted private sector lending and investment incentives include: relationship-driven banking (see Box 6-2) hindering capital market discipline and flexibility, poor supervision and inadequate regulation of financial institutions, implicit and explicit government bailout guarantees leading to moral hazard in the financial sector, heavy reliance on bank debt rather than equity (as securities markets were underdeveloped) leading to excessive leveraging of firms, lack of transparency of the activities and balance sheet of corporations and financial institutions (reflected in the lack of sound accounting and disclosure standards), and informal rather than formal enforcement mechanisms (as manifested in the lack of effective bankruptcy and foreclosure laws). (See Box 6-3 for an analysis of the Asian growth model).

Box 6-2. Arms-length versus relationship (insider) banking

In financial economics, a distinction has long been recognized between market-based and bank-centered financial systems, with the United States and the United Kingdom exemplifying a market-based system and Japan and many other East Asian economies exemplifying a bank-centered system. Commercial banks figure prominently in both. A crucial distinction, however, emerges in the roles that they play.

Economists believe that banks play a special role in financial markets because of the superior information that they often possess about the firms to which they provide finance. Institutionally, this information results from the close ties between firms and their loan officers. In addition, banks often have superior information about their clients' cash flows, as a result of maintaining many of their accounts.

In a market-based system, banks are one of many sources of external finance for firms. In providing funds, they compete with public bond and commercial paper markets, along with well-established markets for equity. Thus, bank loans are provided through "arms-length" market transactions.

In the bank-centered system, on the other hand, firms tend to have strong ties with a single bank (or network of banks). These "main" banks are heavily involved in the management and "governance" of their clients, as a result of their status as the primary -- and often sole -- source of external finance. Ten years ago, economists argued that this privileged status and information enabled banks to extend loans to young firms and firms in distress, firms which would have difficulty obtaining funds in a market-based system. It was even suggested that the

financial structures of the Japanese or East Asian economies might be responsible for the high rates of investment and growth. The bank-centered system, it was argued, overcame the short term focus inherent in the Anglo-American market system. Banks could take chances with riskier firms, since their long term relationships promised compensation in the future from the firms that succeeded (in the form of higher-than-market rates of interest).

This relationship banking regime (sometimes referred to as “insider banking” or “connected lending”) also has weaknesses, which have now been dramatically exposed by the Asian crisis. Instead of making profitable decisions informed by longer horizons, many banks apparently took excessive and economically unprofitable risks. Borrowers who should have been cut off were allowed to continue to borrow, with the result that losses increased. The tightly-concealed system of financing enabled bankers and managers to invest on the basis of personal rather than economic objectives, without market constraints.

Corporate governance tended in some cases toward empire-building, that is maximizing capacity, sales, or market share, rather than maximizing profitability or firm value as economic theory suggests a firm should. The depth of the Asian crisis now suggests that Asian banks and firms developed excess capacity, in sectors such as steel and electronics. Currently, many Asian economies are struggling to overcome the real consequences of these misguided financial decisions. Note that relationship-banking has not been limited to East Asia and its consequences has been observed in other emerging markets and even the U.S., as in the savings and loans crisis episode.

Box 6-3. The Asian growth model

There has recently been a wide debate on whether the Asian growth model had flaws and whether the crisis was due to “crony capitalism.” Until recently most observers thought that these countries had the strong economic fundamentals and structural characteristics necessary for sustained long-run economic growth. Some had warned of economic policy flaws in Asia, but few thought it would lead to a sharp slowdown, and nobody predicted the crisis would be this severe. Not everything about East Asian economies was perfect before 1997, contrary to much that was said then. Conversely, the East Asian economies still possess many strengths which will enable them to recover and grow.

If the origins of the crisis lie in the structural weaknesses in the Asian economic system, then why did it occur when it did? Perhaps there exist natural stages of development, and the Asian financial system, with aspects such as relationship-banking, was better suited to countries at early stages of development. After all, financial intermediation by banks (even in the context of relationship banking) is a tremendously important innovation when the alternative for a firm is financing all investments out of family savings or retained earnings from earlier investments. And as long as growth is rapid, high leverage (that is, a high ratio of debt to equity) is sustainable, and may even be desirable. But when growth slows down, the financial system needs to adapt. Firms need to reduce leverage.

Some slowdown in East Asian growth was probably inevitable at some point after the

breakneck pace of the preceding three decades. Why was the slowdown inevitable? On the list of causes of rapid East Asian growth was the simple principle of economic convergence. This is in addition to such standard fundamentals as the accumulation of physical and human capital, the outward orientation of the economies and institutional factors such as the rule of law and broad economic rights. A country that starts out behind the leaders in per capita income, will tend to close part of the gap over time by growing more rapidly, conditional on those good fundamentals.

There are two reasons for this convergence: the high rate of return on capital in labor-abundant countries, and the opportunity to emulate frontier technology and management practices of the leader countries. But to the extent that the gap has been closed after a few decades, this source of growth is no longer there. Countries run into diminishing returns to capital, limits on the benefits of rural-urban migration, and constraints of infrastructure. Also, as they draw closer to the frontier, they no longer have as much to learn from those that have gone before. Japan had achieved convergence by the 1980s, and Hong Kong and Singapore by the 1990s. Korea and the others still had a ways to go -- a very long way in some cases. Nevertheless, the basic principle remains, that the smaller the remaining gap, the smaller is the particular source of growth represented by convergence.

One controversial view is that the Asian economic growth model was based more on the accumulation of inputs of production, labor (via increased labor participation rates) and especially capital (in the form of high investment rates) rather than the growth of factor productivity. High rates of national investment led to rapid rates of economic growth but the underlying growth rate of total factor productivity (measuring the increased efficiency in the use

of factors and the rate of growth of technological progress) was, according to some studies, more modest. This view also suggests that the very high rates of Asian growth were not sustainable in the long run given the expected fall in the rate of growth of employment and the expected reduction of the rates of investment. However, such a view implied a gradual slowdown of growth, not the sudden and severe crisis that hit these economies in 1997-98.

The factors that would have led to an eventual slowdown of growth interacted badly in mid-1997 with the weaknesses of the financial system, the highly-leveraged economic system, poorly designed capital market liberalization, a slowdown in export markets, a worsening of terms of trade and the development of overcapacity in many sectors. The crisis was the result.

HISTORY OF THE CRISIS AND ITS CONTAGION

In the summer of 1997, financial turmoil in Thailand spread to countries with outwardly similar features at similar stages of economic development: Malaysia, Indonesia and the Philippines. This “contagion” took the form of declines in both stock and currency markets. Singapore and Taiwan, concerned about the competitive effects of the currency depreciation in the original four crisis countries, decided to let their currencies float rather than resist the speculative pressure against their currencies. By October, contagion affected Hong Kong (whose return to China in the summer of 1997 had increased the political uncertainty about the future of this region), pressuring the pegged Hong Kong dollar and sharply depressing local stock markets. The first bout of truly global contagion then ensued as stock markets in the U.S. and Europe fell sharply, and as other emerging market economies were forced to raise interest rates to prevent a

run on their currencies. The spread of the crisis to Korea and the further deterioration in the Indonesian economy led to a worsening crisis in the winter.

Investor sentiment seemed to improve by March as Thai and Korean currencies stabilized, and Korea successfully converted short-term bank debt into longer term bonds. Also, higher interest rates and tighter monetary policy in Latin America following the October 1997 contagion episode helped to stabilize investors' confidence in that region. In April, however, several negative developments led to a new loss of investor confidence. Plunging commodity prices, resulting in large part from the deepening recession in Asia, hurt a wide range of commodity exporters. Oil exporters such as Mexico, Venezuela, Russia and Ecuador were severely affected by plunging oil prices. Agricultural exporters such as Australia, New Zealand, Canada and Argentina were also impacted (as the crisis in Asia and large global supplies of agricultural products led to a sharp fall in agricultural prices) along with mineral producers such as Chile and Peru. Violence in May surrounding the collapse of the Suharto regime devastated confidence in Indonesia and challenged remaining confidence in East Asia. Pressures upon currencies as far from East Asia as Pakistan and South Africa, a sharp deterioration of business conditions in Japan, and the continued fall of the yen added to the pessimism. That last factor led to the concern that China might devalue its currency and that the Hong Kong peg would collapse, causing another round of currency depreciations in Asia. However, China gave assurances it would not devalue, and the pegs held. The above listed negative developments, however, led to another round of sharp declines in emerging markets equities starting in May.

Financial turmoil spread next to Russia, resulting from the fall in the price of oil (the

country's biggest export), a deteriorating current account balance, weak tax collections, a large fiscal imbalance financed by short-term ruble debt and disappointment in the pace of structural reforms. The manifestations included a sharp fall in the Russian stock market, pressure on the currency, and a sharp increase in the interest rate on ruble public debt. An IMF package aimed at reducing the fiscal deficit was negotiated in July. The IMF package failed to restore confidence as the government of Russia proved unable to implement its anti-crisis program in the face of opposition from the Duma, from powerful special interests represented by oligarchs, and from those who sought a return to communism. The deterioration in market conditions culminated in a comprehensive breakdown in confidence in the first weeks of August.

On August 17, the Russian government, faced with growing losses of foreign reserves triggered by capital outflows, decided to devalue the ruble, to restructure its short-term public debt unilaterally in a form that implied material default, and to impose a 90-day moratorium on Russian private sector foreign liabilities payments. These decisions led to a severe financial crisis in Russia. This, in turn, contributed to a dramatic spread of investor pessimism to Latin America and other emerging markets and to a sharp downturn in equity markets in the U.S. and other industrial countries. The contagion from Russia to Brazil and other Latin American countries signaled some degree of financial panic as investors appeared to withdraw capital indiscriminately from countries that differed substantially in the strength of their economies. In the week following the Russian devaluation, investors' sharp loss of confidence in emerging markets may have been partly caused by the perception that the IMF had few resources left and/or was not willing to use them to rescue a country that until then had been considered "too

important to fail.” Investors apparently drew the wrong lesson from the enforcement of conditionality in the face of unsound macroeconomic policies. The loss of confidence may also have been partly caused by the perception that other countries might follow Russia on the path of unilateral defaults, debt moratoria and capital controls.

