What Kind of International Financial Architecture for an Integrated World Economy?*

by

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1. Introduction

The financial crisis that broke out in Thailand in July 1997 and then spread to other parts of East Asia has had devastating effects on the economies involved. It brought about a deep recession, causing a sharp decline in living standards, rising unemployment, industrial breakdown, and social dislocation. In the international dimension, the foundations of the international financial architecture were severely shaken by the East Asian financial crisis of 1997-98, although two previous crises in the first half of the 1990s – the ERM (Exchange Rate Mechanism of the European Monetary System) crisis of 1992-93 and the Mexican crisis of 1994-95 – were also region-wide crises.

Three region-wide crises in the 1990s have shared a common characteristic in that those crises gave rise to the exchange rate collapse. However, the two emerging market crises have been widely characterized as the financial crises of the twenty-first century, clearly distinguished from previous balance of payments crises.\(^1\) The ERM crisis was primarily a currency crisis and the industrial countries affected did not experience a serious banking crisis with a disruptive impact on the real economy except for Scandinavian victims, Sweden and Finland. Great Britain and Italy – countries that were the first to abandon the peg of the sterling and lira to the German Mark – did not suffer a serious deterioration of macroeconomic indicators.

In his recent paper, Eichengreen (2000c) asserts that Europe is different from developing countries. Europe’s developed, diversified economies are less volatile and its financial markets are deeper. As in the U.S., governments and firms in Europe have long been able to make long-term loans in their own currencies. Another advantage

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\(^1\) Michele Camdessus named the Mexican crisis “the first financial crisis of the 21st century.” See Camdessus (1995).
unique to Europe is a region-wide commitment to political integration and monetary cooperation whose credibility somehow seems to hold from 1992. Latin American and Asia, for that matter, have so far made an effort for regional commitment after Europe, but the development in those emerging market continents is of an entirely different sort from the kind Europe has. As also pointed out in Eichengreen (2000c), however, the ERM crisis was a predecessor of the Mexican and Asian crises in the sense that both private capital movements and domestic financial fragility played prominent roles.

As shown in Tables 1-3, the associated output losses in the ERM crisis were more limited than in the Tequila and the Asian crises. However, the crisis-affected countries of those three region-wide crises have shown remarkable V-shaped recovery, despite variation in the adjustment pattern in each crisis. By the same token, the ERM crisis and two full-fledged emerging market crises invited a heated debate over the causes of crisis. The first-generation crisis model (e.g. Krugman, 1979; Flood and Garber, 1984) explains excessively expansionary macroeconomic policies and resultant worsening current account imbalance as the primary cause of precipitating speculative attack. In contrast, the second-generation model (e.g. Obstfeld 1986) stresses the causal role of changes in market participants’ expectations and concomitant speculative attack as a major trigger to precipitate policy change that validates the expectations. As noted by Garber (1996), however, there exists the possibility of observational equivalence of crisis development between the two models.

This paper does not attempt in any detail to disentangle the causes of the crises in the 1990s. In sum, our presumption is that both economic fundamentals and market sentiment were intertwined in leading to the crises. More importantly, those three region-wide crises have systemic implications to the globally integrated financial markets and the international financial architecture. In the context of a capital-account
dominated crisis, capital-account liberalization tends to heighten financial risks. Capital surges and abrupt reversal of capital flows were conspicuous in those three crises, as shown in Tables 4-6. Most of EMS countries removed capital controls in the years leading up to the crisis (Eichengreen, 2000c). In Mexico, ambitious structural reform program with capital market opening invited the ensuing surge in private capital inflows which allowed Mexico to finance current account deficits on the order of 7 percent of GDP in 1992-94 (Edwards and Savastano, 2000; Sachs, Tornell and Velasco, 1996). In East Asia, even partial but premature and mismanaged capital account liberalization led to a surge in borrowing by private sector with unwarranted exuberance until the bubble crashed in 1997 (Furman and Stiglitz, 1998; Radelet and Sachs, 1998).

Current arrangements for integrating emerging market economies (EMEs) into the global financial system are still defective. In the eyes of many EMEs, few of the structural deficiencies of the international financial system that also contributed to crisis have been sufficiently rectified. Along with consistent and lasting structural reforms in East Asia, creating a new international financial architecture would need to be more balanced; it should address the problem of market failures that beset international capital markets and that often prompt financial panic and herd behavior. Even if the most ambitious architectural reform might not forestall a future financial crisis, a new international financial architecture should temper the depth and scope of subsequent disruptions in the aftermath of the inevitable next financial crisis.

Since the East Asian financial crisis of 1997-98, numerous proposals for reforming the international financial system have been put forward. From the viewpoint of the East Asian countries, relatively little has been accomplished vis-à-vis reducing the degree of instability in the international financial system and improving its capacity to manage crises when they occur. Thus, additional reforms are needed both to better
prevent such crises in the future and to respond more effectively to the painful disruptions that will inevitably occur. As was in the Mexican crisis of 1994-95, however, the appetite for radical reform of the international financial system has receded considerably in the wake of global recovery. Signaling this new perception, at their meeting in Cologne in June 1999, the G-7 Finance Ministers explicitly ruled out the possibility of creating any new institution and made it clear that their aim would be to work with the existing system, strengthening it when necessary.

There is nothing wrong with incremental change as long as it yields positive outcomes. However, the reality is that the already slow progress would not safeguard financial stability in the emerging market economies. As long as the structural problems on the supply side of international capital are not adequately addressed, the East Asian countries will remain as vulnerable to future crises as they were before. Would the international community need another global crisis or two before reaching the political consensus that seems almost impossible at this juncture?

In what follows, we will examine various architectural reform issues in light of the East Asian financial crisis. Because the international financial architecture covers such a broad area, this paper focuses on a few selected issues. Section 2 discusses the reform of international financial institutions. Section 3 examines the current process of setting and enforcing international standards. Section 4 deals with bailing in the private sector. Section 5 examines the issue of exchange rate regimes and capital controls. Section 6 discusses problems created by highly leveraged institutions (HLIs) and policy issues to properly regulate those institutions. Finally, section 7 considers an alternative safeguarding scheme – the so-called “regional financial arrangements” – to supplement and complement the existing global financial architecture.
2. Reform of International Financial Institutions

2.1 Role of International Lender of Last Resort

The debate on the need for an international lender of last resort (ILLR) dates back to the inception of the Bretton Woods system. The British proposal under the title “Proposals for an International Clearing Union” preserved all of the most distinctive features of John Maynard Keynes’ approach. The proposal was centered on establishing an International Clearing Union, which would issue a new international currency to be called bancor, and provide automatic financing for current account deficits. However, the IMF was built upon the alternative proposal prepared by Harry Dexter White, Assistant Secretary of the U.S. Treasury, under the title “Suggested Plan for a United and Associated Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations.” The U.S. proposal was based on the idea of a credit union, “in which each member’s access to balance of payments finance was to be based on the quota it contributed to the common pool and on a reciprocal commitment to grant credit to other members” (Giannini, 1999).

The issue floated up again in the 1970s when the dollar crisis of August 1971 constituted a threat to the Bretton Woods parity system. With the collapse of the rule-based international financial order between 1971 and 1973, most industrialized countries moved toward floating, not so much because this was an agreed solution, but because it emerged out of a failure to produce an agreed solution (James, 1996). Furthermore, the international activity of commercial banks increased dramatically with the advent of the Eurocurrency markets and the need for recycling the sizeable oil surpluses of OPEC countries complicated the international monetary order (De Bonis,
The issue of ILLR may be simplified into two questions. The first is whether there is a need for an international lender of last resort. If so, the second question is what institutions, or group of institutions, should assume the responsibility. According to Kindleberger (1973 and 1989), the international dimension of crises makes a case for such a global institution. When a crisis is unfolding, countries may face limited access to capital markets even though they are implementing appropriate policy corrections. As a domestic lender of last resort can act quickly to stem a bank run of an illiquid but solvent financial institution, an international equivalent can be expected to play a similar role not only in enabling an illiquid but solvent country to survive, but also in arresting contagion to other countries. In other words, the justification for public intervention in the form of official financial institutions, at both the national and international level, is related to the need for corrective action in order to overcome the problems derived from inefficient or missing markets.\(^2\)

As for the second question, either the central banks or major financial center institutions had assumed the role of an international lender of last resort, be it informal, until the Bretton Woods institutions were created in 1945. Yet even the Bretton Woods institutional setting did not suitably bring forth a full-fledged international lender of last resort (De Bonis, Giustiniani, and Gomel, 1999). Instead, the IMF was created as a quasi lender of last resort or, as Fischer (1999) puts it, a crisis manager-lender in order to provide temporary liquidity assistance to its member countries needed to correct their balance of payments deficits. However, the principles governing the IMF’s lending

\(^2\) Many conservative economists, including Schwartz (1986), Meltzer (1986), and recently Bordo et al. (1996), have challenged Kindleberger's argument for intrinsic instability in the world financial market without an international lender of last resort. They provide a counterargument that markets are intrinsically stable, efficient and smoothly operating and that contagion effects are negligible. They argue that an international lender of last resort would create a greater problem, rather than a solution.
activities cannot be reconciled with the classic *Bagehot* rules. Furthermore, as long as the IMF cannot issue a world currency, the role of an international lender of last resort is inevitably limited.

The current discussion on the reform of the international financial system effectively rules out the possibility of creating a world central bank. Eichengreen (1999), for instance, dismisses the idea of a global central bank as quixotic. This leads to the question of whether and how the existing Bretton Woods institutions should be reconstructed to serve as a lender of last resort. On this question, there appears to be at least four competing approaches.

The first approach, which reflects the view of Kindleberger’s detractors, proposes that even the limited role of the IMF as a quasi lender of last resort should be further circumscribed because it has become the source of moral hazard in the global financial system (see also Capie, 1998 and Goodhart, 1999). Although there is no empirical support for the moral hazard problem associated with the IMF (Bergsten, 2000a), the Republican-led majority of the Congressionally appointed *International Financial Institutions Advisory Commission* (known as the Meltzer Commission) calls for drastically shrinking both the scope of IMF intervention and the role of the World Bank in development finance. The majority report advocates turning most development finance over completely to private capital markets, except in the poorest countries, and restricting IMF lending to countries that pre-qualify according to strict free market criteria.

As opposed to the idea of drastically reducing the role of the IMF, it is possible to create a global crisis lending mechanism by strengthen the IMF as a quasi lender of last

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3 Bagehot set out his proposals first in *The Economist*, of which he was editor in the middle decades of the century, and then in Lombard Street (1873). In the latter, Bagehot set out three principles governing the Bank of England: (1) lend freely to solvent borrowers; (2) at a high rate of interest, (3) on a good banking securities. See Capie (1998) and Goodhart (1999) for further discussion.
resort and by the same token complementing it with the liquidity support of the G-7 countries. This is the second approach.

In the current international context, it is not clear whether the IMF, or IMF and World Bank combined together, could even assume the role of a quasi lender of last resort. The experiences with managing the Mexican and East Asian crises in fact have shown that the IMF simply did not have enough resources to lend in sufficient volume to arrest a financial panic, let alone preventing it, without bringing in the liquidity support of the G-7 countries. In view of the critical role played by some of the G-7 countries in managing the Mexican and Korean crises, the IMF together with the G-7 countries could develop an institutional lending arrangement that adheres to the Bagehot rules in crisis lending and substitutes for the role of an international lender of last resort. To be viable, such an arrangement would require (i) a substantial increase in the amount of resources to be deployable on short notice at the Fund and (ii) institutionalization of a second line of defense primarily supported by the G-7 countries. This is the second possible approach for the reform of the role of the Bretton Woods institutions as an ILLR.

