INTRODUCTION

For Thailand, Indonesia, South Korea and Malaysia, the much-celebrated “Asian Economic Miracle” came to an abrupt end in 1997. After three decades of virtually uninterrupted expansion, these countries saw their financial systems collapse, their economies falter and millions of their citizens returned to poverty, all within a few months. The financial crisis spread quickly to the Philippines and Hong Kong, and then to Brazil and Russia. That it did not spread further was due as much to good luck as to good planning.

Every country’s financial angst has its own origins and remedies. Earlier crises had often originated in the fiscal exuberance of developing country leaders. The International Monetary Fund (IMF) would then be called in and would “consult” with the errant officials. On the basis of assurances that they would rein in the government’s budget, restore confidence in the banking sector and maintain reasonable price stability, the country would be offered financial assistance from one or another of the Fund’s special facilities. While there is some debate over the general effectiveness of IMF policies, particularly their long-run impact, the Asian crisis presented a very different set of conditions to the Fund. It was triggered not by financial excesses of governments but by those of the private sector. It reflected, moreover, a set of new and more complex factors stemming from the globalization of financial markets that made the crisis both more opaque and contagious. The Asian situation thus required remedies different from those that had been tried in the past.

This paper discusses the major causes of the Asian crisis and comments on the scope and timing of the IMF’s response. It then considers, in light of the IMF’s Asian experience and given the fact that globally-integrated financial markets daily move amounts greater than most countries’ annual GDPs, alternative proposals for ensuring that local financial pressures do not escalate into major crises.

PERSPECTIVE

It is useful to start by recalling the origins of today’s international financial system. In June 1944, even before WWII had ended, the United States and Great Britain convened a group of economists and financial experts from forty-four nations at Bretton Woods, New Hampshire to design the financial/economic architecture for the post-War world. Their goal was to put the pieces of the international financial system back together in a way that would underwrite continued growth and stability and pro-
scribe any return to the destructive trade and financial practices of the 1930s [Acheson, 1969, 81–84]. The Bretton Woods conferences had as their starting point a lucid and comprehensive memorandum prepared by a team of experts that included, among others, John Maynard Keynes, Harry Dexter White and Dean Acheson. Based in part on that document, within three weeks the conferences were able to agree on the main policies and institutions that they believed would create a sound, long-lasting post-War economic and financial system. The main pillars were the International Bank for Reconstruction and Development (the “World Bank”), the International Monetary Fund (IMF), and (after some political maneuvering) the General Agreement on Tariffs and Trade (GATT) 1947.

The shadow of the Depression of the 1930s loomed large over the Conference. It was obvious that European and American follies—inward-looking exchange rate policies, competitive currency devaluations, beggar-thy-neighbor trade practices, liquidity hoarding and the like—had intensifi ed and deepened the Depression. The new IMF was to serve as both a firewall against any recurrence of such practices and a stabilizer of the international monetary system. To carry out these roles, the Fund was granted unprecedented oversight and interventionist authority. Reconstructing Europe’s infrastructure and industry was the charge of the new World Bank. Unwinding the legacy of trade restrictions and moving the industrialized nations to an open, global trade regime was the role of the GATT.

Although the Bretton Woods architecture proved both prescient and durable, it was far from perfect, and its fault-lines soon began to appear. The conferences, for example, had not envisaged the emergence of a new variety of financial crises, one that affected not the industrialized nations but the newly independent developing ones. While this turn had not been anticipated, the conferences had in fact provided enabling language in the IMF’s Articles of Agreement [IMF, 1947, 2] that permitted the Fund to craft responses to the Third World’s fi nancial problems. For the most part they took the form of what would now be called “patches”—ways of working around unforeseen problems by adding new lines of program instructions. The Fund’s patches did help to calm, if not cure, the fi nancial problems of stress-prone developing coun-
tries. 1 Authority for these new programs is implicit in the first Article of the Fund’s Articles of Agreement.

IMF ROLE AND RESPONSIBILITIES

The first Article provides the Fund with considerable, but not unlimited, latitude in discharging its primary stabilizing responsibilities. It states that the Fund is to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income, and to the development of the productive resources of all members; to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depre-
viation; and

To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade [Gavin, et al., 1959, 4–8].

To check on compliance, the IMF was to monitor member countries’ progress toward agreed-upon payments arrangements and provide short-term financing to enable them to deal with transitory difficulties without resorting to measures that might threaten their own or international prosperity.

The IMF’s structure as laid down at Bretton Woods has remained relatively unchanged over the years. Few Amendments have been added since 1945 when the Fund’s Articles were adopted. On the other hand, a large number of patches in the form of special-purpose financing facilities and programs have been added, most during the past two decades.