Although Latin American economies were structurally much stronger than Russia’s, investors increasingly sought to avoid risk everywhere. Emerging market sovereign spreads (see Box 6-4 on sovereign spreads) over Treasuries had risen to about 1500 basis points (15 percentage points) by September. This was thought to signal an extreme increase in the risk aversion of international investors and substantial withdrawal from emerging markets and other risky investments, in favor of “safe haven assets,” notably U.S. Treasury bills. The sharp increase in the preference for liquidity and the attempt to unwind highly leveraged positions added to the pressure on the prices of a wide range of risky assets. As described in Chapter 2, capital markets within developed countries including the United States were also affected by the “flight to quality”: while yields on safe government securities fell, the spread over Treasuries of high-yield securities (junk bonds) increased sharply. Even the spreads of high-grade corporate bonds rose to some extent, reflecting the generalized increase in investors’ risk aversion. The severe losses and near-collapse of a prominent hedge fund contributed to some investor panic. By early October there were hints of a possible generalized global credit crunch: rising spreads on the entire range of bond instruments from relatively safe high-quality corporate bonds to junk bonds and emerging market sovereign instruments; an interruption of access to international capital markets for most emerging economies; a drying-up of bond financing in all emerging markets and a

shrinkage in new bond issues in industrial countries; evidence of a tightening of lending standards by commercial banks in the United States; a slowdown in reported earnings growth and contraction in stock markets.

However, by the middle of November, the conditions in international and domestic capital markets had significantly improved and confidence was restored, thanks to a number of positive developments.

- The Federal Reserve reduced the Federal Funds rate three times -- at the end of September, in mid-October and again in mid-November -- helping to restore confidence and liquidity. Also, a series of interest rate reductions in Japan, Canada, most European countries and a number of other countries amounted to a significant easing of monetary conditions in the world economy.
- In October, Congress approved funding \$18 billion for the IMF, opening the way for about \$ 90 billion of usable resources to be provided by all the IMF members to the liquidity strapped institution.
- Negotiations leading to an IMF and multilateral support and stabilization package for Brazil (eventually announced on November 13) and the commitment of the G7 and 13 other countries to support this crucial country's adjustment efforts contributed to calm Latin American markets.
- Japan passed legislation to address the problems of the banking sector and the government proposed a supplemental fiscal package, restoring some confidence in the Asian markets.

- The yen appreciated sharply in October, reducing the risks of a devaluation by China that could have led to another round of competitive devaluations in Asia; the stronger yen would also help exports to Japan and other third-country markets from other East Asian countries.
- The U.S. expressed strong support for policies to promote strong growth in the industrialized countries as a prerequisite for the recovery of crisis afflicted economies. In a series of speeches, President Clinton presented a number of policy proposals to deal with the crisis: an emergency fund within the IMF to support countries subject to speculative pressures despite good economic fundamentals; measures to support accelerated systemic restructuring of banks and corporations in Asia; significant increases in multilateral financial institutions' support of social safety nets in crisis countries; increases in trade financing to the affected countries; and support for the reform of the international financial architecture.
- The October 30 Statement of the G7 Leaders and the Declaration of the G7 Finance Ministers and Central Bank Governors confirmed the strong commitment of the major industrial countries to restore growth, and contain and solve the current crisis; they also endorsed the creation of an enhanced IMF facility to provide contingent short-term lines of credit for countries pursuing strong IMF-approved policies; and they presented concrete proposals to implement the G22 recommendations (discussed in Chapter 7) for the reform of the international financial architecture.

Box 6-4 Sovereign Spreads in Emerging Markets

The advent of the Asia crisis has witnessed the promotion of many terms from the confines of fairly arcane financial discussions to the lexicon of popular press verbiage. One such term, the “sovereign spread,” has achieved increasing prominence. What is it, and why is it significant?

Understanding the sovereign spread begins with the basics of the government bond market. The last decade has witnessed a tremendous increase in the availability of foreign debt and equity securities. Indeed, the term “emerging market” was coined to refer to those economies that gained unprecedented access to international capital markets over this period. In general, the first securities issued by the emerging markets were government bonds, and most issued bonds promising payments in either local currency or U.S. dollars.

With the advent of these securities, two very interesting comparisons were made possible. The first focuses upon the difference between the yield to maturity of dollar-denominated (or other G7 currency-denominated) emerging market bonds and U.S. (or other G7) government bonds of the same maturity. The yield to maturity is the rate of return earned by holding a bond until it matures, taking into account all interest and principal payments. When bonds are issued at par -- that is when the interest rate they promise is the same as the interest rate that investors demand to hold them -- their yield to maturity is equal to their coupon rate. This difference in yields is the premium the market demands for the extra risk that holding the emerging market bond entails. More precisely, this premium is compensation only for additional *default* risk, since payments are made in foreign currency.

The difference in yields, or implicit risk premium, is the emerging market's "sovereign spread." Among other useful interpretations, it can be combined with the assumption that U.S. government bonds are default-risk free to derive fairly straightforward estimates of the default probabilities incorporated in emerging market bond prices.

During the periods of extreme market turbulence following the Mexican peso crisis and the Russian default, sovereign spreads increased sharply. By mid-September 1998, such spreads were around 1500 basis points signaling contagion from Russia to Latin America and other emerging markets. At their height, these spreads implied very high default probabilities for many countries, leading to the conclusion either that markets were irrationally pessimistic or that investors were becoming more risk averse (See Chart 6-2).

Another interesting comparison can also be made. Comparing the yield on dollar- and local currency-denominated bonds isolates the market's assessment of currency risk. Interestingly, even in most "fixed" exchange rate regimes, a positive currency risk premium can be observed. In these cases, investors either expect a change of regime or are earning an implicit "insurance" premium for the possibility that one might occur.

CAUSES OF THE CRISIS

Identifying the cause of the 1997-98 Asian crisis has engendered heated debate. Previous currency and debt crises – such as the ones observed in Latin America in the 1980s – typically shared several common characteristics: crisis countries had large budget deficits and high public debt; they suffered high inflation as a result of deficit monetization; and they

experienced low economic growth and had low saving and investment rates. In Asia, however, the opposite conditions prevailed in many of countries just prior to the crisis: low budget deficits, low public debt, single digit inflation rates, high economic growth and high saving and investment rates.

Some argued that this apparent lack of usual fundamental problem in the Asian crisis supported self-fulfilling crisis models, which challenged the more conventional interpretations which are based on economic fundamentals. These models identified phenomena such as international bank runs, irrational panic, fickle investors, volatile hot money, self-fulfilling bad equilibria and non-fundamental speculative capital flight.

Despite the appeal of these new theoretical models, a competing explanation was based more traditionally on fundamentals. Beneath apparently strong economic fundamentals in East Asia lay serious institutional weaknesses, macroeconomic policy mistakes, and severe structural distortions. These vulnerabilities eventually led to the crisis in the summer of 1997.

First, the financial sectors were prone to fragility because of distortions such as relationship banking, corrupt credit practices, directed credit to favorite firms and sectors, political distortions in the allocation of credit, poor regulation and supervision of the banking system and moral hazard deriving from implicit or explicit government bailout guarantees of the financial institutions (See Box 6-5 on moral hazard). Such financial sector weaknesses

contributed to a lending boom and overinvestment in projects and sectors that often were risky and of low profitability, such as real estate and other non-traded sectors and excessive capacity accumulation in some traded goods sectors. Also speculative purchase of assets in fixed supply fed an asset price bubble, with stock market prices and real estate prices rising beyond what fundamentals warranted. Poor corporate governance and what has now come to be called “crony capitalism” exacerbated the distortions in this system and fueled the investment boom. Domestic and international capital liberalization may have aggravated the original distortions and imperfect incentives faced by banks and firms as it allowed them to borrow more and at cheaper rates in international capital markets.

In Thailand, regulations restricting entrance in the banking system led to the growth of non-bank finance companies. Such companies were largely unregulated as they were non-banking institutions. They borrowed excessively to finance the boom in the real estate sector. Liberalization of capital account regulations, for example in the form of the Bangkok International Banking Facility, led Thai financial and corporate firms to borrow excessively and at very short-term maturities. Such facility became only a tool for resident Thai banks and firms to borrow from abroad. Fifty-six of these finance companies borrowed excessively from abroad in foreign currency, were distressed even before the Thai baht crisis, and were eventually closed down once the currency crisis surfaced.

In Korea, the excessive investment was concentrated among the chaebols, the large

conglomerates dominating the economy. The chaebols' control of financial institutions, together with government policies of directed lending to favorite sectors and misguided industrial policies led to excessive investment in traded sectors such as autos, steel, shipbuilding and semiconductors. The excessive capacity thus created was associated with very low profitability of such investment. By early 1997, well before the onset of the won crisis, Korea was in sharp economic difficulties and seven out of the thirty main chaebols were effectively bankrupt.

In Indonesia, some business practices tended toward corruption and over 80 percent of all bank credit consisted of directed credit, channeled to politically favored firms and sectors. Indonesia had already suffered from a banking crisis in the early 1990s but did not reform its banking system in the direction away from relationship finance and crony allocation of credit. Moreover, most of the borrowing was in foreign currencies, compounding debtors' inability to repay when the local currency depreciated. Note that, in Indonesia, a large fraction of foreign banks lending went directly to the corporate sector rather than being intermediated through the domestic banking system.