Major steps have been taken in recent years to increase the amount of resources EMEs and other DCs could draw from the IMF for their provision of liquidity. Notwithstanding these efforts, which have led to a series of quota increases, the size of the IMF financial resources today, as a proportion of the total GDP of its member countries, is only one third of what it was at its inception in 1945 (see Table 7).

Another problem of the IMF facilities is that they cannot be disbursed in a speedy manner to these countries suffering from liquidity shortage. Realizing this limitation, the IMF and the World Bank have introduced new facilities intended to increase the amount of resources to be deployed on short notice. They include the Emergency
Financing Mechanism introduced after the Mexican crisis, Supplemental Reserve Facility (SRF) established in 1997, the Contingent Credit Lines (CCL) introduced in April 1999 at the IMF, and the supply of guarantees on the part of the World Bank. However, serious questions still remain as to whether these facilities could be activated in time to guard against any speculative attack.

While the IMF plus the second line of defense supported by the G-7 could be a viable arrangement, it may not be readily acceptable to many EMEs and DCs. By its nature, the enlarged arrangement would be subject to political pressure, especially from the G-7 countries that contribute the largest share of its financial resources. The second possible approach may need to justify a system of global financial governance controlled by the G-7 countries.

A third approach to reforming the IMF as a quasi lender of last resort emphasizes the need of creating regionally based monetary funds to complement the role of the IMF (Rose, 1998, Bergsten, 2000b). As will be shown in section 7, the idea of establishing a regional monetary fund in East Asia has been strongly opposed by both the IMF and the U.S. Treasury on the ground that regional funds could weaken the role of the IMF and also aggravate the moral hazard problem.

The fourth view is directed to a limited reform but an even larger global role for both the IMF and the World Bank. A minority report of the Meltzer Commission, written by C. Fred Bergsten and signed by several Democrats, supports this approach. The recent meetings of the IMF’s International Monetary and Financial Committee (IMFC) and of the Finance Ministers and Central Bank Governors of the G-7 countries also rejected virtually all of the radical proposals of the Meltzer Commission majority. They reaffirmed the central role of the IMF as a quasi-lender of last resort, acknowledging the potential risk of moral hazard but placing it in a decidedly secondary position.
While in broad agreement on the role of the IMF, the G-7 Finance Ministers, who convened on July 8, 2000 in Fukuoka, Japan, recommended two pricing changes in the management of the IMF facilities. One change is to increase the interest charges on all non-concessional facilities, with the rates set on a graduated basis, depending on the duration of the outstanding obligation. The new pricing structure is intended to establish more consistent incentives across facilities, encourage access to private capital, deter inappropriate large-scale access to, and discourage prolonged use of IMF resources.

The increase in the interest rates is not without problems, however. If the SRF penalty rate were to be extended to all non-concessional IMF lending, it could worsen the underlying external position of the borrowing country rather than improve it. When countries finally decide to ask the Fund for emergency loans, they are already in dire circumstances where the private sources of international financing have almost dried up. For the SRF, the penalty rate is reasonable, but the initial rate of charge on other non-concessional IMF loans that is as high as the SRF rate may not be justifiable, because the decision to go to the Fund is likely to be less price-elastic.

Furthermore, whatever the economic merits, the decision to go to the IMF is politically costly from the viewpoint of the incumbent government since domestic political opponents may take advantage of the relatively powerless authorities. In most cases, the crisis-affected countries tend to request IMF loans late in their survival games. In this regard, a “conditionality-equivalent” interest rate is high enough to deter, at least, the moral hazard of the incumbent government (Goldstein, 2000). An additional interest premium cum conditionality would be excessive and, in most cases, make it more difficult for borrowers to service their external debts.

A second element of the pricing change of the IMF facilities involves reducing the rate of charge and the commitment fee on CCL resources. The CCL was established in order
to protect innocent victims from the perils of speculative contagion. These “good guys” would have pre-qualified for CCL access on the basis of well-defined and transparent standards of sound economic and financial policies. By making the CCL easier and more attractive to use, any currency contagion would quickly come face-to-face with a large liquidity backstop. However, there still remains the real issue of the mechanism to select a few “good guys with first-class policies” from the many EMEs.

A selection process for pre-qualified countries has a trade-off between eligibility and extra burden for complying with pre-qualification standards. Moreover, as long as countries applying for the CCL could be interpreted as countries in trouble, not many countries are likely to apply for the CCL even if the rate of charge and the commitment fee on CCL resources are significantly reduced below that on the SRF. A post-activation review conducted by the IMF could in theory reassure the market that the economic situation for a pre-qualified country requesting activation of the CCL is not directly related to its own policy mistakes, but developments largely beyond its control. But the question still remains as to whether the market will accept the IMF’s assessment. For these reasons, eligible applicants for the CCL are likely to be limited, and hence a larger group of innocent victims to speculative contagion would be excluded. The IMF should therefore be more cautious in exercising its leverage in admitting eligible candidates by imposing the stringent pre-qualification requirements based on its discretionary policy preference. If this were not the case in practice, many potentially eligible EMEs and DCs would find no incentive to apply for the CCL.

2.2 Conditionalities versus Pre-Qualification

Four standards are considered most crucial in judging progress towards meeting international standards: (I) the Special Data Dissemination Standard, (ii) the Basle Committee’s Core Principles for Banking Supervision, (iii) the Code of Good Practices on Fiscal Transparency, and (iv) the Code of Good Practices on Transparency in Monetary and Financial Policies.
The IMF’s clear mission is to promote financial stability and macroeconomic prosperity of the member countries. In dealing with the recent financial crises, however, the IMF has included in its conditionality a large number of reforms in many sectors including the corporate and public sectors and the labor market. In the aftermath of the East Asian crisis, the IMF’s structural policy conditionality has become the target of intense criticism. In a recent paper, Goldstein (2000) describes a number of criticisms leveled against the IMF conditionality. One concern is that the IMF structural policy conditionality is often viewed by developing countries as so costly and intrusive as to discourage to seek Fund assistance during crisis. A second criticism is that structural reforms in a crisis will serve to frighten private investors about the seriousness of the problem, which will make it more difficult to restore market confidence. A third is the biasedness of the Fund’s conditionality against developing countries. The Fund often asks developing countries to carry out reforms that it would not ask of developed countries. The above three concerns are well worth noting, but they are secondary and are not addressing the fundamental problems of the IMF conditionality. One such problem is that when the IMF strays from its core competence and expertise of macroeconomic and financial policies into longer-term structural reforms, the Fund may not be able to manage financial crises in an efficient manner.\(^5\)

Feldstein (1998) was the first to criticize the IMF for moving beyond its traditional macroeconomic adjustment role by including in the program a number of structural elements. However, Fischer (1998) in his reply to Martin Feldstein (1998) asserts that the basic approach of the IMF to these crises has been far better than if the structural elements had been ignored or the Fund had not been involved. Eichengreen (2000b)

also supports the Fund’s view that the IMF cannot realistically keep its hands off the structural reform business. He asserts that if there is one lesson to be learned from the Asian crisis, it is that structural weaknesses in prudential regulation, bankruptcy and insolvency procedures, and corporate governance can greatly aggravate macroeconomic instabilities.\(^6\) The IMF may have to continue to address these matters, but in case they do, they should do it in a more sensitive manner to the social, cultural and historical circumstances of its member countries.

The Meltzer Commission, on the other hand, was extremely critical of the existing approach to Fund conditionality. The majority on the Meltzer Commission concluded that “detailed Fund conditionality has burdened IMF programs in recent years and made such programs unwieldy, highly conflicting, time consuming to negotiate, and often ineffectual.” It recommended permitting the Fund to only lend to the countries that pre-qualify for assistance by building impeccably strong banking systems. However, rigid rules for IMF lending are patently unrealistic. Lending only to the countries that pre-qualify for assistance would mean that the international community would be indifferent to the fate of countries that do not meet the pre-qualification requirements, or to the instability that might be generated by systemic risks in the global financial markets. For these reasons, the Fund’s conditionality cannot easily be replaced by the pre-qualifications proposed by the Meltzer Commission. However, those conditionalities attached to the Fund’s programs should not go beyond its core competence that helps crisis-affected countries regain access to international capital markets. At the same time, they should be more carefully tailored to the very different economic conditions of the EMEs and provide sufficient liquidity in a prompt manner with a proper menu of policy.

\(^6\) Many academic researchers and pundits have argued that the East Asian crisis was mainly attributable to deep-seated structural weakness. Blame has been heaped on “the Asian way.” Unfortunately, arguments for “Asian cronyism” seem to be the redoubt into which the Washington consensus has sought refuge, so that defects in accountability, transparency, and governance in East Asia eventually get punished by singularly conscious and rational market (Montes and Popov, 1999).
advice.

The second critical problem of the IMF conditionality is that multiplication of reform measures and the reliance on structural benchmarks and program reviews have made it difficult for Fund borrowers to comply with the conditionality. They have also increased the uncertainty the borrowers have to face in a crisis situation. In the East Asian crisis countries, which received IMF assistance, short-run policy goals were not necessarily consistent with medium-run structural reform objectives. Restructuring and reform would be imperative to not only minimizing the likelihood for an occurrence of the crisis, but also building a strong foundation for the recovery of sustainable growth. However, a wide array of reform packages would entail institutional reforms to take time. Structural reforms are medium- or long-run development issues that cannot be easily achieved in a short span of time. If pursued aggressively without due consideration of implementation difficulties, structural reforms could delay economic recovery or would end up being perfunctory gesture (Park, 2000b).

2.3 Governance of the IMF

The G-7 Finance Ministers acknowledged that for the IMF to maintain its legitimacy, credibility, and effectiveness as a global institution in the international financial system, it is essential that the IMF’s decision-making structure and its operation remain accountable. This announcement may be seen as a welcome sign of progress and shows that the IMF is now examining the formula for calculating country quotas, which need to be able to reflect changes in the world economy.

The structure of the IMF is similar to that of a credit union. Thus, the IMF should be a universal institution working in partnership with all its members, based on their shared
interests. However, unlike a typical credit union, there is a clear demarcation between net depositors (lenders) and net borrowers. Industrial countries constitute the majority of lenders, whereas EMEs and DCs make up practically all of the borrowers of the IMF. A few rich industrial countries control the decision-making process as well as the operations of the IMF. Given this dominance, one could legitimately raise the concern that the IMF may be “too responsive to its principal shareholders, which are high income, international creditor countries whose interests do not necessarily coincide with those of the global society as a whole” (Gregorio, Eichengreen, Ito, and Wyplosz, 1999).

In order to redress the imbalance between industrial countries and EMEs in managing the IMF, EMEs and DCs should be given the opportunity and be prepared to contribute more resources for the operation of the IMF. Commensurate with their enlarged contributions, the EMEs and DCs should be accorded greater representation both on the board of directors and in management. Many EMEs are more willing, and able, to share the burden of financing various IMF credit facilities than ever before. This issue of representation will become more contentious in the future, if the IMF is given a central role in the surveillance and enforcement of various standards.

One should, of course, recognize that the IMF is an international institution providing the public good of contributing to international financial stability. Crisis management and prevention do have externalities, and are not only the responsibility of EMEs and DCs but also of the advanced countries. Looking into the future, the IMF will mostly be lending to EMEs and DCs in an emergency, and will serve as their crisis manager (Fischer, 1999). The IMF would seldom lend to the G-7 countries even when they were

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7 The collapse of the par value system in 1973, combined with the growth of international capital markets, made the IMF irrelevant as a source of finance for industrial countries. No major industrial country borrowed from the IMF after 1976 and its financing role therefore focused only on developing countries, with countries in transition being added in due course (Ahluwalia, 1999).
in a crisis. It is only natural and logical for EMEs and DCs to have a greater voice in managing the organization that is primarily serving as their crisis lender-manager.