THE IMF RECORD

Well into the 1960s, the IMF did a credible job of helping the countries of Western Europe stabilize their exchange rates, deal with transitory current account imbalances and build an international monetary system based on convertible currencies tied to the U.S. dollar. The Fund and most observers acknowledge, however, that these successes were made possible by the vast amount of capital transferred to these countries under the U.S. Marshall Plan and successor programs.

Following the liberalization of their capital accounts and the U.S. decision to remove the dollar as the anchor of the international currency system, the major industrialized countries moved toward floating exchange rates. This violated the Fund’s Articles, which were promptly amended to fit the new reality. The Fund was instructed, as part of these new arrangements, to “exercise firm surveillance over the exchange rate policies of members.” In fact, this mandate had little real meaning. The industrialized countries were by then able to most virtually all of their liquidity needs from the private capital markets. Since they had no need for IMF resources, the Fund’s new “firm surveillance” responsibilities [Kenen, 1989, 69–81] were essentially null and void.

Although the IMF continued its annual rounds of consultations with member-country governments, its influence on the policies and programs of the industrialized countries was by now greatly diminished. The IMF’s open membership policy had, however, resulted in a three-fold increase in members classified as “developing countries.” This new group, the less-developed nations of Asia, Latin America and Africa, had become increasingly dependent on the IMF for advice and assistance, especially the latter. The shift in the Fund’s client base brought a new set of needs and challenges. These low-income client countries needed financial assistance that was more concessional (longer grace periods, extended maturities and below-market interest rates) than had been required by industrialized members. And, increasingly, they required relief from foreign exchange debt service burdens that were hobbling their efforts to develop.
Contacts and consultations between the Fund and its member countries have become closer, more frequent and more comprehensive. The Fund’s conventional “Stand-by Arrangements” were now accompanied by full-scale country analyses and country-specific assistance programs. New packages were added to deal with low-income countries’ needs for longer repayment periods and below-market interest rates. The Fund had, in 1963, the Compensatory Financing Facility (CFP) to help these countries overcome temporary shortfalls in export earnings. The CFP was followed in the 1970s and 1980s by an alphabet-soup of new special financing arrangements intended to better meet developing countries’ needs. These included the Extended Fund Facility (1974), the Supplementary Financing Facility (1979), the Structural Adjustment Facility (1986), the expanded Compensatory and Contingency Financing Facility, (1988) the Enhanced Structural Adjustment Facility (1988) and, most recently, the Supplemental Reserve Facility (1997), the latter created to accelerate disbursements to deal with the Asian financial crisis (IMF, 1998).

The purpose of these new program packages was to provide more and easier access to IMF credit to low-income countries. To qualify for such help, the Fund required the country’s authorities to formulate a “Letter of Intent” that spelled out how they proposed to correct the country’s domestic and international financial imbalances. Since public sector extravagance was the cause of many of these countries’ difficulties, IMF “conditionality,” (spelled out in the Letter of Intent) typically called for reducing the central government’s budget, raising interest rates, improving tax collection, devaluing the country’s currency, and preparing a time-bound plan for meeting outstanding external debt obligations.

Fund policy at first required that, in order to gain access to the Fund’s special financing facilities, prospective borrowers had to be current on payments due foreign commercial banks. The Fund thus seemed to rank debt service to foreign banks ahead of a country’s development efforts, and it opened itself up to charges that it had become a bill collector for foreign banks. The debt problems of developing countries, in many cases the legacy of imprudent earlier borrowing, had meanwhile worsened as bank credits dried up and net official assistance declined. Paradoxically, both the World Bank and the IMF had by the late 1980s become net importers of capital from their developing member countries.

The next major IMF patch was the “Brady Plan.” The Plan was framed in 1989 by the staff of the then U.S. Treasury Secretary to deal with a financial crisis brewing in Mexico. The Fund had by then moved away from requiring countries to be current in their external debt service payments as a pre-condition for drawing on its special facilities. The Brady Plan went a step further. It recognized that debt service burdens were crippling the economy of Mexico (and of other developing countries); and it proposed that the foreign banks responsible for Mexico’s staggering debt problems should bear, by means of write-offs or discounting of debt instruments, some of the costs of providing relief. By most assessments, the Brady Plan did help to defuse the gathering Mexican financial crisis. However, it turned out to be a one-time, special-country case. The Plan depended on “voluntary” participation by foreign commercial banks. It has not proved very popular as a means of providing developing countries’ debt service relief (Steinherr, 1989).

While the Fund has continued to provide assistance and advice to its developing country members, it has become increasingly clear that their problems were broadly developmental, rather than narrowly financial. Most developing countries need medical personnel and delivery systems; improved nutrition and education; functioning legal, financial and commercial institutions; skills and technology; and long-term capital investments in infrastructure. Besides these constraints, there is a fundamental mismatch between the short- and medium-term loan assistance the Fund can provide and these countries’ requirements for grants and for long-term, concessional loans for development.