Empirical studies confirm that the return to capital sharply fell in the region as the result of excessive investment. Studies show a rapid build-up of fixed assets throughout Asia from 1992 to 1996 with particularly rapid growth in Indonesia and Thailand. With most of the growth financed with debt (especially in Thailand and Korea), high levels of corporate leverage

were already prevalent in 1996, well before the currency crisis increased the burden of foreign debt. At the same time, moderate to low profitability severely impaired the ability of many Asian firms to meet their interest payment obligations. In Korea, the average debt to equity ratio of the top thirty chaebols was over 300% by the end of 1996; and by 1997 the return on invested capital was below the cost of capital for two thirds of the top chaebols.

The excessive investment boom in the East Asian region led to large and growing current account deficits that were financed mostly via the banking system and the accumulation of short-term, foreign currency-denominated and unhedged liabilities. Regimes of exchange rates that were semi-fixed to the dollar exacerbated the problem in two ways. First, they led to real appreciation (as a result largely of the 1995-98 appreciation of the dollar) that worsened the current account problem. Second, fixed exchange rates led borrowers to discount the possibility of future devaluation, and thereby led them to underestimate the cost of foreign capital. Also, while budget deficits were apparently low, the implicit and explicit government guarantees of a bailout of the financial system in a crisis implied large and growing unfunded public liabilities that emerged once the currency crisis triggered a wider banking crisis.

Moreover, exogenous disturbances made the East Asian countries vulnerable to crisis: the slowdown of export growth among many Asian countries in 1996 and the worsening of the terms of trade, partly associated with a slump in the world price of semiconductors; the

persistent stagnation of the Japanese economy in the 1990s; the weakness of the yen that caused a real appreciation of Asian currencies that were effectively pegged to the U.S. dollar; and the emergence of China as a major regional competitor.

In 1997, the bubble started to burst. The stock markets dropped (in some cases accelerating a reversal that had started before 1997) and the emergence of wide losses and/or outright defaults in the corporate sectors revealed the low profitability of past investment projects; non-performing loans that were already increasing before the currency crisis hit the East Asian financial institutions. Then, the firms, banks and investors that had heavily relied on external borrowing were left with a large stock of short-term, foreign currency-denominated and unhedged foreign debt that could not be easily repaid. The exchange rate crisis that ensued exacerbated the problem, as the currency depreciation dramatically increased the real burden of the debt that was denominated in foreign currencies and led to further financial crisis for banks and firms. The free fall of currencies was intensified by the sudden rush of firms, banks and investors to cover their previously unhedged liabilities in foreign currency. In turn, this accelerated depreciation aggravated the original foreign currency debt problem creating a vicious circle.

Concerns that the governments were not committed to structural reforms worsened the policy uncertainty, led to widespread capital outflows and worsened the currency depreciation.

While the crisis was triggered by fundamentals, some have argued that currency and stock

markets overreacted, falling more than merited by economic fundamentals. Panic, herd behavior and a generalized increase in risk aversion by investors led to capital flight and a sudden reversal of capital flows that exacerbated the crisis.

The instability and sharp reversal of capital flows to the East Asian region as the investors' flight emerged in the second half of 1997 is clearly evident in the data. As Table 6-2 shows, net private flows to the five Asian crisis countries (Thailand, Korea, Indonesia, Malaysia and the Philippines) averaged \$89 billion per year in 1995-96. In 1997, the reversal was dramatic as the capital flows show a net outflow of \$6 billion. This sharp reversal between 1996 and 1997 equaled to more than 10 percent of the GDP of these five countries. Most of the reversal occurred in the second half of 1997 as foreign investors fled and international banks sharply withdrew their short term loans to these five countries. Commercial banks accounted for three quarters of this reversal withdrawing \$29 billion in 1997. While equity investments also fell in 1997, the decisions by international commercial banks not to roll over their loans to Korea, Thailand and Indonesia severely exacerbated the financial crisis and the currency collapse. In 1998, it is estimated that net private outflows were even larger than in 1997, about \$25 billion, driven again by large scale bank withdrawals.

The result of this drastic reversal of capital flows has been a severe adjustment of the current account of the affected countries and a sharp contraction in economic activity. The current account deficit for the five crisis countries went from a deficit of \$55 billion in 1996 to

one of \$26 billion in 1997 (with most of the adjustment in the second half of the year) and a estimated surplus of \$59 billion in 1998. As private capital has fallen sharply, the financing gap has been transferred to the official sector (IMF, multilateral and bilateral official creditors) and to foreign reserves: while in 1996 the Asian five made small net transfers to official creditors, they received net official flows of \$31 billion and 28 billion in 1997 and 1998 respectively. Moreover, while in 1995 and 1996, net private inflows in excess of current account imbalances led to sharp increases in foreign exchange reserves, the turnaround of capital flows in 1997 led to a loss of foreign exchange reserves equaling \$31 billion.

While the reversal of capital flows in 1997 was partly explained by the fundamentals and policies followed by the crisis countries, its size and concentration in the second half of 1997 confirm that investors' flight, especially commercial banks, contributed to the severity of the crisis. The calls for fairer burden sharing by the private sector and mechanisms for creditor coordination, enshrined in the reports of the G22 working groups (see below), recognize that the private sector may be a cause of financial crises, needs to be involved in preventing them and, if they do occur, needs to play its fair share in solving them. Collective mechanisms to coordinate creditor behavior in periods of acute borrower distress would also be quite useful. Indeed, the Korean crisis eased in early 1998 when, in an agreement mediated by the U.S. Treasury, the commercial banks agreed to roll over about \$20 billion of loans to Korean banks by turning them into medium term bonds. It would be useful to design

orderly workout mechanisms to ensure that such cooperative outcomes – such as a rollover and/or restructuring of loans – occur before, not after, a currency and financial crisis triggered by sudden capital reversals puts a country on the brink of default, as threatened Korea in December 1997.

Box 6–5. Moral Hazard in Financial Institutions

Economists have long discussed the perils of “moral hazard.” It is a central idea in the economics of “asymmetric” information, the study of transactions in which buyers and sellers have differential access to relevant information.

Moral hazard originated in studies of insurance markets. In theory, insurance markets perform a service by transferring risks from small-scale risk-averse agents to large-scale highly diversified or (approximately) risk-neutral insurance companies. In principle, insurance contracts can be created to transfer the risks associated with virtually any actuarially certain outcome.

Insurance markets are inevitably plagued, however, by human nature. By reducing the risks individuals face, insurance companies can inadvertently encourage them to engage in more risky behavior. Examples of this “moral hazard” abound: insured homeowners, for instance, are more likely to build homes in a flood plain or in an areas prone to wildfires and avoid installing alarms and anti-theft system; insured drivers might drive more recklessly. If insurance companies can observe this behavior, they can simply charge higher premiums. If they can’t, they might try to regulate and monitor their clients’ behavior, and make sure clients share some

of the burden of the losses they incur. Sometimes this works, and other times insurance markets simply don't exist.

The same ideas have been applied on several levels to commercial banks. In the banking context, banks are unfortunately subject to a rather unique risk that requires insurance. If depositors suddenly lose confidence and seek to withdraw their funds *en masse*, banks will quickly exhaust their cash reserves. Since most investments are illiquid, attempts to call them in prematurely will diminish their value. As a result, even good banks can fail if a bank run occurs.

Given the pivotal role that banks play within all modern economies, most governments provide insurance against bank runs, through both deposit insurance and by establishing a “lender of last resort.” The former seeks to prevent bank runs by reassuring depositors that their funds are safe, regardless of long lines at the bank teller. The latter stands ready to provide emergency loans, so that banks need not liquidate their loans to repay depositors. Instead, they can call them in gradually (absorbing smaller losses) or attract depositors back in order to repay the lender of last resort.

This insurance against bank runs, however, creates moral hazard among bank shareholders since it reduces their risks. Since they make loans largely with their depositors' money, bank shareholders have an incentive to “gamble” by purchasing excessively risky assets. When things turn out well, shareholders reap the rewards. It also subjects depositors to moral hazard of their own: if they stand to lose nothing in the event of a bank failure, they have little incentive to monitor investments and compliance with capital adequacy standards.

Insurance against bank runs thus comes at the inevitable expense of increased moral hazard. The optimal tradeoff is not clear. What is clear, however, is that the provision of government insurance -- either through explicit policies or implicit (so-called "too big to fail") necessities -- requires prudential regulation and supervision, and the maintenance of strong capital adequacy standards to mitigate the effects of moral hazard.

In East Asia, implicit and explicit government guarantees to bail out financial systems (in the form of deposit insurance and lending of last resort) were not combined with sufficient regulation and enforcement of capital adequacy standards. International investors, rightly or wrongly, also allowed perceived guarantees to absolve them of the need to monitor lending decisions. Moral hazard problems thus led banks to borrow too much from abroad and invest in projects that were too risky at home.

THE CAUSES OF CONTAGION

The spread of market dislocations from one country to the next -- the so-called contagion effect -- has been observed in the behavior of exchange rates, stock markets, and emerging market sovereign debt spreads. As with explanations for the crisis itself, some observers interpret this contagion as proof that markets are irrational and prone to unjustified panic. Various explanations based on economic fundamentals also exist, however.

Common Shocks

Contagion may be due to common shocks or policies. For example, the weakening of the yen negatively affected numerous Asian currencies. In addition, falling commodity prices hurt commodity exporter countries. Thus, the same economic shocks affected countries as distant as Russia, Mexico, Canada, Australia, New Zealand, Chile, Peru and Argentina.

Trade Linkages

When a country devalues its currency, its competitive position improves relative to that of its major trading partners. Their trade balances are likely to worsen in response, and speculators foresee this. Trading partner currencies, in turn, experience speculative pressure. Another channel occurs through income effects: a downturn in Japan depresses Asian exports to Japan and vice versa. These relationships were an element in the spread of the currency crisis within East Asia in 1997. Evidence suggests that contagion is related to strength of trade links and regional factors.