Industrial countries are likely to object to the idea of giving EMEs and DCs larger representation in running the IMF. They may argue that without the dominant participation of the industrial countries, the IMF may suffer from leadership problems, deterioration of the quality of staff output, and laxity in the enforcement of standards and loan conditions. If the decision-making process at the IMF is not politically neutral, and for this reason the EMEs and DCs cannot expect more active participation in the IMF decision-making process, then the G-7 and the IMF should consider amending the IMF Articles of Agreement to strengthen the independence of the Executive Board and give the Fund financial independence (Gregorio, Eichengreen, Ito, and Wyplosz, 1999).

The rule requiring an 85 percent supermajority for important changes in IMF policy should be changed as well. In an age when European and Asian governments complain that the Fund too often allows itself to be used as an instrument of U.S. foreign policy or “Wall Street-Treasury Complex,” giving the U.S. effective veto power undermines the legitimacy of the institution worldwide (Eichengreen, 2000b). Reform of the procedure for appointing the Managing Director is imperative, so that there is a more open process and candidates are considered on their merits. The Executive Board should be more independent, for essentially the same reasons that it is desirable to make the board of a national central bank independent of the government.

While it is easy to advocate such political reforms for transforming the IMF itself as a more equitable and legitimate institution, there is no simple politics. For quota reform for example, increased voting rights for currently underrepresented members would be allowed only when currently overrepresented members agree to reduce their proportionally greater voting rights. Since any reallocation of quotas and voting rights is
seen as a zero-sum game, even perfectly designed quota formula would not satisfy political interests of members involved. Blecker (2000) proposes an idea that “one could link a country’s willingness to join the good housekeeping club via best-practice financial supervision and other types of economic reforms, with the country obtaining a larger quota and winning greater voting rights at the Fund.” Should efforts for good housekeeping have continued among the emerging market members, international political reforms would be able to come out of the existing inertia.

3. International Standards and Codes

Recent financial crises have underscored the idea that domestic financial institutions should be supervised and regulated adequately, since structural deficiencies such as laxity in risk management, poor governance, inadequate loan classification, and loose loan-loss provisioning could invite crises and serious contagion. As a basic national financial infrastructure, a growing number of proponents suggest establishing a set of international standards and encouraging countries to adopt them. Harmonization of standards is also expected to achieve domestic financial stability (Eichengreen, 1999a).

The development and adoption of common standards is likely to reduce transaction costs in the process of financial integration and therefore foster international trade and investment, as well as to increase transparency and reduce moral hazard. Minimum standards are needed to reduce uncertainty about the substance of law in different jurisdictions (Pistor, 2000).

While the establishment and enforcement of international standards is an important step towards building a legal architecture for global markets, harmonization has met serious challenges on theoretical as well as political grounds. This section discusses
some of these challenges.

3.1 Standardization versus Regulatory Competition

In a recent paper, Pistor (2000) argues that the existence of a fairly well developed, well functioning domestic legal infrastructure is a precondition for the success of the reforms related to standardization. When this infrastructure does not exist as in most developing countries, reforms in accounting standards, securities legislation, insurance legislation, and corporate governance in an emerging market economy could become faux and superficial. Harmonization of standards and codes is often believed to accelerate the process of legal convergence, which is in turn expected to reduce transaction costs for transnational investors and improve the quality of legal institutions in the host countries. In contrast to this conventional view, Pistor argues that standardization could impede the development of effective legal systems in emerging market economies for a number of reasons.

Standardized rules and codes can be fitted into domestic legal systems and enforced, only if they are compatible with other bodies of law that already exist in the standard receiving legal system. In the absence of complementarity between the new rules and pre-existing legal institutions, standardization may distort rather than improve the domestic legal environment. This is because, given the differences in diverse legal cultures, the standardization process may make it necessary to develop synthetic concepts to bridge the differences or agree to the lowest common denominator. Neither result is satisfactory for domestic lawmakers and economic agents because harmonization will result in sub-optimal rules and prevent flexible adaptation to better rules and to changing circumstances.
Ultimately, the success of the proposed standards and codes will depend on the existence of local constituencies with a strong interest in and understanding of the new rules. The success will also require domestic agents to comply with the new rules voluntarily. Without voluntary compliance, enforcing new standards will not be effective. For these reasons, Pistor (2000) argues that regulatory competition is preferable to harmonization, because the former could produce laws of which relevance will be understood domestically and also will teach regulators that in the long run they will be better off by protecting investors and developing an effective legal system.

3.2 Too Many One-Size-Fits-All Standards

From the perspectives of emerging market economies and developing economies, there already exist too many standards and codes to be observed. The Financial Stability Forum (FSF) has now highlighted 12 key codes and standards that are crucial, and identified additional 64 standards relevant for sound financial systems. Of these, 12 deserve priority implementation and other 43 standards are complementary to the key codes.\(^8\) Not all countries can be expected to meet the same standards, since they are not at the same level of development. In particular, the one-size-fits-all approach is likely to ignore the institutional constraints of EMEs and DCs.\(^9\) If enforcement of common standards does not permit a degree of variation and flexibility at the individual country

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\(^8\) The FSF’s Compendium of Standards provides one-stop references for 43 economic and financial standards relevant for sound financial systems. These standards are no less important than complementary to the 12 key standards, dealing with particular functional areas. The FSF also notes additional standards not included in the Compendium. The proposed inclusion of these additional standards will bring the total number of standards in the Compendium to 64 from the current 43.

\(^9\) Andrew Crockett of the BIS appreciates the complexity of implementing standards: “It would be unreasonable to expect an emerging or developing country with a rudimentary financial sector to comply with standards that an advanced financial center has reached only after decades of development. Sensitivity will be required to balance the desire to move quickly to best practice, with the need to recognize practical constraints” (excerpted from Archarya, 2000).
level, standardization efforts could result in harmonization in a shrewd direction and hence incur enormous adjustment costs in the EMEs and DCs (Rodrik, 1999). With regard to IFI conditionality, some of the standards could act as a wedge with which a broader set of policy and institutional preferences – in favor of an open capital account, deregulated labor markets, arms-length finance, and Anglo-Saxon style corporate governance – will be imparted to the recipient countries (Rodrik, 2000).

For the poorest DCs, the budgetary cost of implementing a myriad of codes and standards can be enormous.\textsuperscript{10} Data collection and processing, as well as strengthening the regulatory and supervisory standards would require technical assistance, equipment, training, and computerization. Without these being funded by external grants, the cash-strapped DCs would have little choice but to squeeze the budget for most socially vulnerable groups (Soludo and Rao, 1999). Indeed, the implementation costs of building the necessary legal and institutional infrastructure where those standards and codes could work out effectively would be a formidable burden to taxpayers in the EMEs and DCs. In realization of these difficulties, the G-7 Finance Ministers agreed to work together with the IFIs, the FSF, and international regulatory and supervisory bodies to provide technical assistance and training to emerging market and developing countries.

In order to reduce adjustment costs to manageable proportions, transitional arrangements may have to be made for EMEs and DCs to prepare for the implementation of international standards as in trade negotiations. For example, the Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement,\textsuperscript{11} which are

\textsuperscript{10} Finger and Schuler (1999) show that the cost of implementing just some tiny aspects of the WTO commitments was significant for many developing countries. For example, poor and heavily aid-dependent economies such as Tanzania had to spend some US$ 10 million on modernizing its customs operation; Madagascar spent US$ 11 million to implement sanitary and phytosanitary standards; Algeria spent US$ 112 million on locust control; and Russia spent US$ 150 million to improve the disease control component of food processing facilities. These are only the minimum aspects of the spending required to comply with global standards. Imagine then what the total spending would mean for the budgets of these poor countries (Soludo and Rao, 1999).

\textsuperscript{11} Despite WIPO efforts to promote international comity toward IPR protection, countries had achieved
the most comprehensive international standards on IPRs, gives different countries different transitional periods in addition to a one-year transition period after the entry into force of the WTO agreement. Developing countries and economies in transition are entitled to an additional four-year transition period except for obligations pertaining to national and MFN treatment. But developing countries are also entitled to an additional five-year transitional period for product patents in the fields of technology that are not protected by the time they apply the agreement. The least-developed countries are entitled to a ten-year transitional period from the date of the application of the TRIPs provisions – that is, eleven years after entry into force of the WTO agreement – to enable them to comply with the obligations of the agreement. They are also allowed to request an extension of this period.

3.3 Legitimacy

In most of the forums or agencies drawing up standards, EMEs and DCs are not included or, at best, are underrepresented. Despite the lack of expertise among the EMEs and DCs, if the G-7 countries want to introduce a set of international standards, they should follow a more legitimate process of negotiation, a la Uruguay Round (1986-93). This may be particularly necessary if the interest of the advanced countries, on one hand, and that of the EMEs and DCs, on the other, diverge. The G-7 countries could take the initiative in starting a negotiation process among the IMF members towards introducing international standards rather than tacitly consenting to a set of

little harmony by the mid-1980s. In most cases, WIPO conventions simply required that their signatories follow national treatment, and they lacked minimum standards either for levels of protection or for the coverage of subject matter. The prevailing perception of the industrial countries was also that the WIPO lacked effective powers to discipline signatories for noncompliance. These regulatory and institutional shortcomings prompted a bloc of U.S.-led industrial countries to push for the inclusion of IPRs in multilateral trade negotiations in the early 1980s (Primo Braga, 1996).
readymade ones, because standard setting should not be biased towards a particular model of an industrial country. Even major industrial countries cannot agree on specific standards for banking, corporate governance, disclosure, and accounting, because they understandably insist on standards that will serve their own interests.

The negotiations may not take many years, as the Uruguay Round did, but they will have to go through an arduous and protracted process of settling the differences between the industrial countries and the EMEs and DCs. Such a negotiation process will be costly, but unless the IMF member countries come to an agreement on internationally agreed common standards, one cannot ensure the compliance of the firms, banks, and governments of the EMEs and DCs. In order to reduce the number of participants and make the negotiations more manageable, one possibility is to limit participation in the initial stages to those EMEs and DCs with relatively resilient financial regimes. Not truly multilateral, but sensibly plurilateral agreements on international standards would invite more participation from the EMEs and DCs. Without such a process, it is quite possible that there would emerge only two sets of competing standards supported by the U.S. and the EU, respectively. Neither set of standards would, in that case, reflect the needs or wishes of the EMEs and DCs.

3.4 Sovereignty and Global Governance

The establishment and enforcement of common standards could also raise the question of sovereignty in managing financial systems and conducting monetary and fiscal policy in emerging market economies. Even if the G-7, the EMEs and DCs could come to an agreement on a set of international standards to be observed, there still remains the question of enforcement. As noted earlier, enforcement will typically be difficult unless
some stringent and observable parameters are devised and subject to international surveillance. A relevant example is provided by minimum bank capital requirements, along the lines set out by the Basle Committee in 1988. Such requirements were introduced by most developing countries, but only nominally enforced. For example, all East Asian banks before the crisis generally satisfied the eight percent BIS ratio.\textsuperscript{12} The awareness of these problems has generated an intense debate on how to provide an effective surveillance mechanism. A concerted effort in this direction is the joint IMF-World Bank’s Financial System Stability Assessments Program, aimed at evaluating the health and vulnerabilities of member countries’ financial systems.\textsuperscript{13} The program also includes the assessment of compliance with the BCBS Core Principles.