Overall, the developing country financial consensus has in no sense been solved, nor has it gone away. Rather, it was pushed aside by the financial and economic implosion of the Soviet Union in 1989/90. The Fund’s industrialized members pressed the IMF to rush into the breach and to play a role for which it had not been intended and for which it was not well equipped: to macro-manage and bankroll the transformation of Russia and the former Soviet Union from centralized to market-based economies. Neither the IMF’s loans and recommended banking sector reforms nor the ill-advised “shock therapy” (prescribed by misguided but influential “transition experts”) has met with success. IMF loans to Russia now total some $20 billion. The second $640 million tranche of a recent $4.5 billion loan (most of which is earmarked for interest due on past IMF loans) is in arrears as the Russian economy has become increasingly anarchic and dysfunctional. In the meantime, charges of money laundering by, among others, the Russian mafia and some senior government officials, possibly involving the proceeds of earlier IMF loans are, being investigated (Charlton, 1999).

THE ASIAN FINANCIAL CRISIS

In the past two years the Fund has faced yet another problem: the financial crisis that has swept through some of East Asia’s former economic leading lights and has spread from Asia to Russia and Brazil. While the Asian crisis appears to be in remission, at least for the present, recovery has been uneven and uncertain, and many of the conditions that sparked and fueled the Asian crisis remain unaddressed.

It seems like only yesterday—in fact it was in 1993—that the World Bank published its upbeat The East Asian Miracle—Economic Growth and Public Policy (World Bank, 1993). The Bank reported that for most of the three prior decades, the East Asian “tigers,” with South Korea as the leader of the pack, and the “Newly Industrializing Economies”—Indonesia, Malaysia, and Thailand—had generated increases in gross domestic product at the unprecedented rate of 5 percent to 7 percent a year. Questions were raised about whether the “miracle” was genuine in terms of having achieved a shift in productivity or whether it was simply the result of pouring more resources into these economies. Yet the benefits were tangible. An estimated 350 million East Asians had been lifted out of poverty. It appeared that the countries had broken out of the poverty trap and had entered the ranks of dynamic and self-sustaining economies.
Now, less than six years later, that glowing scenario has turned to ashes. During 1997 and 1998, South Korea, Thailand, Malaysia and Indonesia experienced various degrees of financial and economic collapse. Scores of banks and corporations have gone bankrupt, per capita income has plunged, billions in savings have evaporated, millions of workers have lost their jobs and some have taken to the streets. The specter of collapse spreading further through Asia and to other corners of the global economy remains very much alive.

Since the first signs of the impending crisis appeared in each of these countries' financial sectors, one wonders if the IMF understood from the outset what was happening, and whether its remedies were timely and appropriate; or, conversely, if the Fund's prescriptions made a bad situation worse. One of the underlying causes of earlier financial crises in Central and Latin America and in Africa had been excessive spending by governments. Chronic public sector budget deficits had generated price inflation and trade account imbalances that led to overvalued currencies and the flight of capital. The IMF's conventional prescription in such cases called for reducing central government expenditures and increasing revenues by improving tax collections, raising interest rates to dampen speculation and keep funds in the country, devaluing the country's currency to increase exports and contain imports, improving governance and reforming banking. Although serious doubts have been expressed about the Fund's overall, longer-term impact, these remedies appear to have helped restore a degree of fiscal and financial equilibrium in the short run in countries able to muster the political will and public support needed to implement them.3

The crises in East Asian countries, however, reflected few of the characteristics of earlier financial crises in Central and Latin America. Government budgets had been running substantial surpluses, price inflation had been moderate, interest rates were positive, saving rates were high, and current account balances were positive. For most of their "miracle" period, in fact, these Asian countries had experienced, besides stunning rates of domestic growth, rapid expansion of exports and trade account surpluses and a build-up of their foreign exchange reserves [World Bank, 1998, passim].

To promote their exports, the East Asian countries had liberalized their current accounts, but not their capital accounts, and had made their national currencies freely convertible into foreign exchange for current account transactions. Most had also pegged their national currency to the U.S. dollar, thereby all but eliminating exchange risks and the cost of hedging for traders and investors. While it was acknowledged that a corresponding liberalization of capital account transactions would be beneficial in the longer term, these countries' central bankers recognized that large, sudden movements of capital could be risky without a banking system able to prevent such transactions from destabilizing the country's financial sector and economy [ibid., 6]. Nor was it overlooked that restrictions on capital transactions protected owners of domestic firms and industries—usually members of powerful extended families, government officials and, in the case of Korea, the chaebols—from equity dilution and unfriendly takeovers. In the so-called Asian model, enterprises were in any case highly leveraged, and borrowing rather than equity had long been their main source of fresh capital. The debt/equity ratio of South Korean corporations, for example, was over 317 percent in 1996, twice the U.S. level [ibid., 8].