Competitive Depreciations

Contagion may also spread as a result of active competitive depreciation policies among countries that are competitors in third-country markets, in addition to being the result of investors' speculative pressures when there are strong trade links. If one country devalues, a competitor may be tempted to devalue as well to restore its competitiveness. For example, the first wave of depreciations in Asia in the summer of 1997 worsened the cost-competitiveness of all the countries in the region that had initially maintained their

nominal exchange rate fixed. As the currencies of countries that were competing in the same world markets came under attack sequentially and depreciated sharply, the fundamental equilibrium value of other currencies, that had not yet depreciated, started to deteriorate. Concerns about such loss of competitiveness explain, for example, the decisions of Taiwan and Singapore to allow their currencies to fall as the other regional currencies were being devalued. Also, the weakness of the yen throughout 1997 and 1998 may have contributed to these trade and competitiveness-related devaluations in the East Asian region.

Other Real and Financial Linkages

Other real and financial links may also serve as a conduit for contagion. If a country invests in and lends heavily to another, negative economic news in the latter will negatively affect markets in the former. The pressures on the stock markets and exchange rates of Korea, Hong Kong and Singapore, for example, were related to the fact that these economies had heavily lent to, invested in and traded with Indonesia and other Asian economies in crisis. Such losses also affected banking institutions and other financial firms in Japan, Europe and the U.S. that had invested in East Asia and Russia, partly explaining the contagion to industrial countries' financial markets.

Imperfect Information and Investor Expectations

Poor economic policies and negative shocks in one country may lead investors to expect that similar policies and shocks will affect other countries. Failures of financial institutions or

devaluations in one country may signal to investors that other similar countries in the same region have similar problems (such as overinvestment, weak financial institutions, external imbalances, insufficient foreign reserves or high short-term foreign debt) or that they are unwilling to defend their currency aggressively. In such cases, contagion results from investors' revisions of expectations. The unwillingness of country after country in Asia to defend more aggressively its exchange rate parity with higher interest rates in 1997 revealed to investors the policy preference of many East Asian countries.

This type of contagion may also result from changed expectations concerning the odds of official bailouts. The news in mid-August of 1998 that Russia – the example of a country deemed too-big-to-fail – would not receive further official assistance given its policy weaknesses and its decision to devalue, default on its debt, and impose exchange controls, shook international investors' confidence and increased their concern that other emerging markets might follow similar policies and/or might not be bailed out. Spreads on emerging market sovereign instruments had not previously priced in this possibility, and the spread of contagion to Brazil and Latin America was rapid and sharp. Also, large highly leveraged financial institutions (such as hedge funds) who lost money in one market (Russia) faced margin calls that forced them to liquidate their positions in other markets, adding to the contagious effects of the Russian default.

Shifting Risk Aversion and Investor Sentiment

Against these fundamentals-based explanations stand alternatives based on investor behavior and sentiment. Some argue that, as volatility increased in financial markets, investors withdrew from many emerging economies without drawing careful distinctions among them concerning the strength of fundamentals. Phenomena such as financial panic, herd behavior, loss of confidence and a generalized increase in risk aversion may have played some role in the spread of the crisis in 1997-98 within Asia, from Asia to Russia, from Russia to Latin America and other emerging markets and eventually to G7 capital markets.

The increase in investors' risk aversion is clearly indicated by the sharp increase in sovereign spreads in the summer of 1998 (see Box 6-4). To explain such a large increase in spreads without resort to increased risk aversion requires the unlikely assumption of a perceived increase in the probability of sovereign defaults to very high values in many emerging markets. The sharp increase in spreads experienced by Argentina and Chile, countries where it was unlikely that probability of default was nearly that high, provides evidence of a sharp increase in the risk aversion of investors.

POLICY RESPONSE TO THE CRISIS

Role of the international community

The international community (the IMF, World Bank, Asian Development Bank and the G7) moved quickly to stem the financial crisis. Packages to support Thailand, then Indonesia and Korea, were formulated as soon as they were requested. The packages designed for these

countries included, along with financial aid, reform programs aimed at tackling the roots of the crisis and restoring investor confidence. In view of the structural causes of the crisis, these programs went beyond addressing major fiscal, monetary or external imbalances. Their aim has been to strengthen financial systems, improve government and corporate governance and transparency, restore economic competitiveness, and modernize the legal and regulatory environment. As a condition for financial assistance, the IMF has generally required substantial economic reforms, emphasizing fiscal discipline, banking sector restructuring, and the maintenance of high interest rates to avoid capital outflows and currency attacks. The IMF's practice of negotiating, monitoring, and enforcing such policy requirements is termed *conditionality*.

The targets and the tactics of the IMF evolved as the dimensions of the crisis became clearer. The Indonesian case provides a striking example of such modifications. Whereas the first aid package of October 1997 required strict fiscal discipline, the agreement of June 1998 allowed the country to run a budget deficit of as much as 8.5% of GDP. In Indonesia, economic performance deteriorated and budget deficits automatically rose as policy uncertainty, political turmoil and violence worsened the economic outlook through the summer of 1998.

In countries that implemented IMF policy reforms most assiduously - Korea and Thailand in particular - the packages were successful in stabilizing the financial markets and creating the basis for a resumption of economic growth. In these countries, following financial turmoil in the second half of 1997, financial stability returned in 1998 as the stabilization packages were implemented. Both countries saw their currencies appreciate in the first half of 1998 after their

sharp drops in 1997, domestic interest rates fall back to pre-crisis levels by the summer, trade balances significantly improve and foreign reserves start to increase again. The financial crisis certainly has had severe real consequences, as economic activity dropped sharply in 1998 and severe recessions began. However, by the fall of 1998 there were signals suggesting that both economies had bottomed out and economic recovery might start in 1999. In particular, both economies showed an increase in real exports and signs of a recovery of industrial production.

The logic of the IMF packages

The severity of the economic crisis in East Asia has led some critics to challenge the IMF's approach and the wisdom of the particular packages.

Structural Reforms

One criticism relates to the breadth of the restructuring efforts required by the IMF raising a concern that the Fund has been playing an excessively intrusive role in domestic affairs. Specifically, some argue that, by including in the programs a number of structural elements, the IMF was moving beyond its traditional macro-adjustment related areas of competence, which historically had been confined to monetary and fiscal policy. However, an effective rescue strategy had to address the issues at the core of the crisis. These issues were structural rather than traditional macroeconomic imbalances. IMF lending to the Asian region would have served no purpose if financial sector weaknesses (ranging from poor bank supervision and regulation to murky relations among governments, banks and corporations) responsible for the crisis were not addressed. Similarly, the insistence on good governance and the avoidance of

“crony capitalism” represented a precondition to avoid future crises. Arguably, halfhearted reform efforts would not help to re-establish market confidence. There is much evidence to support the IMF view that the origin of the crisis was in the structural weaknesses in these economies, particularly in their financial sectors.

The IMF’s approach to crisis management has always evolved over time in response to the changing problems faced by the world economy. For example, after 1973, the Fund turned its attention from the balance of payments problems of industrialized countries, which by then had abandoned fixed exchange rates, to the problems of developing countries, many newly independent. Similarly, it adopted new approaches in response to the international debt crisis of the 1980s, and adapted its policies to cover the transition to market economies when the Soviet bloc disintegrated in 1990. It is appropriate and desirable that an international agency adapt and evolve in response to the developments in the world economic system.

The Prescription of Tight Monetary Policies

Some have emphasized that the high interest rates prescribed by the IMF to limit currency depreciation had severe repercussions on real growth in economies of the Asian countries. High interest rates do stifle growth, but loose monetary policies in the early stages of a currency crisis exacerbate the extent of the depreciation, which in turn increases the burden of foreign currency-denominated liabilities issued by banks and firms. In the presence of large external net liabilities, loose monetary policies can actually produce financial distress and bankruptcies. A loose monetary policy can also ignite inflationary expectations, as the experience of Indonesia illustrates. One could argue that the severity of the Asian crisis was due in part to the

unwillingness of the governments to undertake the appropriate restrictive measures at the right time. The failure to raise interest rates adequately in Malaysia and Indonesia after the runs on the Thai baht are an example of how such interest rate policies led to further destabilizing depreciation of the currencies.

Restrictive Fiscal Policies

Some have argued that the fiscal policy requirements included in the IMF plans were unnecessarily strict. At the onset of the crisis, the Asian countries under attack were running low budget deficits or even fiscal surpluses, and were characterized by relatively low ratios of public debt to GDP. Arguably, loose fiscal policies at the onset of the crisis would have raised doubts about policy-makers' commitment to reduce the outstanding current account imbalances, jeopardizing the credibility of their plans. Also, while fiscal deficits and debt were typically low before the crisis, in several Asian countries the projected fiscal costs of post-crisis financial bail-outs are estimated to be in the range of 20 to 30% of GDP. As these extra public liabilities translate into a permanent increase in the interest bill paid by Asian governments of 2-4% of GDP per year, there is an argument that fiscal balances must be appropriately adjusted. In this respect, the IMF fiscal plans, on a country-by-country basis, were targeted to raise the necessary revenues to meet these extra interest costs. When the recessions soon materialized in the course of 1998, the IMF progressively loosened its fiscal conditions to allow for cyclically-adjusted fiscal deficits. It must be acknowledged too that the year's revelations about the size and depth of the recessionary effects of the crisis surprised not only the Asian governments and the IMF board, but also the vast majority of country analysts.

The “moral hazard” of international rescue packages.