The Financial Stability Forum has recently elicited three key factors for fostering the implementation of standards.\textsuperscript{14} First is to promote country ownership of implementing standards to make it rather sovereign, while the international community can only encourage it through other channels. Second was to provide incentives for the observance of standards. Market incentives (e.g., different credit ratings, borrowing spreads, asset allocations, etc.) and official incentives (e.g., financial and technical assistance, market access, etc.) should be considered. Third is to mobilize scarce resources (human and financial resources) by enhancing international cooperation.\textsuperscript{15}

\textsuperscript{12} In Korea, banks had no difficulty in satisfying the BIS ratios. At the end of 1997, immediately after the crisis, the BIS ratio on average remained at 8.67 percent. Moreover, five non-viable banks that were closed in June of 1998 were reported to have the BIS ratios of 7.4 percent to 9.6 percent as of the end of 1997. The reported BIS ratios did not accurately reflect the true state of banks’ financial soundness for various reasons. Inadequate loan loss provisions, partial recognition of stock revaluation losses, and loose loan classification standards and accounting rules led to a discrepancy between official figures and the actual state of the banks’ health.

\textsuperscript{13} As of December 4, 2000, a total of 83 reports on the observance of standards and codes (ROSC) modules had been produced for 32 countries, of which 67 have been published on the IMF’s external website. The majority of modules were prepared in the areas of data dissemination (11), fiscal transparency (18), monetary and financial policy transparency (18), and banking supervision (18).

\textsuperscript{14} See FSF (2000b).

\textsuperscript{15} The paper also suggests a five-stage strategy for fostering the implementation of standards.

- Identify and forge international consensus on key standards
- Prioritize standards for implementation, taking account of country circumstances
- Design and effect an action plan to implement standards
Regarding implementation and enforcement, opinions are divided on whether the process should be voluntary or compulsory. For example, the IMF is debating whether implementation of certain standards should be part of the criteria for gaining access to the CCL. Finance ministers from the G-7 consider whether a foreign bank’s home country should adhere to international standards when evaluating if the foreign bank should be allowed entry to their market. The G-7 also recommended that the IOSCO and the Basle-sponsored working groups make membership in their bodies contingent on progress to implementation of standards. That is, the dominant view appears to support compulsory compliance.

If the IMF and other IFIs are given authority to enforce compliance with the common standards, the surveillance mechanism implies that those countries which fail to observe the agreed standards can be penalized in terms of incentives. However, many EMEs and DCs will find it difficult to accept these incentive-based proposals, because such schemes raise the issue of fairness and national sovereignty. If the incentive system is determined and administered by both IFIs and the regulatory authorities of industrial countries, in reality this means that industrial countries can dictate the access of the EMEs and DCs to world capital markets and IMF credit facilities. One cannot also discount the possibility that industrial countries could use the incentive scheme to pursue their own interests. Any direct enforcement by IFIs will therefore impair sovereignty and will diminish legitimacy.\(^\text{16}\)

A universal adoption of common standards on accounting, disclosure, and banking, for example, is likely to promote deeper financial integration at the global level. From the perspectives of emerging market economies, deeper integration could mean

\(^\text{16}\) Acharya (2000) also asserts that the IMF’s role should be limited to the dissemination of information; it should not extend to incorporate standards as part of Fund conditionality.
considerable erosion in their policy autonomy and hence the necessity to coordinate
their macroeconomic and other policies with those of developed countries. Although the
advocates of common standards claim that the universal acceptance of common
standards will help stabilize the international financial market and reduce the frequency
of financial crises, there is no evidence to support such an argument. On the contrary, as
Pistor (2000) notes, harmonization may produce perverse results.

In conclusion, the country or a group of countries that develops, asks other countries
to accept and authorizes the IFIs to enforce compliance with common standards and
codes, thus and so by building a de facto global legal architecture for financial markets
through legal harmonization, needs to provide quasi governance of international
finance. Therefore, the EMEs may justifiably ask whether the group of countries
promoting the universal standards is also prepared to produce public goods such as the
services of a lender of last resort. This question arises because there is no guarantee that
those EMEs which faithfully comply with the common standards will become less
vulnerable to financial crises. If a financial crisis breaks out, and spread to other
countries, those innocent victims suffering from crisis contagion may expect the group
of countries providing quasi governance to assist them with unconditional liquidity
support. This is the reason why harmonization, to be acceptable, should be also
accompanied by provision of a number of public goods such as the services of ILLR
and regulatory authorities.

4. Bailing in the Private Sector

From the creditor and investor side, the past few years also have reminded us that they
tend to underestimate risks as they seek for higher yields. In other words, international
lenders have as much responsibility for the crisis as emerging market borrowers; for every questionable borrower there is a questionable lender.

Efforts for achieving greater private sector burden sharing are motivated by the perception that the official assistance to crisis countries creates a source of moral hazard on the part of private sector creditors. If private sector creditors are bailed out through official assistance without bearing any cost of the crisis, their habitual poor lending and reckless investment decisions would not be rectified. In addition, because the Fund is almost always paid back, many critics point out that official assistance would merely allow private creditors to be repaid at the expense of the taxpayers of the crisis country (Eichengreen, 2000a). On both efficiency and equity grounds, bailing in the private sector – private sector involvement (PSI) – has become a core part of the architectural reform.

Historically, however, this issue is nothing new. The legal doctrine of sovereign immunity would appear to exempt the property of foreign governments from the jurisdiction of domestic courts. Over the years, the practical application of the doctrine has increasingly given creditors leverage to retaliate against defaulting sovereigns (Obstfeld and Rogoff, 1996). Creditors’ legal rights of direct punishment could make it difficult for a country in default to gain access to new international loans. Restricted sovereign immunity certainly has merit in the sense that it would address debtors’ moral hazard. Nevertheless, the Latin American debt crisis of the 1980s ended up with the Brady Plan; it allowed debt forgiveness of about 35 percent for bank claims on much of the region (Cline, 1995). After the Mexican crisis, the 1996 G-10 report, the so-called

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17 Even if foreign lenders have only limited power to directly punish sovereign borrowers, the desire to maintain future access to credit markets provides an incentive to repay (Eaton and Gersovits, 1981). Furthermore, sovereign borrowers in emerging market economies are extremely sensitive to the “sudden stop problem.” The sudden stop problem occurs when an adverse shock sets in; access to the international capital market is immediately denied to emerging market economies and consequently the crisis situation rapidly worsens (Calvo and Reinhart, 2000).
Rey Report, also recommended various proposals for bailing in the private sector. Furthermore, this issue resurfaced after the Asian financial crisis and other subsequent emerging market crises.

However, since keen conflict of interests between creditors and debtors is pitted against each other, most conspicuous divergences persist in this area. The most unsettled part of the PSI issue would be on the question of whether the nature of PSI should be based on predetermined rules or should be handled on a case-by-case basis. Some want those rules to be very hard and tight, while others want to leave a degree of flexibility. The June 1999 G-7 report proposed a compromise approach for the PSI framework – a “case-by-case approach with principles and tools.” G-7 consensus contends that since the cases for private sector involvement will be sufficiently different, no general set of principles will be adequate to cover every case; there will have to be case-by-case variations.

Although G-7 allegation has some truth, constructive ambiguity could become a source of confusion and arbitrary decision. Bergsten (2000a), among the critics, contends that clear rules, tailored to different types of crises, need to be developed for PSI in order to replace the ad hoc approach now being pursued to bail in the private creditors. Under the broadly defined PSI framework laid out in the 1999 Cologne Summit, the G-7 put forward “operational guidelines” for PSI at the IMF/WB meeting in April 2000. They distinguish two different cases. First, private sector involvement could be ensured primarily through reliance on the IMF’s traditional catalytic role: if the member’s financing requirements are modest; or if the member has good prospects of rapidly regaining market access on appropriate terms, even in cases in which the financing requirements are at large. Second, more concerted forms of PSI could be required: if the financing requirement is large and the member has poor prospects of
regaining market access in the near future; or if the member has an unsustainable medium-term debt burden.

These operational guidelines could be valid. As noted in Eichengreen (2000a), however, the cases of Ecuador, Pakistan, Romania, and Ukraine have been disappointing. The IMF’s efforts to condition official assistance on PSI – specifically, on the willingness of investors to roll over maturing debts, inject new money, or restructure existing debts – have been less than a success. Requiring countries on the verge of sudden stop – denied access to international capital markets – to first raise new money as a precondition for IMF assistance is certainly unrealistic, given the palpable reluctance of investors who lost confidence in the crisis country. In this regard, Eichengreen (2000a) contends that ex post measures would complicate the resolution process and aggravate the economic conditions, since an effective bargaining table between international creditors and the crisis country would not be conceivable in most cases.

Despite the disappointing performance of the recent IMF experiments with small poor crisis countries, the official sector will need to insist on appropriate debt restructuring with private creditors as a condition for IMF financial assistance. To make operational guidelines more workable, the IMF could play a role as a crisis lender and manager. Although the IMF stays away from micromanaging the terms of debt restructuring, the IMF could provide bridging loans while the negotiations are in progress, provided it is convinced that the crisis country is negotiating with its creditors in good faith. Or if voluntary negotiations are troubling, the IMF could endeavor to bring the involved players to the negotiation table. As Eichengreen (1999c) points out, however, this moral suasion would be hardly successful for various reasons. Then, what would be required for a workable voluntary approach?
First, the IMF’s analytical capacity would be a most important ingredient for diagnosing the nature of the crisis and assessing the country’s underlying payment capacity and the medium-term external prospects for regaining market access. When creditors’ grab race sets in, but if the IMF judges that the nature of the crisis is closer to illiquidity rather than insolvency, the IMF is expected to play the role of a mediator for arranging an effective bargaining table. This proactive role of the IMF could relieve the market participants’ panicking behaviors. However, it would be technically difficult to distinguish an illiquidity crisis from insolvency crisis when a crisis erupts unexpectedly. It would take time for creditors and the debtor country to reach a correct diagnosis on the nature of the crisis.

Second, more reliable workout-type solutions could be required when the nature of the crisis is rather closer to insolvency as in the cases of Ecuador, Pakistan, and Ukraine. As almost unanimously proposed by the international community,\(^\text{18}\) it would be worthwhile to amend bond contracts to include sharing clauses, majority voting clauses, and minimum legal threshold clauses. If those provisions were incorporated into international sovereign bond contracts, the IMF would not need to normally provide official assistance to the crisis country.\(^\text{19}\) A fair burden sharing based on predictable clauses could be voluntarily settled through successful debt restructuring facilitated by those provisions. However, little concrete progress has been made to date.

This lack of progress has various reasons. First, from the creditor side, this is also related to international standard issue in the area of sovereign bond contracts. The United States is reluctant to follow the market standard governed by U.K. laws, since

\(^{18}\) The international community, including the G-7, the G-22 Working Group on International Financial Crisis, the Council on Foreign Relations, and the IMF, broadly saw merits in incorporating CACs into international sovereign bond contracts.

\(^{19}\) Under the IMF’s policy of lending into arrears, the IMF could provide, in exceptional cases, early support for a member’s adjustment efforts, provided that the member is making bona fide effort to reach a collaborative agreement with its creditors.
the U.S. Trust Indenture Act of 1939 would need to be modified. Historical path
dependence hinders a common standard to be universally adopted. Second, from the
debtor side, U.S.-style international bonds have been the most prevalent bonds issued by
EMEs and DCs until recently. Most EMEs and DCs worry that such bonds would raise
the cost of borrowing. Although recent empirical work by Eichengreen and Mody
(2000) suggest that such worry seems not to be well grounded, countries with poorer
credit ratings would face more difficulties in financing development projects when
collective action clauses (CACs) are incorporated into their sovereign bond contracts.
Third, the use of debt exchange offers may obviate the need for CACs as in the case of
Pakistan, where restructured bonds all included CACs. Indeed, as shown in all recent
cases of bond restructuring (Ecuador, Pakistan, and Ukraine), debt exchanges were the
norm and the CACs were not needed, nor used when available (Roubini, 2000).