At the urging of the IMF, the United States, Japan and other capital exporting countries, these East Asian countries reluctantly began in the mid-1990s to liberalize their capital accounts. The intended sequence was to open the short- and medium-term end of the capital spectrum to foreign bankers and traders first. Long-term foreign capital transactions remained subject to formal and informal constraints and were to be liberalized "in due course."

Since interest yields were higher in these East Asian countries than in the industrialized countries' capital markets, and since their currencies had been pegged to the U.S. dollar, Japanese, European and American banks and other intermediaries began to pile up what they considered to be risk-free, high-yielding loans. At the same time, domestic banks, start-up financial institutions, corporations and a variety of other private intermediaries in these Asian countries found that they could borrow capital more cheaply and more readily abroad than they could at home. In the mid-1990s, for example, a run-of-the-mill Asian investor could borrow Japanese yen at nearly zero interest, invest in a Bangkok skyscraper, and expect to earn a 20 percent annual return.

From the perspective of both borrowers and lenders, East Asia became the modern-day version of the California gold rush. While world trade grew on average by about 5 percent a year between 1990 and 1997, aggregate global private capital flows grew at nearly six times that rate. Between 1990 and 1997, private capital flows to developing countries rose five-fold, from $42 billion to $256 billion. Nearly two-thirds of that amount went to East Asia [ibid., 7].

In the absence of reporting and monitoring requirements and of virtually any other requirements for transaction transparency, the central banks of these Asian countries had no way of knowing how much their banks, business firms and individuals were borrowing overseas. Even if they had had this information, they lacked the experience, skills and legal system that would have permitted them to moderate or check excessive capital inflows. Nor did the central banks of Japan, the United States, or European countries take soundings of the large amounts of capital moving electronically to East Asia. By 1996, annual net private capital inflows to these four East Asian nations amounted to between 5 percent and 15 percent of their annual gross domestic product (GDP). The Bank for International Settlements reported that in 1996 European Union banks' loans outstanding in East Asia amounted to $318 billion. The corresponding figure for Japanese banks was $381 billion, and for U.S. banks it was $46 billion [ibid., 1].

As the volume of capital transfers grew, confidence soared in real estate and other forms of collateral at greatly inflated prices were used in place of due diligence assessments of borrowers by lenders. At the same time, the quality of collateralized assets declined. With the expectation that outstanding loans would continue to be rolled over, short-term borrowing was used increasingly for long-term investments. Hotels, apartment houses and office buildings were built in Seoul, Kuala Lumpur, Bangkok and Jakarta funded largely by short-term foreign loans, often with only the slightest prospect of earning positive returns in the near future. In South Korea, the chaebols, flush with borrowed funds obtained from friendly, often captive merchant bankers, invested in firms and industries whose debt servicing costs were higher than their prospective net earnings.
new and inexperienced banks and quasi-banking institutions. Nor was any tally kept of the foreign loans that had been taken up in these countries' non-banking sector by private firms, non-banking financial entities, the chaebols, and well-connected private individuals.

The East Asian governments liberalized their banking sectors and capital markets, they initially opened up the short maturity end of these markets. This segment is typically characterized by short-term financial instruments and short-term rent-seeking (quick profits). For these reasons, this segment of capital markets can be highly volatile, with violent swings occurring within hours. Long-term capital, which is more often invested in plant and equipment, infrastructure and equities and cannot be so easily liquefied, was to be liberalized "later." While the reason for this sequence was political, the price paid was financial and economic. Because of the shortage of long-term capital during the prior period of economic boom, short-term credit was used to finance long-term investments. The resulting mismatch of borrowing and lending terms was one of the main ingredients of the Asian financial crisis.

In the industrialized countries, little official notice was paid to the explosive growth of short-term and frequently speculative capital transfers to East Asian borrowers. Moreover, new and complex financial instruments (involved, for example, deep discounts, strips, swaps, and new financial intermediaries such as hedge funds and region- and country-specific mutual funds) introduced new agents of volatility into an already overburdened financial scene. When combined with the ability of foreign and domestic traders and money managers to move huge sums of capital from country to country with a few keyboard strokes, these new factors should have caused alarms to go off in the central banks of Japan, Europe, and the United States. But they did, they were not heeded, and the danger that large, volatile and mis-matched capital movements posed for East Asian nations was ignored.

THE IMF AND THE ASIAN CRISIS

What was the IMF doing all this time? For most of its existence, the IMF has been one of Washington's best kept secrets. More recently, however, it has become a favorite target of pundits and critics of every persuasion. At one extreme are those who are convinced that the IMF doesn't put out fires but starts them, and who suggest that the IMF building in downtown Washington, D.C. should be turned into a parking lot. Others believe that the Fund can be only as effective as its member countries permit, and that while it has made mistakes, it plays a necessary role in the international financial system. Yet another view is that the world of international finance has moved far beyond the vision and capabilities of the existing Bretton Woods institutions, and what is needed is, in effect, a global central bank. Finally some, both inside and outside the Fund, think the organization is fine as it is and simply needs more money to do its job.