Some have expressed concern that expectations of IMF-led rescue packages lead to yet another level of moral hazard in the international context: expectations of bailouts may lead international investors to lend carelessly and domestic governments to engage in risky policies. Several objections can be raised against a simplistic view that IMF “bail-out” plans cause moral hazard. First, there is no direct evidence behind the charge that the surge in capital flows to Asia after 1995 was related to expectations of international bailouts in the aftermath of the Mexican rescue package. The second objection regards the issue of who has borne the costs of the crisis: a majority of private creditors, especially bond-holders and equity investors, took a huge hit. By the end of 1997, foreign equity investors had nearly lost three quarters of their equity holdings in some Asian markets. Commercial banks were partially spared: for example, foreign banks operating in Korea demanded public guarantees on bank loans as a precondition for rolling over the existing loans. However, the conditions for these rollovers represented some distribution of the burden between debtors and creditors as short-term loans were converted into medium-term bonds (at interest rates a few hundred basis points above U.S. Treasury rates). The third objection argues that the availability of international support in the event of a crisis will not in fact lead countries to adopt unsound policies. In general, countries try to avoid going to the IMF, since such support comes with quite strict conditions and is politically expensive. In this regard, attaching conditions to assistance gives policymakers incentives to pursue sound policies. Furthermore, casualties of financial crises typically suffer recessions even with current IMF programs.

A fourth, and more substantial point, is that the concern about moral hazard needs to be traded off against the risks of inaction in the event of a crisis. The alternative response to a crisis -- to leave countries and creditors to sort out their debts on their own -- may have more dramatic and distortionary consequences for both domestic citizens and the world economy. The lessons from the interwar period and the 1980s point out that such a strategy requires complex negotiations over a long period of time, during which access to international markets is curtailed and long-term growth drastically reduced. Also, the experience of the 1990s suggests that highly interdependent economies can be subject to the rapid transmission and the 'contagious' spread of speculative waves of financial panic across regions. In this scenario, failure to address a local crisis with the appropriate program of international assistance - and the failure to restore market confidence promptly -- greatly increases the chances of a systemic chain reaction across countries.

Conceptually, the right answer to the above question requires striking the right balance between the adverse consequences of moral hazard on the one hand and currency crises on the other. Implications extend not just to the recovery of invested funds, but to the human impact of severely disrupted economic activity.

U.S. leadership role

Since the onset of the crisis the Administration has worked with the other industrial nations, as well as developing countries and the international financial institutions, to contain financial contagion, to improve the outlook for world economic growth, thereby speeding

recovery in Asia, and to mitigate the impact of the crisis on the crisis-afflicted countries. The United States supported the IMF in its goal of providing financial assistance to countries in crisis that are willing to implement the often tough reforms needed to restore economic confidence and strengthen the underpinnings of their economies. Restoration of confidence is a prerequisite for capital flows to resume. The United States supported the structural goals of these rescue packages, in particular the strengthening of financial systems because, as discussed above, structural weaknesses in financial intermediation were judged to be at the core of the crisis.

In particular:

- The U.S. has supported policies to promote strong growth in the industrialized countries as a prerequisite for the recovery of crisis afflicted economies.
- In October, Congress approved the President's request to fund the American share of increased resources for the International Monetary Fund. The President also called for an enhanced IMF facility to support countries with good economic fundamentals subject to speculative pressures.
- In the fall of 1998 the President proposed a number of new initiatives to sustain the recovery of growth in the crisis-afflicted countries: measures to support accelerated systemic restructuring of banks and corporations in Asia; significant increases in multilateral banks' support of social safety nets in crisis countries; increases in trade financing to the affected countries.
- The U.S. took a leading role in pushing for a reform of the global financial architecture so as to make such crises less frequent and less severe in the future.

The Importance of Sustained Global Growth

Stronger economic growth in industrial countries is a prerequisite for recovery in emerging markets because industrial countries are key trade partners of the crisis countries. The Administration therefore has urged other industrial countries to take appropriate policies to spur sustained economic growth. As world economic conditions deteriorated in the summer of 1998, threatening economic growth in industrial countries including the U.S. while inflation remained subdued, the President called for the G7 countries to put renewed emphasis on the goal of ensuring economic growth. Citing the threat posed to U.S. growth by increased weakness in foreign economies and tighter financial conditions domestically, the Fed decided to cut the Federal Funds rate target from 5.5 percent to 5.25 percent at its regular policy making meeting on September 29. It acted again to lower the Fed Funds target to 5 percent and the discount rate to 4.75 percent on October 16 (in between its regular policy meetings) in response to growing lender caution and unsettled financial markets, as well as to sustain U.S. economic growth. And it lowered again the Federal Funds rate and the discount rate, to 4.75 percent and 4.5 percent respectively, at its November 17 meeting. Other countries, including Japan, most European countries, Canada and a number of developing countries, also eased monetary policy in the fourth quarter, thus helping to support global growth.

Support of the IMF Role

The contagious effects of the ongoing crisis threatened even those countries that had made great progress in implementing sound macroeconomic and structural policies and had

worked to strengthen the fundamentals of their economies. To deal with such threats, the President proposed to find ways to extend emergency IMF financing to countries with sound policies that have acted responsibly, thereby helping them fight off the contagious impact of the ongoing crisis. The G7 Finance Ministers and Central Bank Governors developed plans for an enhanced IMF facility, which they outlined in their October 30 declaration.

For the International Monetary Fund to play its critical role in countering contagion, its resources needed to be expanded. The President urged the major economies to stand ready to activate the \$15 billion remaining in the existing emergency fund of the IMF--the General Arrangements to Borrow (GAB) -- to ensure that the IMF continues to support reform and fight contagion. Also, such emergency funds were doubled with the approval of the New Arrangements to Borrow (NAB). Under the NAB, IMF members will be prepared to make loans to the IMF when supplementary resources are needed to forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system. The potential amount of resources available to the IMF under the GAB and NAB combined will be up to \$46 billion. The NAB was activated, shortly after it entered into effect on November 17, to help finance the IMF arrangement for Brazil, which the Executive Board approved on December 2.

Moreover, this year the President requested, and Congress agreed, to provide much-needed new funding to the IMF. The U.S. agreed to provide \$18 billion, its shares of the quota increase and of the New Arrangements to Borrow. Many observers have been confused about the budgetary consequences of IMF funding legislation. Funds provided to the IMF under

these transactions are considered as exchanges of assets, not expenditures out of the U.S. budget. Through the IMF, the U.S. succeeds in leveraging our own contributions in favor of macroeconomic and financial reforms and more rapid restoration of growth abroad. As an international institution with broad experience and appropriate skills, the IMF is the right organization to play a lead role in handling the crisis. The United States has a great stake in the success of emerging market countries, both in terms of our foreign policy and in terms of the markets for our exporting firms. We could not expect to have a leadership role in the G7 and the world without meeting our fair-share obligations.

At the same time that the United States supported the basic IMF approach, which entailed asking countries to take responsibility for improving economic fundamentals, we recognized the need to do more to help countries get back on their feet, to restore growth and to mitigate the suffering which has been inflicted on so many citizens in the affected countries.

New Initiatives to Restore Growth and Recovery in East Asia

The Administration is working with other financial authorities and international economic institutions to explore comprehensive plans to help Asian corporations emerge from massive debt, where individual firms have been swept under by systemic national economic problems. In Indonesia, Korea and Thailand, the combination of sustained high interest rates and illiquidity has led to harsh economic contraction and a vast overhang of bad debt. Debt to equity ratios that were already very high before the crisis subsequently became unsustainable due to the real depreciation of their currencies and the burden of high real interest rates. Highly leveraged companies cannot service their debt, and a self re-enforcing spiral is created in which

banks' cash flows are squeezed, forcing them to contract new lending not only to illiquid corporations but even to those in better health. The object of comprehensive corporate restructuring is to restore the flow of credit and restructure balance sheets so that firms in these countries can get back to the business of producing output. The Asian Growth and Recovery Initiative, jointly announced by the U.S. and Japan at the APEC Summit in November, includes innovative financing schemes aimed at accelerating efficient bank and corporate restructuring in the crisis-afflicted countries in East Asia.

In an effort to ensure access of crisis-impacted countries to critical imports and to help American businesses continue selling abroad, the Export-Import Bank will establish new short-term credit facilities for critical Asian and Latin American markets. We will coordinate these efforts with our counterparts in other leading industrial nations to ensure that trade credit continues to flow during this period of financial stress. Moreover, the Overseas Private Investment Corporation (OPIC) has developed a new instrument to help emerging economies raise money from international capital markets. The aim is to keep private capital flowing to crisis-impacted but deserving economies.

The severe recession experienced by the crisis countries in East Asia has been associated with a sharp increase in the unemployment rate and the poverty rate. The significant successes in reducing poverty during the boom decades have been suddenly and dramatically reversed in the affected countries. The social costs of the crisis have been severe, especially in Indonesia but also in the other crisis countries. The lack of developed social safety nets such as unemployment insurance and efficient welfare programs exacerbated the social costs of the

crisis. The President therefore asked the World Bank and Asian Development Bank to double their aid through an expanded Social Compact initiative with a focus on strengthening the social safety net in crisis affected countries. The focus would be on job assistance, basic needs, children, the elderly and groups in the affected countries who are most vulnerable to economic distress.

Reform of the International Financial Architecture

Even as it worked to mitigate the impact and contain the spread of the current crisis, the Administration collaborated with other countries to find ways to strengthen the architecture of the financial system so that it is less crisis prone going forward. We need to improve the “rules of the road” so that countries can enjoy the benefits of capital flows while reducing the risks and impacts of economic crises of confidence. Discussions in 1998 concerning the reform of the international financial architecture culminated in the publication in October 1998 of reports by three working groups formed by the G22, a group of systemically significant industrial and emerging market countries which had first been brought together in April 1998. These reports of this G22 group are discussed in chapter 7.