In sum, ex ante “bail-in” measures will enhance the degree of predictability when a
need to restructure international sovereign bonds rises. In the case where the CACs are
not included, there would exist a potential difficulty with many bondholders who may
decide not to participate in the exchange offer, in the hope that they will be able to
subsequently obtain settlement on more favorable terms. However, as mentioned above,
debt exchanges did not verify the concerns regarding the threat of creditor litigation. In
recent experiences of Ecuador, Pakistan, and Ukraine, participation rates in the debt
exchanges were high and creditor litigation had not materialized. In this regard, Nouriel
(2000) has a point that “CACs are only an empty shell that may or may not help a
restructuring process. They are not, by themselves, a tool that provides the answer to the
complex set of questions (when, how, how much, which assets, which creditors, in

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20 Eichengreen and Mody (2000) suggest that spreads on bonds with CACs are lower for good credit
countries and higher for poor credit countries. In this regard, they conclude that the credit market would
function better by differentiating sovereign credit risks and the benefits of reducing debt restructuring
costs outweigh the risk of strategic default.
which sequence) that have to be addressed when trying to restructure bonds.” However, the use of exit consents in the restructuring of Ecuador’s debts may leave an important precedent for future cases of international sovereign bond restructuring, not including CACs. Furthermore, the availability of this technique could serve as even stronger incentives for investors to agree to the inclusion of CACs in bond contracts (IMF, 2001b). If the ex post exit consents were to be used to reduce the leverage of the holdout creditors, more predictable ex ante measures such as CACs would be preferable to investors. If the G-7 Finance Ministers in good faith agreed to recommend in their joint statements that the IMF should encourage the use of CACs to facilitate more orderly crisis resolution, they should now indicate how to promote such encouragement through the IMF.

Another controversial issue related to private sector involvement in the resolution of crises would be the necessity for legalizing temporary standstill arrangements. The consensus formed around the G-7 does not envisage the creation of any formal institutional mechanism for debt restructuring in crisis resolution except for encouragement of CACs. In particular, the G-7 countries do not intend to empower the IMF to authorize any legal sanction on a standstill on payments. However, the IMF is expected to play a critical role in certifying that pre-conditions exist which may justify debt restructuring as an exceptional measure. This implicit endorsement does not mean that the IMF is authorized to make any legal sanction.

A payment standstill could be desirable in the sense that it could minimize the risk of disruptive litigation as in the presence of CACs, and stop it from becoming a solvency crisis. A temporary payment standstill purports to give a crisis country breathing space for successful debt restructuring negotiations, which change the contractual terms by extending maturities rather than reducing the present value of debt service obligations.
It would be the country, rather than the IMF, which would declare a standstill. It would presumably take this action at the same time when it announced that it was approaching the Fund. The IMF could provide emergency assistance while the negotiations were in progress, provided it was convinced that the country was negotiating with its creditors in good faith. The IMF is not to act as an arbiter determining the terms of debt restructuring – that must be left to voluntary negotiations – but it could signal strong confidence in the debtor country’s adjustment programs to the creditors. When the negotiations are concluded, the debtor country would lift its standstill and start servicing its debt on the new contractual terms. In this respect, temporary and voluntary standstill arrangements should be differentiated from outright sovereign defaults (Williamson, 2000).

This temporary standstill arrangement could be made through the inclusion of clauses providing for a debt rollover option in the international loan contracts or bonded debt contracts. The option would entail the borrower, at his sole discretion, to extend maturing debt for a specified period at a penalty rate as espoused by Buiter and Siebert (1999). The penalty rate would be high enough to discourage using this option. When the option is exercised, all creditors would be automatically “bailed in.” Eichengreen (2000a) points out that this new scheme still remains in the realm of theory, compared to the international bonds with the CACs. However, a debt rollover option or temporary payment standstill could be desirable when creditors’ grab race exacerbates the shortage of international liquidity.

When the Korean government decided to go to the IMF, it expected that the IMF rescue package agreed on December 3, 1997 would suffice to stop capital outflows. On the contrary, the foreign creditors accelerated their retrieval of short-term credits. As the liquidity situation further worsened, the Korean government, in close consultation with
the G-7 countries, urgently initiated negotiations with foreign creditors to reach a
temporary standstill arrangement. After a series of intensive negotiations, the Korean
government and 13 representatives of the foreign creditor banks reached a consensus on

Following due diligence, the renegotiated contracts, which stipulated the conditions
for maturity extension, were signed on March 31, 1998, whereby 96.5 percent of the
Korean commercial banks’ short-term debt, amounting to US$ 21.74 billion, was
converted to loans with maturity of one to three years with sovereign guarantees. The
experience shows that Korea’s standstill period, which included a de facto rollover of
short-term debt, lasted from the end of December 1997 through March 1998 – only
about three months. Although the Korean experience implies that the IMF was not
necessarily directly involved in the standstill mechanism, the relative ease with which
the debt is restructured would enable the crisis country to quickly resolve the shortage
of international liquidity. As shown again in the case of Korea, net present value of the
outstanding debt was not impaired – in fact the creditor banks did not take a hit. The
Korean government provided sovereign guarantees along with premium of 225-275
basis points higher than pre-crisis rates.

Although the Korean experience cannot be easily emulated by future crises,
internationally legalized payment standstills would make debt restructuring more
smoothly and orderly in the absence of an international bankruptcy court or procedures
for sovereign debtors. Some would argue that debt restructuring should not be easy
and the crisis countries should be severely punished in order not to repeat defaults.

21 Williamson (1992) proposed “ a legal mechanism for the revision of debt contracts a parallel to the
Chapter XI proceedings under the US bankruptcy law.” To limit creditor’s legal rights of direct
punishment or legal action against sovereign debtors, he suggested to establish the International Debt
Restructuring Agency. Similar proposals include the Global Restructuring Agency (Edwards, 1998), or
the Basle Club (Miller and Zhang, 2000). If the power to limit creditor’s right is given directly to the IMF,
it would require amendment of Article VIII 2(b) of the IMF’s Articles of Agreement.
(Dooley, 2000; Friedman, 2000). However, in the present international capital market environment where borrowers in emerging market economies have made great sacrifice of output rather than default on debt, the issue of borrowers cheating lenders seems much less important than creditors’ moral hazard (Miller and Zhang, 2000).

5. Exchange Rate Regimes and Capital Controls

Since the inception of the Asian currency crisis, the choice of an appropriate exchange rate regime has emerged as a crucial factor for crisis prevention and resolution. This is because the soft-peg exchange rates of East Asian currencies have been blamed for generating crises. A number of relatively fixed-rate countries were forced to abandon their pegs and bands. Many economists and policy makers argued that these regional currencies were overvalued on the eve of the crisis. Accordingly, the so-called corner solutions – greater flexibility (floating) or credible institutional assurance (hard pegs), like the currency board system or dollarization – are gaining wider support. When choosing an exchange rate regime, more emphasis tends to be placed on either flexibility or credibility. As long as developing countries maintain open capital accounts, such two options are considered suitable in light of the “Impossible Trinity Hypothesis.”

Nevertheless, questions related to two corner solutions on whether such extreme exchange rate regimes are adequate for developing countries are rising of late. The biggest problem of free-floating exchange rate regime is how to cope with the short-term volatility of exchange rates and the possibility of intermediate and long-term

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22 The lack of an operational definition of overvaluation is still troubling. In fact, pre-crisis Asia was not on a rigid dollar peg as most countries adjusted their rates from time to time. Statistically, there is no correlation between pre-crisis rigidity, or overvaluation of the domestic currency, and the severity of subsequent currency attacks (see Ohno, 1999). Interestingly, Chinn (1998) reported that the Korean won was undervalued even before its discrete drop in value during the crisis.
misalignments. These concerns may lead to the question to what extent intervention under the free-floating exchange rate regime should be permitted.

Many developing countries having adopted de jure free-floating exchange rate regimes also attempt to reduce exchange rate fluctuations through intervention. Calvo and Reinhart (2000a) call this “fear of floating” in explaining why exchange rate rigidity is conspicuous in the case of developing countries. The root causes of the marked reluctance by developing countries to float their exchange rates are multiple.

Developing countries are sensitive to exchange rate fluctuations because the cost of exchange rate volatility is greater than the benefit when compared to developed countries. Many developing countries are reluctant to allow the nominal exchange rate to appreciate, when circumstances are favorable (i.e., capital surges, positive terms of trade shocks, etc.). This probably stems from fear of the “Dutch Disease” type problems. Loss of competitiveness and serious setbacks to export promotion are major concerns of export-led developing countries. Developing countries with large external liabilities (denominated in foreign currencies) are also required to watch for the drastic exchange rate depreciation (or devaluation) that may increase the debt burden on financial institutions and heightening the likeliness of a currency and financial crisis. If a developing country’s financial sector vulnerability deepens due to drastic exchange rate depreciation, the sovereign credit rating of the developing country would deteriorate; limited access to the international financial market could lead to a situation of sudden stop (Calvo and Reinhart, 2000b).²³

In addition, exchange rate fluctuations may have substantial impact on the prices in developing countries. Abrupt exchange rate depreciation with low credibility of

²³ According to Calvo and Reinhart (2000b), devaluation is more expansionary with rather than without capital mobility. If market access is not lost, devaluation is always expansionary. As a corollary, if a developing country lost its access to the international capital market, its economy would face a significant contraction.
monetary policy may lead to heightened inflationary pressures on the domestic prices through exchange rate passthrough. To cope with inflationary pressure, the monetary authorities may raise the domestic interest rate as is evident in the high variability of interest rates in developing countries. Although interest rate hikes would contribute to mitigating inflationary pressures and defend the currency as well, negative side effects on the real and financial sector could also be envisaged. “Fear of inflation” accompanied by “fear of floating” would be another toll on the economy in developing countries (Goldfajn and Olivares, 2000). Accordingly, the fact that developing countries need to adopt policies that reduce short-term exchange rate volatility and eliminate intermediate and long-term misalignments brings forward the question whether two-corner solutions are indeed the appropriate exchange regime choice.

The G-7 and the IMF generally agree that no single exchange rate regime is appropriate for all countries or in all circumstances. However, as long as the EMEs and DCs maintain open capital accounts, only two options – flexible exchange rate regimes or those having very hard pegs – may be suitable in light of the Impossible Trinity Hypothesis. However, the adjustment process of a flexible exchange rate regime with free capital mobility could easily generate a cycle of boom and bust in EMEs and DCs. In many East Asian countries, for instance, foreign portfolio investors have become dominant players in determining the direction of asset price movements, since these countries further opened their capital markets during the crisis period. Suppose that the ongoing recovery in East Asia attracts large capital inflows in the region. These large inflows could rekindle asset price bubbles and speculation. When a currency appreciates as a result of capital inflows, market forces can create expectations that will induce even greater capital inflows, further pushing for greater appreciation in the nominal exchange rate, together with a larger trade deficit.
Furman and Stiglitz (1998) provide a very plausible story by which, given the circumstances of the East Asian economies, a floating exchange rate would have exacerbated the problems. With irrational expectations, investors may extrapolate the exchange rate appreciation, so that investing in, say, Thailand looks an even better deal, with the huge real estate returns plus an appreciating currency. The increase in the exchange rate discourages exports, and thus allows internal macroeconomic balance to be achieved at a lower interest rate than otherwise. But suddenly one day the real estate bubble bursts; in the process, capital flows reverse, and the exchange rate plummets.