The East Asian financial crisis has added to the debate about the IMF's future. A look at the Fund's performance in Thailand, Indonesia and South Korea can help illuminate this discussion [IMF, 1998].
Thailand

By the time Thai authorities called in the IMF fire brigade, the baht had been under attack by investors and speculators for some five or six months. The government had depleted a large part of the country's foreign exchange reserves in a futile attempt to maintain the baht's value, and both economic activity and the exchange rate were in steep decline. In late August 1997, the Fund's Executive Board approved a financial package for Thailand of $4.0 billion, to be disbursed over 34 months. For its part, Thailand, in a Letter of Intent, undertook a set of financial sector reforms that included identifying and closing some 50 non-viable financial institutions and recapitalizing the banking system. To provide the necessary budget for the proposed recapitalization, the Thai government agreed to shift from a budget deficit to a surplus equal to about 1 percent of GDP, in part by raising the value-added tax. Interest rates were to be raised to stem the outflow of investment capital, and the baht was to become subject to a managed float. An initial Fund disbursement of $1.6 billion was approved, not a very substantial amount given the heavy pressures the baht was experiencing.

Three months later, in late November 1997, the IMF Executive Board's review of the Thai situation revealed that, the IMF package notwithstanding, the baht had continued to lose value and the economic slowdown was sharper and more pervasive than Fund staff had anticipated in August. The Fund program was modified, but mainly it reiterated the need for a budget surplus and for major financial sector reforms. In December, the Fund made its second disbursement—a modest $510 million.

As the Thai crisis deepened and as financial distress began to spread to neighboring Asian countries, the Thai Letter of Intent was progressively modified—first in February 1998, and again in May, August and December. Each modification reversed the Fund's initial contractionsary prescriptions. Fiscal and monetary measures were turned from negative to positive in order to stimulate domestic economic activity, to stabilize the baht and to create a much-needed social safety net. Interest rates were reduced and the Fund's previously ordained budget surplus was transformed into a deficit target.

The contraction of the Thai economy continued. Real GDP declined by an estimated 8 percent in 1998. Weak domestic demand was reflected in a sharp drop in imports that produced a current account surplus. The domestic money supply was meanwhile expanded and financial sector restructuring continued. To their credit, Thai government officials resisted the temptation to impose capital and currency controls (as neighboring Malaysia had done, with unexpected short-term benefits for that country's recovery), and sought instead to increase foreign direct investment. For its part, the Fund continued its release of financial tranches: $270 million in March of 1998, $130 million in June and in September and $140 million in December (ibid., 3-4).

Indonesia

The IMF's involvement in the Indonesian crisis began a few months after Thailand and followed an essentially similar pattern. The Fund's initial response followed traditional lines: reduce central government budget expenditures, increase interest rates and float the rupiah. As in the Thai case, this prescription failed to account for the fact that Indonesia's financial and economic stress had originated in excessive borrowing by the private sector rather than by the government. Unlike the Thai case, however, in Indonesia the borrowing spree had involved private individuals, families and corporations rather than banks. Again, the Fund underestimated the severity of the economic downturn and (notwithstanding years of visits and consultation) failed to grasp the breadth and depth of the country's crisis. Fund staff assumed that the economy could be turned around with conventional remedies. Instead, the crisis deepened and spilled out into the streets in the form of angry rioting and looting.

Back in Washington, the IMF Executive Board approved an initial program of financial assistance for Indonesia early in November 1997. Financial support of some $10 billion was committed for a three-year period and $3 billion was released for immediate disbursement. The IMF program was one of fiscal restraint. It included a budget surplus target of 1 percent of GDP, restructuring the financial sector, including closing a large number of undercapitalized private banks and merging of state banks; and a plan for improving the institutional, legal and regulatory framework of the financial system. In addition, foreign trade and investment were to be liberalized, a flexible exchange rate policy introduced and interest rates raised.

During the following months it became clear that the Fund's reform prescriptions and financing were unable to restore confidence in either the economy or in the rupiah. The economy's slide deepened. Following another IMF review, a "Memorandum of Economic and Financial Policies" was issued early in January 1998. Its main new features were a reversal in fiscal policy from contractionary to expansionary, the cancellation of several capital expenditure projects of questionable origin and priority, and, in response to public demonstrations, emergency measures to ensure more adequate food supplies at affordable prices.