4. JAPAN’S ECONOMIC AND FINANCIAL CRISIS

Japan, the leading Asian economy, has inadvertently played an unfortunate role in the emergence and spread of the crisis. Since the start of the 1990s, Japan has suffered a hangover from the bursting of the stock and land bubbles of the

preceding decade. In 1996 it appeared that the economy was recovering, after four years of disappointing growth. But with a large increase in the consumption tax in April 1997, designed to address longer term demographic pressures on Japan's budget, the country fell into another economic recession. The level of activity started to decline in the second quarter of 1997.

Japan's economic weakness reduced demand for imports from the region. Japanese authorities loosened monetary policy and pushed interest rates extremely low. The associated continued depreciation of the yen relative to the U.S. dollar from mid-1995 to the summer of 1998 may have exacerbated exchange rate tensions in the region, and in 1997 contributed to a steep real appreciation of the Asian currencies that were tied to the dollar.

Japanese banks, already in fragile condition after the bursting of the 1980s bubble and weakened by a stagnant economy in the 1990s, had lent heavily to other Asian economies. Given the very low interest rates in Japan, large scale lending to the fast-growing East Asian countries had been stimulated by the higher returns available outside Japan. As a result, Japanese banks had the greatest exposure of OECD countries to Asian countries, and were hard hit in the Asian crisis. In addition, as the Japanese crisis deepened in 1997-1998, many banks suffered losses and chose to recall foreign loans in order to avoid a domestic lending squeeze. At the same time, however, banks and firms in South East Asia that had borrowed from Japan were hit by the currency shocks and the financial outlook of Japanese banks and securities firms deteriorated as a result.

Compared to the American role in the Mexican crisis of 1995 -- when the U.S. economy was in a strong cyclical upswing -- the weakness of Japan in 1997-98 undoubtedly exacerbated somewhat the recession in Asia and worsened the unfolding of the currency crises. At the same time, the Asian crisis, coming on top of domestic difficulties, hit Japan's vulnerable economy hard.

As the world's second largest economy, Japan has a key role to play in maintaining global economic growth. Japan's performance will help determine the prospects for Asia's recovery.

Japan has now entered a full-fledged recession. Real growth over the four quarters of 1997 amounted to -0.4%. In the first half of 1998, Japanese real GDP was down 4.3% at an annual rate. By late 1998, there were still few if any signs of recovery. Japan risked a descent into a deflationary spiral in which falling prices raise real interest rates, further discouraging spending. The United States argued that Japan should take strong and sustained fiscal measures to stimulate domestic demand, to restore confidence, deal promptly and effectively with the problems of its banking system, open its markets and deregulate its economy.

By the fall of 1998, as non-performing loans were surging, bank lending declined due to loan write-offs, capital constraints and tighter credit standards. The ensuing deepening economic contraction convinced Japanese policy makers that economic reforms should be accelerated. On the banking side, legislation was passed to provide funds for addressing the problems of the banking system. Of the 60 trillion yen (about \$500 billion) in the financial package, about 30 percent was committed to protect depositors, 40 percent to recapitalize weak banks and 30 percent to purchase the shares of nationalized banks. While questions remain concerning the implementation and effectiveness of the package, the banking reform bill is a necessary but not sufficient step towards restructuring of the financial system. On the fiscal side, in April 1998 the government announced a 16 trillion yen fiscal stimulus package, which included public works expenditures and tax reductions. This package, however, failed to generate a rebound in economic activity, as public spending was delayed relative to plans and recessionary pressures intensified. By the fall of 1998, the government had started to consider a supplementary package of expansionary fiscal actions. Accordingly, in November 1998, the government announced a plan to pass a third supplementary budget aimed at implementing during 1999 over 17 trillion yen in public works and other measures, as well as more than 6 trillion yen in tax cuts during an extra Diet session convened in late November.

5. EFFECTS OF THE EMERGING MARKETS CRISIS ON THE UNITED STATES

MACROECONOMIC EFFECTS

From the U.S. perspective, an important impact of the international financial crisis has been a deterioration of net exports -- a widening of the trade deficit. In 1998 the U.S. economy grew faster than other industrial countries. At the same time Japan and a large part of East Asia lapsed into a severe recession. This difference in growth rates, coincided with a significant nominal and real appreciation of the U.S. dollar relative to Asian currencies, particularly the yen (from mid-1995 until September 1998). Together these factors explain most of the increasing U.S. trade imbalance (see Chart 6-3). Two of the sectors adversely affected were agriculture and manufacturing. Shrinking exports and low prices (partly due to the financial crisis and partly due to large global supplies of agricultural commodities following bumper harvests), on top of bad weather in some regions, led to a fall in farm incomes. In manufacturing, export goods sectors such as commercial aircraft suffered from the fall of exports to Asia. Import-competing sectors such as steel, textiles and apparel have also been under pressure since the dollar appreciation has reduced the price of imports from the crisis affected countries.

Financial institutions have also suffered losses on their emerging markets loans and investments, and are exposed to even greater losses if the impact of the crisis spreads to important trading partners in the Western hemisphere. Spreads on corporate debt rose in the fall

of 1998, and there was a noticeable tightening of credit standards and loan terms in commercial lending. Further deterioration in the international economic situation would pose a substantial challenge to sustained growth into the start of the next millennium.

While the 1995-98 appreciation of the U.S. dollar (see Chart 6-4) contributed negatively to the trade balance, it has also had a number of beneficial effects on the economy. First, the strong dollar has led to a fall in import prices and a further reduction in inflation. Second, the sharp depreciation of currencies in Asia and the fall in oil and commodity prices has improved the U.S. terms of trade. This increased the purchasing power of U.S. goods over international goods, increasing real incomes (see Chart 6-5 on terms of trade). Third, a strong dollar and subdued inflation have supported low short-term and long-term interest rates low, benefiting households, firms and other borrowers in the economy.

The worsening of the Asian crisis and the spread of financial turmoil to other regions is ultimately expected to contribute to the slowdown of the U.S. economy in 1999. The economy had been growing at an unsustainably high rate in the past three years, however, and labor markets had become increasingly tight. This slowdown might well allow the economy to grow at a rate closer to its sustainable long-run potential growth rate. Arguably, domestic demand had to slow down. Were it not for the loss in net exports, other components of aggregate demand would have declined instead.

THE U.S. TRADE AND CURRENT ACCOUNT DEFICITS AND THE DOLLAR

Short-term aspects of the trade imbalance

In 1998, the differential growth rate of the U.S. relative to its trade partners and the continued appreciation of the U.S. dollar had a significant impact on the U.S. trade balance. The U.S. trade deficit increased significantly during the year. The year-to-date 1998 deficit on trade in goods and services is \$139 billion compared to a \$90 billion deficit in the comparable 1997 period. **[data to be replaced later by more up-to-date statistics]** Compared to a similar point in 1997, year-to-date goods exports in 1998 are down 0.9 percent. Year-to-date goods imports are up a modest 5.1 percent in 1998 compared to the same period in 1997. Relative to past trends, the decline in exports is the more striking of the two figures. **[data to be replaced later by more up-to-date statistics]** A large fraction of the increase in the dollar value of the U.S. trade deficit is due to the fall of U.S. exports to Asia; the contribution of import growth to the increased nominal value of the trade deficit has been so far very modest. As an indication of the likely effect of the East Asia crisis, the decline in U.S. exports to six East Asian countries in the first ten months of 1998 was \$24 billion to \$30 billion, at an annual rate, depending on the seasonal adjustment and timing method used. Korea accounted for almost two fifths of the decline. Most of the 1998 weakness in exports was accounted for by the drop in our exports to six Asian countries: Indonesia, Japan, Korea, Malaysia, the Philippines, and Thailand. Our imports from these countries have also risen—although these imports have been on an uptrend for several years.

The increase in the trade deficit -- and the negative contribution of increased imports -- is larger in *real* terms, since import prices have fallen. Since foreign depreciation lowers dollar import prices, real quantities of imports have increased more than their dollar value. This

contained the increase in the dollar value of imports. The fall in import prices from the 4 Newly Industrialized Economies (NIES) (Korea, Hong Kong, Singapore and Taiwan) was 9.4% between August 1997 and August 1998; similar figures for import prices from Japan show a 5.5% drop. Separate import prices for the other Asian crisis economies are not available. But their fall is likely to be even larger since their currencies fell by more than those of the 4 NIES. Import prices have also fallen because of the sharp drop in the global price of primary commodities. Import prices for petroleum goods were down 31.8% in August relative to a year earlier; import prices for agricultural goods were down 7.7% relative to a year ago. Despite their overall decline, the prices of U.S. imports from Asia have fallen less than dollar-for-dollar with the exchange rate. Thus, the pass-through from exchange rates to import prices has so far been less than full. Conversely, real U.S. exports of goods and services have modestly fallen in the first half of the year.

Longer-term perspective on the current account

International trade has contributed substantially to economic welfare and growth in the United States. Nevertheless, concerns have been expressed about the large and persistent U.S. trade deficit. Some fear the deficits signal the lack of competitiveness of the U.S. economy. Some claim trade deficits cost American workers as cheap imports displace U.S. jobs; finally, others argue deficits result from unfair trade practices of our trading partners. These concerns are unwarranted as the trade balance is determined by macroeconomic factors. Normally, trade deficits are more often associated with strong rather than weak growth of output and employment.