This thought experiment put forward by Furman and Stiglitz (1998) makes it clear that flexible exchange rate regimes would not necessarily have insulated the East Asian economies against the ravages brought on by a sudden change in expectations in a world with no restrictions on capital flows. As also noted in IMF (2000), large exchange rate fluctuations in small or medium-sized open economies may have significant economic costs. While it is important that exchange rates be allowed to adjust in response to market pressures, it may also be appropriate to use domestic monetary policy, or intervention, to limit fluctuations, to the extent they affect inflation and inflationary expectation. Thus, the IMF acknowledges that EMEs and DCs can manage exchange rate fluctuations through an alternative nominal anchor, such as inflation targeting. However, it is still uncertain that this nominal anchor could effectively relieve the exchange rate misalignment caused by the constant pressure of capital flows. Sterilized intervention could more effectively forestall the emergence of such misalignments.

In addition, a perverse belief is that flexible exchange rates are also expected to wipe out the “off-balance sheet” liabilities of the government and in so doing reduce the frequency of currency crises. In a fixed, or pseudo-fixed, exchange rate regime the
liabilities of the public sector would include also the central bank commitment to convert to foreign currency the short-term liabilities of the banking sector (Chang and Velasco, 1998 and 1999). This obligation would enormously increase the amount of potential short-term foreign borrowing. Any shocks to foreign currency reserves or to money supply could shake market confidence in the stability of the exchange rate and would generate selling pressures on the market, transforming contingent liabilities into effective liabilities. However, the fact that the Asian crisis was not limited to currency problems but involved bank runs as well, floating the exchange rates did not prove to be a sufficient measure to revert these economies to stability.  

A common currency, or currency board regime, could be an alternative exchange rate arrangement to replace a flexible exchange rate regime, while maintaining capital mobility. Most EMEs in East Asia would not find it practical or politically acceptable to move in this direction. A common currency could be considered, in the very long run, as a regional monetary arrangement. Albeit political consensus, the huge menu of preconditions for a regional currency bloc will take up a great deal of time.  

In addition, the international community should squarely recognize an important source of systemic vulnerability: the G-7 currency gyrations in recent years have far exceeded any conceivable shifts in economic fundamentals. In particular, the sharp swings in the yen-dollar rate contributed materially to the outbreak of the Asian crisis. Every 10 percent decline of the yen vis-à-vis the US dollar takes US$ 20 billion off the

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24 In the 1992 ERM crisis, the run on weaker currencies was not paralleled by a run on the public debt of highly indebted countries, such as Italy, or by a run on individual banking system. Contagion was limited to the currency market and once the exchange rate commitment was lifted in England and in Italy, the crisis subsided (Chang and Velasco, 1998).  
25 Bayoumi, Eichengreen and Mauro (1999) assert that the essential preconditions for a durable regional arrangement in ASEAN countries are political rather than economic, and by almost any measure Asia comes less close than Europe to meeting those political criteria. If China, Japan and Korea as well as new members of ASEAN are considered as a potential members of the regional currency bloc, however, even the economic criteria pointed to by the theory of optimum currency area (OCA) would not be satisfactorily fulfilled.
trade balances of the rest of Asia (Bergsten, 1999). Every time the yen appreciates against the dollar, the economic growth of non-Japanese Asia picks up, as happened between 1986 and 1988 and again between 1991 and 1995. The reverse is also true when economic growth decelerated and the asset-price bubble burst on the back of a weaker yen in 1989-90 and again in 1996-98 (Kwan, 2000). The soft-peg currencies were extremely vulnerable to volatile fluctuations of the yen-dollar rate. The procyclical aspect of capital flows in and out of East Asia is closely related to the instability of the yen-dollar rate.\(^{26}\)

The international community has encouraged EMEs and DCs to adopt appropriate exchange rate regimes, but it has remained voiceless in reducing the systemic risks generated by G-7 currency gyrations. The flexible exchange rates of the G-7 currencies quite often tend to overshoot wildly and generate equally disruptive misalignments.\(^{27}\) For the G-7, the goal of currency reform can best be pursued by maintaining substantial flexibility but modifying the method by which it is being managed. For the past decade, the interventions have always come long after large misalignments have set in and severe economic damage has resulted (Bergsten, 1999). In other words, sharp swings of exchange rates between the U.S. dollar and the Japanese yen or between the U.S. dollar and the euro destabilize the exchange rates of developing countries, which may in turn become a triggering factor of currency crises in developing countries.

\(^{26}\) Kwan (2000) and Ueda (1998) assert that one of the key determinants of the boom-bust cycle in East Asia was the sharp appreciation of the yen against the dollar between the mid-1980s and the mid-1990s, and its subsequent depreciation. They also find that real investment and speculative financial capital within and into East Asia responded too much to the yen-dollar movements. In a similar vein, Ogawa, Ito and Sasaki (1999) propose a regional basket currency arrangement to mitigate an adverse impact of the yen-dollar exchange rate fluctuations on the trade balance.

\(^{27}\) Floating exchange rates have repeatedly led to the emergence of large misalignments. The U.S. dollar went from being chronically overvalued in the mid-1980s to undervalued in early 1995, only to be overvalued again. The yen has been a large part of the obverse side of that roller-coaster, with the euro’s current undervaluation another part of the obverse. For instance, the US dollar rose by 80 percent against the yen and 40 percent against the D-Mark from early 1996 to mid-1998 and late 1997, respectively. See Williamson (1999) for further elaboration on exchange rate misalignments.
If EMEs and DCs are going to stay with flexible exchange rate regimes, they might consider the introduction of capital controls over short-run capital movements to ease the burden of adjustment through exchange rate fluctuations. In this respect, the IMF, while advocating the overall liberalization of capital account transactions, points to the need to implement measures to influence the volume and composition of capital flows. Such measures could include taxes on short-term foreign borrowing and prudential limits on offshore borrowing (Council on Foreign Relations, 1999; Furman and Stiglitz, 1998).

While there remain differences of view on the merits of capital controls, the mainstream view is that capital controls cannot substitute for sound macroeconomic policies, although they may provide a breathing space for corrective action. However, the flexible exchange rate regime alone may not be able to reduce massive capital inflows, especially short-term capital inflows. Thus, there may be a need for EMEs and DCs to manage massive short-term capital inflows, while they should continue to strengthen their financial system. As it is generally agreed that the Chilean scheme on capital controls was successful in lengthening the average maturity of the country’s external debt, the EMEs and DCs, if necessary, may install the capability of implementing unremunerated reserve requirements (URR) and minimum holding periods (MHP) on capital inflows. This Chilean scheme is widely supported by various economists on prudential grounds.

Johnston and Otter-Robe (1999) stress that capital controls can be used as a third line of defense following the first line of defense (banks’ own risk management practices) and the second line of defense (regulatory supervision). Capital controls are inferior to voluntary risk management and prudential regulations for two reasons. First, capital controls are not well designed to address the principal types of risks involved in cross-border transactions. Capital controls attempt to eliminate various risks by limiting capital flows in general – rather than addressing the risks directly – thereby removing the potential benefits from such flows. Second, capital controls are prone to evasion, which may increase risks to the financial system.

Despite justifiable reasons for adopting capital controls, the legal controls on capital flows are not always effective because economic agents attempt to evade the controls by over-invoicing imports, under-invoicing exports, and mislabeling the nature of capital flows (Edwards, 1999b). With respect to the economic performance of capital controls, Edwards (1999b) disputes that desired goals of capital controls were only achieved. According to his empirical results, Chile’s capital controls did appear to increase the maturity of its foreign debt significantly. However, even in 1996 more than 40 percent of Chile’s debt to banks in the BIS “Reporting Area” had a residual maturity (not contractual maturity) of less than one year, and the total volume of aggregate capital flows moving into Chile during the 1990s did not decline. The controls on capital inflows had no significant effect on Chile’s real exchange rate, and only a very small effect on interest rates. Chile’s capital controls policy helped reduce stock market instability, but the controls were unable to isolate Chile from the very large financial shocks stemming from the 1997-98 East Asian and subsequent crises.

There is another potential difficulty with the Chilean type of capital controls: the adverse selection problem. Some foreign investors, including commercial and investment banks, are not focused exclusively on speculation for short-term earnings. Indeed, many international lenders often move into emerging markets in search of long-term investment opportunities and establish long-term relationships with local financial institutions. Yet, uniform reserve requirements on all types of capital inflows penalize not only short-term speculators but also those investors who will help strengthen and stabilize financial markets of the EMEs. If the reserve requirements are prohibitive enough to alter the composition of debt profiles, these desirable investors might avoid those EMEs and DCs having capital controls. In this regard, this Chilean scheme cannot be a purely unilateral move taken by an individual EME or DC. Most EMEs and DCs
facing volatile capital movements are still very reluctant to adopt this Chilean scheme because it might send unclear or incorrect signals to the international financial markets.

While the Chilean scheme of capital controls is a unilateral approach taken by an individual country, Tobin taxes would be a global approach to discourage short-term speculation in currencies. In other words, Tobin taxes should universally and simultaneously be implemented by all countries, so that the policy is effective. However, this renders them technically and politically unfeasible.

A large but not diversified financial system is highly exposed to systemic crises. An economy having an equally deep but more diversified financial sector, where equity and bond markets are also well developed, would be positioned to be resilient to contagion shocks. Thus, a number of structural policy actions should be geared to strengthen the financial sector. A partial list would include the development of capital markets, effective corporate governance, prudential supervision and regulation, and a cautious policy of financial liberalization. In particular, developing capital markets is essential to the emergence of long-term debt instruments.

Too often, financial liberalization – both internally and externally – has been synonymous with the accelerated development of short-term instruments. Domestic financial liberalization, with its removal of limits on bank interest rates, credit expansion and required reserves, has often resulted in the fast acceleration of bank credit and conversely of money aggregates. External liberalization, in turn, has prompted a large upswing in short-term inter-bank funding from more developed to developing economies (Chang and Majnoni, 1999). The recent East Asian experience made the case of the lesson that market freedom requires regulatory vigilance. In South Korea and Thailand, as in so many other developing countries, financial liberalization and capital-account opening led to financial crisis precisely because of inadequate
prudential regulation and supervision (Rodrik, 2000).\(^{30}\)

The Korean experience vividly shows how inadequate regulation and supervision has led to serious maturity mismatch. For merchant banks which served as an important vehicle for raising the fund required for the Chaebols’ voluminous investment, the liquidity ratio in foreign currency was only 3-6 percent for all the periods up to the financial crisis. 30 merchant banks were heavily engaged in offshore operations by borrowing cheap short-term Japanese funds from Hong Kong to finance mostly long-term investment projects. With 80 percent short-term debts put into 70 percent long-term assets, the maturity mismatch blew up when Korea’s credibility deteriorated. However, those merchant banks were not properly supervised. Neither unified accounting standards nor standards for classifying non-performing loans existed, and supervision had been perfunctory at best. This lax supervision allowed merchant banks to enjoy freedom without any discipline (Chung, 1999; Wang, 2001).

6. Highly Leveraged Institutions

The bankruptcy of Long-Term Capital Management (LTCM) in August 1998 was a vivid example of how the collapse of a single, relatively small hedge fund could keep a wider circle of financial institutions stay awake for fear of their stability. Until LTCM created serious financial difficulties for numerous trading counterparts and the markets themselves, industrial countries did not in fact pay much attention to hedge funds as a potential source of systemic risk in world financial markets. Since then, the international community has attempted to draw lessons from the LTCM episode and to examine what policy actions should be implemented through direct or indirect

\(^{30}\) Furman and Stiglitz (1998) also blamed East Asian governments for undertaking rapid financial and capital account deregulation without addressing the concomitant need to beef up their supervisory capacity. Kane (2000) attributes policy mistakes to the perverse belief that financial deregulation would enable their insolvent banks to grow their way out of trouble.
regulation over hedge funds, which are largely unregulated investment partnerships.