The rupiah continued to fall and economic conditions continued to deteriorate. Three months later, in April 1998, yet another review was held, and another "Supplemental Memorandum of Economic and Financial Policies" was issued. It continued the structural reforms of the financial sector and began to address the need for restructurizing foreign exchange indebtedness and the problems of bank closings and domestic liquidity shortages that were stifling Indonesia's banking and corporate sectors. The country's social safety net was also to be strengthened through added support for small and medium-sized firms and new public works programs.

A "Second Supplemental Memorandum of Economic and Financial Policies" followed in June 1998. It acknowledged that the economic situation had worsened and that confidence had been further eroded by social disturbances and a change in government leadership. The budget deficit target was then raised to 8 percent of GDP. New and revised Letters of Intent and "Memoranda of Economic and Financial Policy" followed in July, September, October and November of 1998. As poverty and social unrest spread, each successive Letters of Intent added more strands to the social safety net and reinforced on-going financial sector reform efforts. Following its normal performance-linked disbursement procedures, the Fund provided final financial support in tranches: $1 billion in April 1998, $1 billion in July, supplemented by some...
South Korea

For many of the same reasons, South Korea had also become vulnerable to the contagious financial crisis. Responding to pressures from the United States and the IMF, the Korean Government had removed a number of restrictions on foreign participation in the manufacturing and banking sectors. The government had been an active participant in the banking sector, and links between the chaebols and the banks fed a rapid expansion of unsound investments, much of it funded by short-term merchant bank borrowing abroad. These weaknesses became increasingly visible both within and outside the country. Exports stagnated, the current account turned negative and price inflation accelerated. The Korean won came under increased pressure and foreign bankers and traders headed for the doors.

The Korean government approached the IMF for assistance in December 1997, and a program of assistance and reform was agreed upon. It included comprehensive financial sector restructuring that, among other things, called for closing or recapitalizing scores of undercapitalized merchant banks and severing the long-standing close relationships among the government, the chaebols and the banks. In addition, it provided for further trade and capital account liberalization and for a target budget surplus equal to 2 percent of GDP to fund the recapitalization of the banking sector.

The Fund's staff had seriously underestimated the severity of the South Korean economic recession. Besides writing its conventional prescriptions, the Fund had set a much too short a time frame within which reforms were to be implemented. The Korean economy continued to contract and scores of banks and businesses closed their doors. Meanwhile, a Letter of Intent was agreed upon in December 1997 that essentially reiterated the previous reform regime. As the Korean financial and economic crisis worsened, additional Letters of Intent were issued in January, February, May, July and November of 1998. These prescribed the by-now-familiar remedies but included a few new ones as well: a switch from a budget surplus to a deficit target of 5 percent of GDP; increased social safety net expenditures, financial sector restructuring, including recapitalizing and/or closing banks, debt workouts with foreign creditors, trade and investment account liberalization, an easing of interest rates and greater corporate transparency.

The Fund pared out its financial assistance in tranches tied to Korea's implementation of its Letters of Intent. Some $5.0 billion was disbursed in early December 1997, followed later in the same month by $3.5 billion from the Fund's new Supplementary Reserve Facility and by an additional $2.0 billion at the end of that month. Fund disbursements of financial assistance to Korea in 1998 amounted to $2.0 billion in January, in February and in May, and $1.0 billion in August and in December (ibid., 15-17).
ing off financial problems requires a focused and rapid response; structural reforms cut across many sectors and are longer-term.

It has been suggested that the Fund should leave structural and institutional reforms to the World Bank and the regional banks. This would strip the Fund of its most persuasive reform lever, with no assurance that another financial institution would fill the gap. Moreover, the implicit division of labor presupposes a degree of consensus, cooperation and coordination among the IMF, the development banks and, most importantly, the concerned countries that is highly unrealistic given their divergent interests, objectives and decision-making processes. A further consideration is that in most cases one or another of the Fund’s member countries is likely to be pressing IMF management to go easy on reforms and get the check in the mail. In any event, the IMF’s Asian experience, while less than brilliant, does not indicate the need to separate the organization’s financial carrots from its structural reform sticks—only that they be applied with greater sensitivity to the country’s circumstances, needs and priorities.

The proposal that the IMF rush in with financial assistance raises the issue of “moral hazard.” The usual analogy is that people will worry less about smoking in bed if they have fire insurance on their homes. In international finance, moral hazard arises if lenders and borrowers are assured in advance that the Fund (a government or another institution) will guarantee the repayment of their loans in the event of a financial crisis. In that case, borrowers and lenders might be less concerned with the quality of the underlying assets. Moral hazard may be more of an issue in theory than in fact. It places little value on the time, costs and difficulties involved in obtaining financial guarantees and in collecting on them. In any case, it is doubtful that lenders would extend loans or that borrowers would seek them for doubtful projects even if they might eventually be able to recover their principal in the event of a financial crisis. It should be possible to build enough uncertainty, time delays and ambiguity into guarantee arrangements to forestall unsound lending.