The current account as the saving-investment balance

Unraveling these misconceptions requires an understanding the determinants of the trade balance and of the closely related concept, the current account balance. The trade balance is equal to the difference between the value of exports - the goods and services sold by U.S. residents to foreigners - and the value of imports - the goods and services which U.S. residents buy from foreigners. The current account balance simply adds other sources of foreign income and foreign payments to the trade balance. The most important additional items are interest and investment earnings received (paid) on foreign assets (liabilities), and aid grants and transfers. As such, the current account is the difference between national income (the sum of domestic production and the net income received or paid from abroad) and national spending (the sum of private and public consumption and investment spending). Since national saving is equal to the difference between national income and total consumption, the current account is also equal to the difference between national saving and national investment. If a country's national income is greater than its spending or, equivalently, if national saving exceeds investment, the current account is in a surplus. Conversely, if a country spends (consumes and invests) more than its national income, investment exceeds saving and the current account is in a deficit.

If a country runs a current account deficit, it receives a capital inflow (borrowing) from the rest of the world and its net foreign liabilities will increase over time if the country is a net debtor (or its net foreign assets will decrease if the country is a net creditor). Conversely, current account surpluses increase the net foreign assets of a country. A country can finance an excess

of investment over saving in two ways: it either runs down existing foreign assets and/or borrows (in the form of debt or equity) from the rest of the world. In either case, the excess of investment over saving reduces a country's net foreign assets (defined as foreign assets minus foreign liabilities). Foreign assets and liabilities include both debt (such as commercial banks loans and bonds) and equity items (such as foreign direct investment (FDI) and portfolio equity).

Business cycles, long-run growth and the current account

The conventional wisdom that current account deficits are bad as they lead to a loss of jobs and a fall in output in import-competing sectors is mostly misguided. Empirically, high growth of production and employment are often associated with current account deficits while slow growth and recessions are often associated with current account surpluses. This is confirmed by Chart 6-6 for the United States where it is clear that the current account improved or was in surplus during the recessions of 1974-75, 1980-82 and 1991-92 and worsened or was in deficit during the period of cyclical upswing (1970-1973, 1983-89, 1993-1998). This reflects both the behavior of import demand during recessions and the cyclical movements of saving and investment. During a recession, both saving and investment tend to fall. Saving falls as households adjust consumption more slowly to a temporary fall in income and investment declines since low profits reduce profitable investment opportunities. Investment, which is highly sensitive to the profitability of capital, tends to drop more sharply than saving during recessions. The current account thus tends to improve. The trade balance improves during a recession because imports tend to fall with overall consumption and investment demand. The converse

occurs during periods of boom when sharp increases in investment demand tend to outweigh increases in saving and lead to a worsening of the current account.

The relation between the current account and economic performance holds not only on a short-term or cyclical basis, but also on a long-term or structural basis. Often, countries with high economic growth tend to have structurally larger current account deficits, while countries with low economic growth tend to have a current account surplus.

To see why, note that countries can experience investment booms as a result of a number of factors. New natural resources (minerals) are discovered. Technological progress might lead to profitably develop and produce new products. Structural economic reforms (like trade liberalization or capital market liberalization) or macroeconomic stabilization policies can also lead to expectation of high future economic growth and high profitability of new investments.

In all these cases, the investment boom must be financed with saving. If the national saving of the country (the sum of private and public saving) is not sufficient to finance all new profitable investment projects, the country will run a current account deficit, i.e. it will rely on foreign saving to finance the excess of investment over national saving. The current account deficit is merely the result of thousands of individual firms borrowing debt or equity funds to finance investment. As long as these individual decisions are profit-maximizing, it makes sense for a firm to go to capital markets external to the firm and borrow funds equal to the difference between the value of the new investment projects and the firm's savings (retained earnings). The resulting current account deficit will be optimal for the country.

In the aggregate, the current account deficit will imply a capital inflow (borrowing).

These capital inflows are similar to those of an individual firm. There are several ways that this inflow of foreign savings takes place. Firms might borrow directly from foreign banks or investors. Alternatively, domestic banks and financial intermediaries might borrow from abroad lending the proceeds, in turn, to local firms. Equity instruments can also be used; if foreign investors provide enough equity funds to acquire a controlling interest in the local firm, the investment is deemed “foreign direct”. Other purchases of equity are considered “portfolio” equity flows. In all these cases, a current account deficit is financed by some form of foreign saving (foreign capital). And, as in the case of a domestic firm, it is optimal for the country to borrow funds from the rest of the world and accumulate foreign debt as long as the new investment projects are profitable. Conceptually, the new capital should lead to increased net exports generating the trade and current account surpluses necessary to eventually repay principal and interest on the foreign debt. So a current account deficits might actually be associated with an increase the rate of output and employment growth rather than destroy jobs and production.

The link between current account deficits and growth is confirmed by a comparison of the U.S. trade balance with those of its G7 partners since the cyclical recovery of 1992 (Charts 6-7 and 6-8). As the figures show, there is a negative correlation between output growth and the current account and between employment growth and the trade balance. The U.S. has had the fastest growth rate of output and employment and the largest trade deficit. Conversely, Japan has had the second slowest rate of growth of output and the largest trade surplus. Trade surpluses are also the norm in Europe where growth of output and employment has been disappointing.

Similarly, the unemployment rate in the U.S. has been low and falling since 1993 while in the

1990s the unemployment rate in Europe has remained high and has been rapidly growing in Japan.

Historically, countries in early stages of rapid economic development, such as the U.S., Canada and Argentina in the early part of this century, had an excess of investment over saving and ran structurally large current account deficits for long periods of time. The same holds in more recent times: developing countries that are growing faster than developed countries and are capital-scarce usually run structural current account deficits compared to the average surpluses of slower-growing more mature economies.

The increased current account deficit thus appears to be a mostly macroeconomic phenomenon as the increase in the U.S. investment rate has outpaced the increase in the saving rate. The differential growth and investment performance between the U.S. and the rest of the world underlies this deterioration. Similarly, the employment level is also a macroeconomic phenomenon that does not bear a systematic link to the level of the trade balance or the level of trade protection. In the short run an increase in the trade imbalance, such as the one associated with the Asian crisis, may lead to temporary dislocation of workers in export and import-competing sectors as exports fall and imports rise. However, as the U.S. strong employment growth and falling unemployment rate in 1998 suggest, the loss of jobs in some tradeable manufacturing sectors was more than compensated by the increase of jobs in the non traded and service sectors as well as in the new information technology sectors.

Budget deficits and the current account

Under some circumstances, current account deficits can be cause for concern. Since the current account is the difference between national saving and national investment, a current account deficit may be due either to an increase in national investment and/or a fall in national saving. National saving, in turn, may decline as a result of increases in the government budget deficit (government dissaving), or to a fall in private saving. While a current account deficit due to an increase in national investment may be growth-enhancing, a deficit driven by an increase in government deficit may be harmful if the government deficit does not finance necessary and productivity-enhancing public goods.

This type of deficit spending, if it persist, can result in an unsustainable build-up of foreign debt. For example, in the late 1970s many developing countries ran large budget deficits to finance growing government spending. To finance these deficits, the governments borrowed heavily in the world capital markets (either directly from international banks or indirectly by issuing bonds purchased by foreign investors), and accumulated very large stocks of foreign debt. By 1982, many governments encountered difficulties in repaying interest and/or principal on their foreign liabilities, and a severe 'debt crisis' erupted. Many countries had to negotiate a rescheduling of their foreign liabilities to avoid defaulting. Unlike firms that borrow to finance profitable investment projects, governments which borrow from abroad are less likely to use the proceeds for profitable investment. Fiscal deficits are rarely self-financing, especially if such deficits are chronic, the result of excessive spending and structural lack of fiscal revenues.

The United States' large current account deficits in the 1980s, driven by large fiscal deficits, were a matter of concern for this reason. High budget and current account deficits, the so

called “twin deficits”, led to high real interest rates, a crowding out of productive investment (as evidenced by the fall in the investment rate after its recovery from the 1982 recession) and a reduction in long-run growth opportunities. Chart 6-9 presents the United States current account deficit against the national saving rate, the public saving rate and the national investment rate. By definition, the current account is the difference between national saving and national investment; this identity, however, is obscured by measurement errors. In recent years, there has been a large statistical discrepancy between the income- and the product-side measures of GDP. Because of this widening discrepancy, the current account deficit has widened in spite of the narrowing of the gap between official measures of saving and investment.

The chart clearly shows the “twin deficits” of the 1980s: as fiscal deficits increased in an environment of tight monetary policy in the early 1980s, the U.S. dollar appreciated in real terms and the current account went into a large deficit. The crowding out of productive investment by the fiscal deficit is suggested by the fall in the investment rate between 1984 and 1990 as large fiscal deficits kept real interest rates high. The current account improved during the 1990-1991 recession as the investment rate slumped sharply during the economic downturn.

In the 1990s the fiscal deficit first fell, then disappeared. It turned to surplus by 1998. In spite of this, the current account deficit has increased again. However, this increased deficit can be seen as “virtuous” as it has been driven by a strong rise in the investment rate that has outstripped the improvement in the national saving rate. The gross investment rate rose from a low of 12.2% of GDP in middle of 1991 to 16.0% in the third quarter of 1998. As the current account deficit in the 1990s has been accompanied by rising saving and investment rates, it need

not be considered with alarm. Some have expressed concern about the fall in the household saving rate. However, the overall saving rate is up as both the public sector and the business sector have significantly increased their saving rate. Also, the fall in the household savings rate is less sharp if one takes explicit account of capital gains income.

The high economic growth in the United States since 1993 has featured an investment boom that could not be financed by domestic saving only. Thus, the current account deficits contributed to the strong growth of output and employment during the decade. In a closed economy that could not borrow from abroad or receive foreign direct investment, a surge in investment demand would have led to higher interest rates, and investment would inevitably have been constrained by the supply of domestic saving. Therefore, the accumulation of capital, the growth of output and employment would have been smaller if the U.S. had not being able run a current account deficit in the 1990s. Far from choking growth and employment, paradoxically the large current account deficit allowed faster growth in the U.S. economy.