In order to develop a relevant regulatory framework for highly leveraged institutions (HLIs) including hedge funds, a strong rationale needs to be made in the first place. To be sure, hedge funds have played a prominent role in certain emerging markets (i.e., Malaysia and South Africa) and experiences of speculative attacks in related matured economies (i.e., Austraila and Hong Kong). However, given the growing international activities of other non-bank financial institutions and institutional investors, Eichengreen (1999c) contends that hedge funds are just one of many players in the markets and thus are not necessarily singled out as a market disturber. In the same vein, the IMF study on hedge funds led by Eichengreen and Mathieson (1998) dismissed the need to regulate hedge funds on the basis of systemic risks and market integrity.

However, many EMEs and DCs have expressed concerns that the market size matters in that relatively small EMEs and DCs cannot safeguard financial stability against potential speculative attacks by large hedge funds. The FSF Working Group on HLIs set up a Market Dynamics Study Group to examine the role of HLIs in 1998 in the dynamics of mid-sized markets, including Australia, Hong Kong, Malaysia, New Zealand, Singapore and South Africa. The Study Group report marks a sharp shift from that of the IMF, arguing that threats to market integrity occurred in two forms (de Brouwer, 2000).

What was found is that some macro hedge funds and proprietary trading desks (to a lesser extent), had large and concentrated positions in a range of markets; those trading positions at times had a disproportionate and destabilizing influence on price dynamics in financial markets (FSF Working Group on HLIs, 2000). When rapidly adjusted, such trading positions can exert substantial impact on market prices, more so when liquidity in markets is thin. Furthermore, the very presence of such large players, by their
powerful reputation, can influence decision-making by other market players, who either follow what they perceive the large players to be doing, or simply exit the market in order to avoid taking positions contrary to those of large players.

Some HLIs also used particularly aggressive tactics in several markets at particular periods of vulnerability, notably in Australia, Hong Kong, Malaysia and South Africa. Among their aggressive tactics was unusually heavy selling in periods of tranquility, unusually aggressive rumor mongering, and manipulating trading systems. They deterred contrary position taking and increased further the one-sided bets in the markets (de Brouwer, 2000). Hong Kong’s experience with the hedge funds in 1998 provides some substantiation, although it is difficult to obtain hard evidence of exactly what the hedge funds did that year, because they were not subject to any regulatory requirements (Yam, 1999).

Those concerns based on case studies are certainly valid, although the FSF Working Group was unable to reach a consensus on whether market integrity had in fact been undermined. The Working Group concludes that “the impact of HLIs on markets is likely to be very short-lived and that, provided the fundamentals are strong, HLI positions and strategies are unlikely to present a major independent driving force in market dynamics.” Therefore, more substantive evidence would be required at this point to support tighter regulation of hedge funds.

The policy actions made by the international community in the past year or so have focused on improving counterparty risk management, and improving risk management within HLIs. As Eichengreen (1999c) also emphasizes, creating mechanisms for effective information sharing is the obvious solution to monitor the overall size of creditors’ exposures to HLIs. For industrial countries, an international credit registry to more systematically assemble national regulators’ data on their banks’ exposures to
HLIs could serve that purpose. However, for those EMEs and DCs concerned with the potential market disruption by large hedge funds, available options are entry and exit taxes to discourage the kind of short-term capital flows in which hedge funds engage themselves (Eichengreen, 1999c). In order to exercise these options of capital control, an important prerequisite would be to examine the behavior of foreign investors, including hedge funds.

Recently, an emerging literature on behavioral finance attempts to explore empirical evidence on the hypothesis that foreign investors, hedge funds or offshore funds pursue destabilizing trading strategies. However, lacking the data on actual position holdings of the funds, most researches utilize return information to infer trading strategies.\textsuperscript{31} Kim and Wei (1999a), by using a unique Korean data set that details every foreign investor’s monthly stock positions, found that nonresident institutional investors are always positive feedback traders (e.g., rushing to buy when the market is booming and rushing to sell when the market is declining), whereas resident investors were negative feedback (contrarian) traders before the crisis but have switched to be positive feedback traders during the crisis. Also Kim and Wei (1999b) study the behavior of offshore investments as compared with their onshore counterparts in the U.S., UK, Singapore and Hong Kong. Evidence that offshore funds indeed trade more aggressively than their onshore counterparts, judging from the average turnover, is provided in their findings. However, they cannot find any strong evidence to support the hypothesis that the offshore funds engage in positive feedback trading.

What EMEs and DCs need to act at this point is not the outright introduction of capital controls based on anecdotal evidence. Although those options could be useful in some cases, a more important task is to implement a better monitoring system of short-term

\textsuperscript{31} Inferred positions may be seriously misleading: there is no substitute for the facts. See de Brouwer (2000).
cross-border capital flows, including the activities of HLIs. Hard evidence could be obtained only when micro data on flows and positions by investor type, source country, offshore vis-à-vis onshore are available and a thorough examination is conducted based on those data. For that purpose, electronic data collection system based on registered investors’ automatic reporting in real time could provide useful data for identifying whose aggregate positions are in fact destabilizing financial markets. However, authorities in charge of monitoring should not use this information in a heavy-handed manner against particular investors, for any intervention targeted at particular investors would severely undermine the development and operation of the country’s financial markets. If hedge funds or offshore investment funds in aggregate are seen to undermine market integrity and generate systemic instability in EMEs and DCs, then relevant policy options could be pursued later.
7. Regional Financial Arrangements

7.1 Arguments against Regional Financial Arrangements

After the crisis touched off in July 1997, Japan proposed the creation of a regional monetary fund in East Asia, which received a positive response from a number of East Asian countries. The idea was, however, strongly opposed by the U.S., the European countries and, of course, the IMF for a number of reasons. Eichengreen (1999c) and others dismiss the contention that an East Asian regional fund may have a comparative advantage in diagnosing regional economic problems and prescribing appropriate solutions on the basis that it will increase competition in the market for ideas. A more serious argument is that East Asians are not ready for, or capable of, creating and managing an effective regional monetary fund. According to Eichengreen (1999c), East Asia in contrast to Europe, for example, lacks the tradition of integrationist thinking and the web of interlocking agreements that encourage monetary and financial cooperation in Europe.

For over a half century, European countries have worked very hard to develop a wider web of political and diplomatic agreements which encourage their cooperation on monetary and financial matters. Certainly, such a web does not exist in East Asia. As for East Asia’s limited capacity, Eichengreen (1999c) has a point. If the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for finance. However, East Asia may be on the brink of an historical evolution, as Europe was half a century ago (Bergsten, 2000b). Having suffered such a painful and costly financial crisis, the East Asian countries are prepared to set aside their differences and work together to develop a region-wide self-defense
mechanism against future crises. After three years of crisis management, East Asia has
developed a large pool of skilled and experienced people capable of managing regional
financial cooperation among countries in the region. Furthermore, the type of
arrangements currently being discussed in East Asia does not necessarily require
integrationist thinking or a web of interlocking agreements as in Europe.

Furthermore, East Asians may not be prepared to negotiate an international treaty
which includes provisions for sanctions and fines for countries that do not adjust their
domestic policies accordingly. This unwillingness would make it difficult for the
regional fund to impose politically unpopular policies on the member countries and,
therefore, may pose a serious moral hazard problem.

However, moral hazard is not a problem that will beset only regional arrangements.
The IMF is not immune to this problem and the task force report of the Council on
Foreign Relations (1999) advises “the Fund to adhere consistently to normal lending
limits to redress the moral hazard problem.” The reasons why East Asian financial
arrangements would suffer more from the moral hazard problem than the IMF, or any
other regional institutions, have not been made clear. As Sakakibara (2000) puts it, if
those countries unaffected by the East Asian crisis do not have any political incentive to
contribute their own money, they should say so instead of using the moral hazard
argument as an excuse for opposing regional arrangements in East Asia.

Another controversial argument against regional financial arrangements is that there
may be no need for regional funds and other arrangements in a global economy where
much of the trade in goods and services is increasingly conducted in cyber space. The
ongoing revolution in information and communications technology will accelerate both
globalization and virtualization. What the world economy needs is, therefore, a new
system of global governance, which may include a global central bank and global
regulatory authorities. In the case of financial markets and financial services industries, the scope of governance should be increased to the global level so as to realize scale economies and to accommodate the market forces driving financial globalization. That is, public goods, such as the services of a lender of last resort and regulatory institutions, could be better provided at a global level.

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

7.2 Rationales for Regional Financial Arrangements

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

As Lawrence (1996) points out, the forces driving the current wave of regionalism may differ fundamentally from those driving earlier moves toward regionalization in this century, and the current initiatives represent efforts to facilitate their members’ participation in, rather than their withdrawal from, the world economy. Developing countries are motivated to join regional groupings as their participation could facilitate implementation of a strategy to liberalize and open their economy. Since most of the East Asian EMEs are pursuing export cum foreign investment-led policies, they will gain very little by forming a regional arrangement that is designed to thwart globalization.

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

Many EMEs and DCs, in particular those which have experienced a financial crisis, are taking measures to build up their foreign currency reserves above the level that has been regarded as adequate in terms of their import requirements. For instance, Korea is currently building a level of reserves (US$96.20 billion as of the end of December 2000) equivalent to 20 percent of its GDP, largely because of the increased volume of its capital account transactions. By any measure, this level is excessive, costly, and representing a clear case of resource misallocation. To reduce the amount of reserve holdings, at least some of the EMEs and DCs could enter into an arrangement for precautionary lines of credit with private financial institutions. They could also rely on the IMF as a quasi lender of last resort, which could provide an additional issuance of SDRs.

There are other schemes for reducing the holdings of foreign currency reserves. For example, a group of countries, not necessarily from the same region, may decide to pool a certain percentage of their reserves to create new credit facilities for themselves. An individual country belonging to the arrangement would not have to hold as much reserves as it would otherwise, if it can borrow from the credit facility. The group of thirteen East Asian countries (ASEAN+3) has command over a large amount of foreign currency reserves estimated to be more than US$800 billion (See Table 8). Depending on how these reserves are pooled together and managed, a mere ten percent of the total amount will be sufficient to provide a first and second line of defense against any speculative attack. If the East Asian countries had been able to cooperate to use part of their reserves to supply short-term liquidity to Thailand, East Asia could have been
spared the misery of recession and social dislocation.

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

Finally, East Asians must begin to examine the possibilities and desirability of cooperation and coordination in exchange rate policies, creation of a regional currency unit, and eventually an East Asian common currency. An East Asian monetary fund could serve as a forum for such an examination, although these monetary options are not viable at this stage.

7.3 Challenges and Tasks

Three years have passed since the crisis. Asia returned to positive growth in 1999, much faster than had been expected. Some economists would like to call this recovery a tenuous one, hinting that a double dip could be expected unless fundamentally important structural problems are successfully addressed. It is certainly true that we cannot overemphasize the importance of restructuring the economy into one possessing strong economic fundamentals. However, it is also important to prepare for regional financial arrangements that could greatly contribute to the stability of the financial
system in the region, unless the architectural deficiencies of the global financial system are satisfactorily rectified.

There has been an emerging consensus in East Asia that East Asians must join forces to establish regional financial arrangements which will help them fend off speculative attacks and, in so doing, stabilize the East Asian financial markets. However, it is still at an early stage and it is not altogether clear at this stage whether they will be able to successfully negotiate the creation of such arrangements, given the different interests of diverse countries with respect to regional financial cooperation. Details of the swap arrangement mechanism among the ASEAN + 3 countries will have to be worked out, and at this stage it is too early to tell whether ASEAN will be able to design a scheme acceptable not only to ASEAN member states but also to China, Japan, and Korea.

Now that China is about to join the WTO, Chinese policy makers realize that they may have to liberalize and open their financial markets and financial services industries sooner than expected. They also realize that as the country with the largest market, they must contribute to, and cooperate with, other countries in order to sustain financial stability in East Asia. However, China will find it very difficult to support any regional arrangements dominated by Japan.