THE FUTURE

The Bretton Woods architecture is showing its age. The economic and financial world the conference envisaged and, in particular, the kinds of problems they expected the IMF to deal with, are history. The question now is whether the Fund’s mandate and patched-up programs are adequate to cope with—and impact—today’s huge, seamless and fast-moving financial markets. This issue is being framed even more broadly in terms of whether to try to upgrade the IMF and the current international financial architecture, or whether to retire it and replace it with new, forward-looking institutions.

This question has brought little in the way of consensus. Upgrading proposals typically include variations of the following:

**Enhanced Transparency and Accountability.** Macro-economic data as well as transactional information should in the future be based on uniform definitions and standards and should become rapidly and

readily available to all public, private and international participants in international financial markets.

**Stronger Financial Systems and Financial Market Restructuring.** The intent is to recognize that the liberalization of capital markets is an essential component of a well-functioning market-based economy, but that it should follow, not lead, the strengthening of financial sector institutions and the establishment of systems to record, monitor and, as appropriate, regulate capital transfers.

**Oversight of Foreign Direct Investment and Regulation of Speculative Flows.** This proposal would involve the imposition of reserve requirements on foreign borrowing or a negative interest rate on short-term withdrawals, as well as the prioritizing of long-term capital investments so that resources would be directed to high priority investments, not to speculative or lower priority ventures.

**Avoiding the Mismatch of Borrowing and Investment.** This proposal would seek to avoid the use of short-term loans to finance long-term investments and to prevent short-term credits from being repeatedly rolled over as a substitute for long-term financing.

In addition to these upgrading proposals, a more fundamental proposal has been made that would require major improvements in the coordination of financial and monetary policies at the international level. In place of current periodic summits and ministerial-level “Interim Committee” meetings, a permanent secretariat would monitor and promote policy consistency and coordination among the major financial-center countries. The secretariat might simply represent an expansion of IMF or OECD monitoring roles and might mainly involve more frequent and/or continuing high-level contact among those countries’ central bankers. An extension of this proposal would establish a mechanism to provide closer coordination among the major security regulatory agencies, including the U.S. Securities and Exchange Commission, in order to ensure the orderly development and operation of international security markets.

Another proposal would make the future IMF a combined international lender of last resort and a manager of potential financial crises, corresponding in essence to the Federal Reserve System in the United States. The Fund, it is argued, is well positioned to perform both functions. As a crisis manager, the Fund would take the lead in formulating and negotiating rescue and workout plans with member countries and their public and private sector creditors in order to forestall financial problems. As a crisis lender, the Fund would take the lead in mobilizing and disbursing country-specific financial rescue packages. To function as a lender of last resort, the Fund would have to be granted authority to create and issue Special Drawing Rights (SDRs).
on an as-and-when needed basis and to allocate them directly to countries in need rather than to countries based on their IMF quotas [Fischer, 1989].

There is a strongly held contrary view that patching up an antiquated system is not the answer. What is required instead is a new Bretton Woods Conference that will visualize and create policies and institutions to meet the future needs of a global financial/economic system. A core institution should be established under this formulation to be a global central bank with the authority to oversee the international financial activities of all member countries, much as the Federal Reserve does for the 50 American states [Soros, 1998]. A step in that direction was in fact taken with the inauguration of the European Central Bank in 1999. The Bank was established to coordinate the monetary and fiscal policies of its eleven member countries—to establish a single currency, the euro, and to prescribe exchange rate bands, budget deficit ceilings, and convergent interest rates for the European Community as a whole. Since high-visibility matters of national sovereignty are at stake at nearly every turn, it remains to be seen how the scope and responsibilities the European Central Bank develop [Reuters, 1998]. There is also a suggestion that we are already on the way to the de facto creation of three currency areas—a European euro area, an Asian yen area and a North American dollar area. Whatever its pros and cons, this type of trilateral arrangement would surely facilitate the coordination of international financial policy.

These micro-measures would do little to ensure greater international financial stability and, presumably, fewer contagious financial crises. But on the larger question of architecture for the future, reams of papers and hours of discussions have produced little in the way of ever-arching concepts or consensus. What has been produced so far comes nowhere near the vision and intellectual content of the architecture that emerged from Bretton Woods a half-century ago. This suggests that the needs and designs for such future architecture are too opaque and complex to be captured by a series of ad hoc meetings, papers and piece-meal proposals. What is required is an approach that is consistent, comprehensive, and systemic. In the view of many observers, that can happen only if and when the United States takes seriously its role as leader of the new global economy. A decisive step in that direction would be for the United States to convene a "Bretton Woods II" Conference and invite leading experts from all major nations to contribute to the design of the economic and financial architecture for the coming decades.