The Asian crisis and the current account deficit

In the Asian countries that suffered a severe crisis in 1997-98 saving rates were high and large current account deficits were driven by investment booms, not by large fiscal deficits. In spite of being driven by high investment rates, however, the build-up of debt deriving from the Asian countries' current account imbalances became unsustainable because many investments undertaken did not generate returns sufficient to cover the cost of borrowing. Investment is not always a good thing; firms should borrow only as long as the expected returns on the investments

are at least as high as the cost of the borrowed funds. Otherwise, they eventually experience losses, financial crises and possible bankruptcy as their investments do not generate enough funds to repay their loans. The story of the Asian crisis is in part one of current account deficits and foreign debt accumulation caused by booming investment. This investment turned out to be excessive since these economies had already reached sustained levels of capital accumulation. In Asia, there were too many marginal investments in the 1990s that turned out to be not very profitable. The Korean chaebols that - partly because of misguided government incentives - built excessive capacity in many sectors is a vivid example. Throughout the East Asian region the rate of return to capital, while still positive, appeared to be falling in the 1990s signaling a deterioration in the quality of the investment projects.

Moreover, borrowing from the rest of the world is least problematic when the new investments produce goods that can be sold in foreign markets. Foreign debt needs to be serviced and, at some point, repaid. For a debtor country, the only way to avoid permanent, and ultimately unsustainable current account deficits, is at some point to run trade surpluses. If the new investments are instead concentrated in the non-traded sector of the economy (such as commercial and residential investment), they create goods (housing services) that are not usually traded internationally. So, in this case the long run ability of the country to repay its debts through trade surpluses may be limited. For example, some Asian countries in the 1990s ran large current account deficits that financed new and excessive investments in the non-traded real estate sector (residential and commercial building). The investments went bust in 1996-97 because a glut of real estate ultimately caused the real estate price bubble to collapse and lead to

a rapid fall in the price of land and real estate values. Then, the firms and individuals that had borrowed foreign funds (and/or the banks that had borrowed the foreign funds and in turn lent these funds to domestic firms and households) to finance real estate investments experienced financial distress as they became unable to service their loans. They borrowed too much in foreign currency to finance investments that turned out to have low or negative returns. The outcome in Asia shows the danger of running a current account deficit to finance excessive low profitability investments.

The U.S. international investment position

If current account deficits continue year after year, creditor countries eventually become net debtors: every year the increase in the stock of net foreign liabilities equals the current account deficit, leaving aside valuation effects. A clarification of terminology is in order. Increases in a country's net foreign liabilities are not necessarily "foreign debt". Capital inflows which finance current account deficits can take the form of both debt and equity (FDI for example). This arithmetic relation between the current account and the change in the net foreign asset position of the country is shown in Chart 6-10. In the 1970s, the U.S. was a net creditor country. However, the string of current account deficits in the 1980s led to a reduction of net foreign assets and eventually - in 1987 - turned the U.S. into a net debtor country. As the current account deficits of the 1980s were mostly driven by fiscal deficits and low national saving rates, the accumulation of net foreign liabilities of the U.S. was greeted with with some concern. The large fiscal deficits were financed by government bonds, some of which were bought directly by

foreign investors. The increasing net foreign debt of the U.S. was associated with the fiscal imbalance.

Since 1993, however, the current account deficits have been driven by increases in national investment rates. So additional net foreign liabilities have been driven by the need to finance of this investment boom abroad. The foreign financing has taken the form of foreign direct investment, portfolio investment and purchases of U.S. equities (see Chart 6-11 for trends in inward and outward FDI). In this respect, the concerns about the sustainability of this large stock of net foreign liabilities are unfounded; the size of net foreign liabilities is modest, at only about 10 percent as a share of GDP; an increasing share reflects productive lending for investment opportunities; and the U.S. capital stock is large enough to generate the income needed to service it. In the same way in which foreign direct investment and foreign borrowing benefit and enhance growth in developing countries that borrow to finance productive investment, foreign borrowing by the U.S. has sustained and supported a high rate of capital accumulation and economic growth in our country. Fiscal prudence, market competition, free trade, deregulation, greater economic liberalization, creative inventiveness and high productivity of capital have made the U.S. a prime location for productive investment, as the surge of inward foreign direct investment since 1993 attests.

Policies towards the external imbalance

The recent increase in the trade deficit following the Asian crisis has brought back concerns about the effects of trade imbalances. Calls for protection of domestic industries have

been raised based on alleged effects of unfairly cheap imports on import-competing industries. The evidence presented above confirms that the trade balance is a macroeconomic phenomenon and is determined by the overall balance of saving and investment in the economy, not by microeconomic factors such as foreign trade practices and market access. The large trade imbalances of the last few years have contributed to the high economic growth and low inflation rate experience by the U.S. since 1993. In this regard, the calls for protection and trade restrictions are misguided. Most of the worsening in the trade balance in 1998, for example, has not been due to rapidly rising imports -- which grew at a modest rate -- but rather to a fall in exports, mostly to the crisis countries in Asia. Raising tariffs and imposing barriers to trade would not help the U.S. economy in the aggregate, but would exacerbate the problems faced by the U.S. and world economy. Economic recovery in Japan and East Asia will be promoted by the ability of these countries to export goods and services to the rest of the world. As their economies recover, their demand for our goods and services will increase as well, once again fueling our own export growth. Protection would hurt us as well as our trade partners. If the economies currently in crisis in Asia and around the world find their ability to export to the U.S. blocked, not only will their prospects for recovery be hampered, but our own growth prospects will be greatly diminished as well. With trade protection we may be able to reduce our trade imbalance, but this would be a pyrrhic victory. A recession in the U.S. might reduce the current account imbalance (as in previous U.S. recessionary periods). But to have a smaller trade imbalance at the cost of a severe contraction of output would be a dismal achievement. The economic welfare

and well-being of a country are determined by its ability to produce and consume a wider range of goods and services, not at all by its overall trade balance with the rest of the world.

Moreover, given the recent high volatility in international financial markets, changes in U.S. trade policy away from open markets might have serious immediate consequences. Stock markets, exchange rates and other financial assets prices could react negatively to the perception that the U.S. might become more protectionist, inward-looking and ready to start controversial trade actions against trade partners. Given the serious worldwide macroeconomic conditions and the contagious worldwide spread of the financial crisis, it is worth remembering that the Great Depression of the 1930s was exacerbated by the dramatic switch to protectionist policies in the United States and the industrial world. The effects of further stock market declines on households' financial wealth and the effects of a severe slowdown in U.S. growth on real incomes and employment levels would likely be much larger than any benefit received by specific sectors via increased trade protection. Given the increasing worldwide pressures to restrict trade, it is of the utmost importance to maintain an open trade regime in the U.S. and around the world.

In serving as a major engine of global growth, the United States will almost certainly continue to see an increase in its trade deficit in 1999. Of course some sectors, those that are heavily exposed to trade, will experience disproportionate impacts. Nevertheless, the United States must accept a rising trade deficit if the crisis countries are to recover. This means working to counter protectionist pressures at home just as we urge the crisis impacted countries

to keep their own markets open and as we call for Japan and Europe to do their share to support the recovery of demand in the world economy.

6. CONCLUSION

In a period of great market turmoil, the first imperative of the Administration has been to work with the international community to stabilize international financial conditions and to sustain growth in the world economy. No country, including the United States, is an island in the world economy. The growth prospects of all industrial nations will suffer unless we all do our part. This need has been clearly recognized by the United States and its G7 partners. They indicated in September 1998 that the balance of risks in the world economy had shifted. While one never wants to be complacent about price stability, inflation is not currently the clear and present danger it has been for much of the last thirty years. Countries should commit themselves to preserving or creating conditions for sustainable domestic growth. Strong growth in the industrialized countries is a prerequisite for recovery of crisis afflicted economies.

Sustaining America's growth means working to increase competition in our own markets, and remaining engaged in the world economy. The case for open and free commerce is that it forces us to innovate and to compete, ultimately speeding the productivity gains that are the source of improved living standards. The economic case for opening markets to international trade is strong. Trade offers American producers broader markets and it offers American consumers lower prices and a wider choice of goods. This is true even though, like domestic

competition and technological change, it brings challenges when it disrupts established patterns of economic activity.

Beyond working to ensure growth in the industrial world, the United States has focused since the outset of this crisis on the need to contain financial contagion and to restore the confidence of market participants, a prerequisite for capital flows to continue. The Administration has supported the IMF in its mission of providing financial assistance to countries in crisis that are willing to implement the often tough reforms needed to restore economic confidence and strengthen the underpinnings of their economies. At the same time we are working to design and implement the new architecture of the international financial system. The goal is to maintain and expand the free mobility of goods and capital and at the same time to ensure the stability of the international financial system in a world of continued integration and globalization. These reforms of the international financial architecture are discussed in Chapter 7.

Sustaining America's growth means working to increase competition in our own markets, and to remain engaged in the world economy. International openness will continue to promote innovation and facilitate the productivity gains that lead to improved living standards. Trade offers American producers broader markets and it offers American consumers lower prices and a wider choice of goods. Increased competition, both foreign and domestic, requires inevitable adjustment when it affects traditional patterns of production and trade. The case for open and competitive commerce, however, remains strong in spite of the crisis. This is as true for the United States as it is for developing countries: a open trade environment will support the recovery of growth in the crisis-afflicted countries and ensure the continued growth of the world

economy. This is not a time to look inward, but rather a time to continue to expand our vision outward.

At the start of his Administration in 1993, President Clinton declared: "The truth of our age is this - and must be this: Open and competitive commerce will enrich us as a nation...And I say to you in face of all the pressure to do the reverse, we must compete, not retreat." Then, as now, the Administration remains strongly committed to such free-trade, outward-looking, internationalist policies.