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

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

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

8. Concluding Remarks

Unlike in other commodities and services, trade in financial intermediary services is
dominated by industrial countries: practically all developing countries are net importers,
whereas most of the developed countries are net exporters of financial services. At the
same time, most of the developing countries are recipients of foreign direct and
portfolio investment supplied by advanced economies. The rules and regulations governing trade in financial services and capital account transactions are not well established. The IMF, which serves as a quasi lender of last resort, is often viewed as the handmaiden of the U.S. Treasury. Because of these features of international finance, trade in financial services and assets is often perceived to be one-sided and unfair to developing countries.

From the early 1990s, developed countries led by the U.S. have exerted pressure on developing countries to adopt market-oriented reforms. Although they were not prepared to do so in the absence of an efficient system of financial regulation and supervision, they nevertheless proceeded with financial market opening.

When East Asian countries were amidst international liquidity runs in 1997, some of these countries were not able to defend themselves and subsequently had to seek IMF financial assistance and accept the Fund’s stabilization programs. These crisis-hit countries were criticized for not having restructured their financial, corporate and public sectors along the lines suggested by the Washington Consensus. This failure was singled out as the main cause of the crisis and understandably, these crisis-hit countries were subject to heavy doses of structural reforms. The East Asian crisis became contagious, even threatening the stability of major international financial centers. The severity and contagiousness of the East Asian crisis underscored the importance of and renewed interests in reforming the international financial system. The G-7 led reform, however, has concentrated its efforts on the financial and corporate sectors of developing economies, while by and large ignoring the problems of the supply side of international finance.

As East Asia climbed out of the danger zone and fear of contagion receded accordingly, the G-7 and international financial institutions have turned not as keen to
garner much support they would need for the reform as they had been during the crisis. The ongoing debate on the future direction of the international financial reform in fact suggests that most of the problems that beset the international financial system are likely to remain unchanged. This pessimistic outlook arouses deep concern in developing countries that they will continue to be vulnerable to future financial crises, even if they faithfully carry out the kinds of reform recommended by the IMF and the World Bank. Given this reality, developing countries may have to develop a defense mechanism of their own by instituting a system of capital control and adopting an exchange rate system that lies somewhere between the two corner solutions.
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Table 1. Real GDP growth rates of European economies, 1990-1994 (in %)

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*GDP: percent change over previous year.

Table 2. Real GDP growth rates of Latin American economies, 1992-1996 (in %)

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Table 3. Real GDP growth rates of East Asian economies, 1995-1999 (in %)

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Table 4. Net Private Capital Flows to European Economies, 1990-94

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1) Net foreign direct investment plus net portfolio investment plus net other investment.

(In billions of US dollar)

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1) Net foreign direct investment plus net portfolio investment plus net other investment.
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<td>11.62</td>
</tr>
<tr>
<td>Net foreign direct investment</td>
<td>33.85</td>
<td>38.07</td>
<td>41.67</td>
<td>41.12</td>
<td>36.98</td>
</tr>
<tr>
<td>Net portfolio investment</td>
<td>0.79</td>
<td>1.74</td>
<td>6.94</td>
<td>-3.73</td>
<td>-11.23</td>
</tr>
<tr>
<td>Bank loans and other</td>
<td>-2.77</td>
<td>-4.99</td>
<td>-17.57</td>
<td>-35.80</td>
<td>-14.12</td>
</tr>
</tbody>
</table>

**Japan (in millions of US$)**

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Total net private capital inflows</td>
<td>-46.18</td>
<td>-13.36</td>
<td>-105.43</td>
<td>-99.12</td>
<td>-25.20</td>
</tr>
<tr>
<td>Bank loans and other</td>
<td>2.55</td>
<td>43.69</td>
<td>-114.7</td>
<td>-38.59</td>
<td>12.24</td>
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</table>

**Singapore**

<table>
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</thead>
<tbody>
<tr>
<td>Total net private capital inflows</td>
<td>-4.73</td>
<td>-5.20</td>
<td>-13.23</td>
<td>-21.31</td>
<td>-16.71</td>
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<tr>
<td>Net foreign direct investment</td>
<td>0.92</td>
<td>2.05</td>
<td>-0.77</td>
<td>7.02</td>
<td>3.04</td>
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<tr>
<td>Net portfolio investment</td>
<td>-7.36</td>
<td>-11.01</td>
<td>-12.91</td>
<td>-7.84</td>
<td>-7.08</td>
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<tr>
<td>Bank loans and other</td>
<td>1.70</td>
<td>3.77</td>
<td>0.45</td>
<td>-20.49</td>
<td>-12.66</td>
</tr>
</tbody>
</table>

1) Net foreign direct investment plus net portfolio investment plus net other investment.

### Table 7. Quotas, SDRs and Global Indicators

<table>
<thead>
<tr>
<th>Year</th>
<th>Total IMF quotas</th>
<th>Calculated quotas</th>
<th>Current payments (or imports)</th>
<th>GDP (or national income)</th>
<th>Reserves</th>
<th>Variability of current receipts or of exports</th>
<th>Cumulative SDR allocation</th>
<th>Quotas to imports</th>
<th>Quotas to GDP</th>
<th>Imports to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1944</td>
<td>8.0</td>
<td>8.0</td>
<td>21.0</td>
<td>29.0</td>
<td>61.1</td>
<td>135.2</td>
<td>212.0</td>
<td>0.58</td>
<td>0.04</td>
<td>0.06</td>
</tr>
<tr>
<td>1950</td>
<td>8.0</td>
<td>18.0</td>
<td>19.0</td>
<td>31.0</td>
<td>102.0</td>
<td>330.0</td>
<td>545</td>
<td>0.17</td>
<td>0.14</td>
<td>0.13</td>
</tr>
<tr>
<td>1965</td>
<td>21.0</td>
<td>31.0</td>
<td>139.0</td>
<td>213.0</td>
<td>718.0</td>
<td>2,168</td>
<td>3,700</td>
<td>0.15</td>
<td>0.14</td>
<td>0.14</td>
</tr>
<tr>
<td>1970</td>
<td>29.0</td>
<td>718.0</td>
<td>2,168</td>
<td>4,253</td>
<td>11,083</td>
<td>17,884</td>
<td></td>
<td>0.14</td>
<td>0.09</td>
<td>0.06</td>
</tr>
<tr>
<td>1978</td>
<td>61.1</td>
<td>61,083</td>
<td>17,884</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.06</td>
<td>0.01</td>
<td>0.20</td>
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<tr>
<td>1990</td>
<td>135.2</td>
<td>11,083</td>
<td>17,884</td>
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<td></td>
<td></td>
<td>0.01</td>
<td>0.01</td>
<td>0.21</td>
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<tr>
<td>1998</td>
<td>212.0</td>
<td>135,2</td>
<td>212.0</td>
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<td></td>
<td></td>
<td></td>
<td>0.21</td>
<td>0.21</td>
<td>0.21</td>
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</tbody>
</table>

Sources: IMF, *Report to the IMF Executive Board of the Quota Formula Review Group, April 28, 2000.*

1) Year in parentheses denotes the year when the quota review was completed, i.e., when the Board of Governors' Resolution on quota increases was approved. The corresponding data shown for 1944 and the indicated quota reviews relate to the most recent period for which data were compiled.

2) SDR 9.3 billion was allocated in 1970 - 72, and SDR 12.1 billion in 1979 - 81.

### Table 8. Foreign Reserve of Asian and Other Countries

<table>
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<tr>
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</thead>
<tbody>
<tr>
<td>Japan</td>
<td>115,146</td>
<td>172,443</td>
<td>207,335</td>
<td>207,866</td>
<td>203,215</td>
<td>277,708</td>
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<tr>
<td>China</td>
<td>51,620</td>
<td>73,579</td>
<td>105,029</td>
<td>139,890</td>
<td>144,959</td>
<td>154,675</td>
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<tr>
<td>Korea</td>
<td>25,032</td>
<td>31,928</td>
<td>33,237</td>
<td>19,710</td>
<td>51,963</td>
<td>73,700</td>
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<tr>
<td>Indonesia</td>
<td>11,820</td>
<td>13,306</td>
<td>17,820</td>
<td>16,087</td>
<td>22,401</td>
<td>26,245</td>
</tr>
<tr>
<td>Malaysia</td>
<td>24,888</td>
<td>22,945</td>
<td>26,156</td>
<td>20,013</td>
<td>24,728</td>
<td>29,670</td>
</tr>
<tr>
<td>Philippines</td>
<td>5,866</td>
<td>6,235</td>
<td>9,902</td>
<td>7,147</td>
<td>9,101</td>
<td>13,103</td>
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<tr>
<td>Singapore</td>
<td>57,890</td>
<td>68,349</td>
<td>76,491</td>
<td>70,883</td>
<td>74,418</td>
<td>76,304</td>
</tr>
<tr>
<td>Thailand</td>
<td>28,884</td>
<td>35,463</td>
<td>37,192</td>
<td>25,697</td>
<td>28,434</td>
<td>33,805</td>
</tr>
<tr>
<td>Cambodia</td>
<td>103</td>
<td>177</td>
<td>252</td>
<td>287</td>
<td>315</td>
<td>388</td>
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<tr>
<td>Laos</td>
<td>50</td>
<td>78</td>
<td>155</td>
<td>100</td>
<td>111</td>
<td>101</td>
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<tr>
<td>Myanmar</td>
<td>422</td>
<td>561</td>
<td>229</td>
<td>250</td>
<td>315</td>
<td>265</td>
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**ASEAN+3**

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</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>49,251</td>
<td>55,398</td>
<td>63,808</td>
<td>92,804</td>
<td>89,601</td>
<td>96,236</td>
</tr>
<tr>
<td>Taiwan</td>
<td>92,457</td>
<td>90,310</td>
<td>88,038</td>
<td>83,502</td>
<td>90,341</td>
<td>106,200</td>
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**Sub-Total**

<table>
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</thead>
<tbody>
<tr>
<td>Germany</td>
<td>72,219</td>
<td>77,794</td>
<td>75,803</td>
<td>69,853</td>
<td>64,133</td>
<td>52,661</td>
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<tr>
<td>France</td>
<td>23,520</td>
<td>23,142</td>
<td>23,120</td>
<td>27,097</td>
<td>38,753</td>
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<td>Country</td>
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<td>2001</td>
<td>2002</td>
<td>2003</td>
<td>2004</td>
<td>2005</td>
</tr>
<tr>
<td>---------</td>
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<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
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</tr>
<tr>
<td>Swiss</td>
<td>33,554</td>
<td>34,685</td>
<td>36,775</td>
<td>36,899</td>
<td>38,346</td>
<td>34,176</td>
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<tr>
<td>U.K.</td>
<td>38,529</td>
<td>39,179</td>
<td>37,123</td>
<td>28,878</td>
<td>27,363</td>
<td>30,077</td>
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<tr>
<td>Italy</td>
<td>30,107</td>
<td>32,942</td>
<td>44,064</td>
<td>53,431</td>
<td>25,447</td>
<td>18,623</td>
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<tr>
<td>Canada</td>
<td>10,219</td>
<td>12,629</td>
<td>18,028</td>
<td>15,122</td>
<td>19,911</td>
<td>24,432</td>
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<tr>
<td>U.S.A.</td>
<td>41,215</td>
<td>49,096</td>
<td>38,294</td>
<td>30,809</td>
<td>36,001</td>
<td>32,182</td>
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**Sub-Total**

<table>
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<tr>
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<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>215,809</td>
<td>269,467</td>
<td>273,207</td>
<td>262,089</td>
<td>249,954</td>
<td>226,084</td>
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</table>


1) the data on Brunei, Vietnam are not available, thus not included.