The lack of an overall economic-financial blueprint is not far want of expertise or analytical tools. Rather, it is because patching up the old Bretton Woods system has worked fairly well so far, and for Washington and other capitals, that is the safest and least contentious route. The problem is that this piece-meal approach will not meet the exigencies of the new international economic-financial paradigm that has been created by the conjunction of the "triumph" of market economics and the internationalization of information and technology. Individuals and firms from every corner of the globe can now buy, sell, and invest in what is a virtually seamless, timeless, and borderless global economy. All that they require is a computer, a modem, a telephone line—and financing.

With no visible signs of a multilateral initiative to meet this latter need, an ad hoc informal financial network has emerged pretty much spontaneously to fill the vacuum. Its main features are two: the de facto linking of financial markets around the world, and the nearly total absence of oversight, regulation or control. This stopgap arrangement has proven capable of financing transactions amounting to trillions of dollars, yen, marks and sterling a day. One of its less salutary features, however, has been the relative ease with which it can be manipulated by speculators and predators to bring down vulnerable, but otherwise viable, economies such as those in East Asia.

Presumably near the top of a Bretton Woods II agenda would be the question of how best to consolidate the newly created financial market linkages within an integrated financial system that will serve the larger objectives of maximizing benefits, minimizing costs and increasing stability across the entire international commercial and financial spectrum. Subsidiary issues, including transaction transparency, accountability, oversight arrangements, and the future roles of the IMF and the World Bank, which so far have been mainly discussed as discrete topics, would also be subsumed by broader considerations of the future economic-financial system as an integrated whole.

Another agenda item for Bretton Woods II would presumably be the unfinished (some would say restarted) business of Third World development. This need was foreseen by the conferences at Bretton Woods, and neither the World Bank nor the IMF was initially mandated or equipped to take on the task of development. Their responses have been a series of improvisations, some of which have yielded significant benefits. In other cases, however, their efforts have been less than successful—as in the recent Asian crisis. A fundamental flaw in both agencies' approach to development (a product of their original mandates and operating principles) has been the expectation that within a decade or two the developing countries would be able to repay their Bank and Fund borrowings and still have foreign exchange left over for development.

In summary, major changes in the global economy during the past decade have exposed the shortcomings of the patched-up Bretton Woods arrangements and the folly of continuing along that path. Needed now is new economic and financial architecture that, among other things, can deal with the global economy and develop an effective approach to Third World development. Efforts to design such a forward-looking blueprint would be best undertaken in an international setting with participation by all important nations. It is suggested for this purpose that the United States convene a second Bretton Woods Conference. It is likely that most concerned countries would applaud such an initiative and would send their best and brightest financial and economic experts to participate. Like the conferences at the first Bretton Woods, these experts would be charged with conceiving and designing the next century's international economic and financial architecture. One would hope they would respond to this challenge no less brilliantly than did their esteemed predecessors.
NOTES

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1. An assessment of whether the IMF's prescriptions have helped or hindered the recovery of Latin American and African countries is presented by raisin, H. and niemimke, L. elsewhere in this journal. the fact that discussions of the IMF's World debt relief initiative for "Highly Indebted Poor Countries," first announced in September 1989, continued at the recently concluded annual meetings of those organizations adds weight to the view that the IMF has had only modest success in helping such countries deal with their external debt problems.

2. This paper is concerned primarily with the development of the Asian crisis during 1997-98.

3. See Note 1 above for an assessment of the IMF's successes and failures.

4. Later data were not available at the time of this writing. However, detailed, up-dated data on capital transfers are presented in unctad's 1990 World Investment Report.

5. The theoretical basis for the observed pattern of East Asia's financial sector stress, expansion and instability leading ultimately to crises (the so-called "Minsky Hypothesis") was formulated by Minsky (1990). the "Minsky Hypothesis" has been expanded and elaborated to take account of contemporary conditions (such as partial market liberalization and the sequencing of liberalization) by Arestis and Glickman (1999). for a discussion of the sequencing of financial market liberalization see Edwards (1998) and McKinnon (1998).

6. While the East Asian crisis appears to have moderated, its causes have still to be addressed. In this connection, u.s. Treasury Secretary Robert Rubin, in a major policy address on April 31, 1999, indicated that the spring meeting of G-7 countries (concurred with the meeting of Fund Governors) would take up a "powerful program of reform." the program is expected to include a new IMF "package" in the form of a window that would permit the use of IMF financial resources to preempt an impending crisis, greater private sector involvement in resolving future financial crises, and $70 billion of additional debt relief for heavily indebted developing nations.

7. An assessment of the IMF role in the Korean crisis that is relevant to other affected East Asian countries is presented in nnn (1998).

8. A standing joke in developing countries has it that the initials "IMF" stand for "It's Minsky Failure!"


10. The elements of a possible future international financial structure are presented in terms of "seven building blocks" by Camdessus (1998).

REFERENCES